What Is a Stock Index?

In 1884, Charles Henry Dow averaged the closing prices of 11 stocks he considered representative of the strength of the U.S. economy in a paper that preceded The Wall Street Journal. By 1896, The Wall Street Journal was publishing this average on a regular basis, and the most famous indicator of stock market performance was born: the Dow Jones Industrial Average (DJIA or Dow).

Most people have heard of the Dow, as well as a few other well-known stock indexes that track the overall direction of the market. Indexes and averages serve as useful benchmarks against which investors can measure the performance of their own portfolios. Depending on its makeup, a stock index can give investors some idea about the state of the market as a whole or a certain sector of the market. Conceptually, a shift in the price of an index represents an equitable change in the stocks included in the index.

Basically, indexes are imaginary portfolios of securities that represent a particular market or section of the market. Each index has its own method of calculating a change in its base value, often expressed as a percentage change. Thus, you might hear that an index has risen or fallen by a certain percentage. Although you can’t invest directly in an unmanaged index, you can invest in an index mutual fund that attempts to mirror a particular index by investing in the securities that comprise the index. The performance of an unmanaged index is not indicative of the performance of any specific investment.

Mutual funds are sold by prospectus. Please consider the investment objectives, risks, charges, and expenses carefully before investing. The prospectus, which contains this and other information about the investment company, can be obtained from your financial professional. Be sure to read the prospectus carefully before deciding whether to invest.

All the stocks in an index typically have at least one element in common. They might trade on the same stock market exchange, belong to the same industry, or have similar market capitalizations. Some of the more widely known indexes are the Dow, the S&P 500, the Nasdaq Composite, the Wilshire 5000, and the Russell 2000.

The Dow Jones Industrial Average

The Dow is an index of widely held “blue-chip” stocks that is used as an indicator of the performance of U.S. industrial stocks. Unlike most other major indexes, the stocks in the Dow are unweighted by market capitalization. The 30 stocks included in the Dow are all major factors in their industries. Many have become household names: American Express, Boeing, Coca-Cola, General Electric, Hewlett-Packard, IBM, Intel, Johnson & Johnson, McDonald’s, Microsoft, Procter & Gamble, Walt Disney, and Wal-Mart.

S&P 500

The Standard & Poor’s 500 is an index of 500 of the most widely held stocks — leading companies from all sectors of the economy — chosen for their market size, liquidity, and industry group representation. Because some stocks influence the market more than others, each stock is given a different weight when the calculations are made. This is called “market-capitalization weighting,” which is the type of weighting used for the Nasdaq Composite, the Wilshire 5000, and the Russell 2000. Over 70% of all U.S. equity is tracked by the S&P 500.

Nasdaq Composite Index

The National Association of Securities Dealers Automated Quotation system, or NASDAQ, represents all domestic and non-U.S. based common stocks traded on The NASDAQ Stock Market. It includes over 3,000 companies — more than most other stock indexes —many of which are in the technological field. Of course, The NASDAQ Stock Market isn’t restricted to technology issues. Many other well-known companies, such as Starbucks and Amgen, are listed there. The NASDAQ Stock Exchange was established in 1971 as the world’s first electronic stock market.

Wilshire 5000

Probably the most broadly based market index is the Wilshire 5000 Total Market Index. Originally comprising 5,000 stocks, the Wilshire 5000 now uses more than 5000 market capitalization–weighted security returns to adjust the index. The index tracks the overall performance of stocks actively traded on the American stock exchanges; the companies are all headquartered in the United States.

Russell 2000

Started in 1972, the Russell 2000 Index gauges the performance of 2,000 “small cap” stocks that are often omitted from large indexes. This market capitalization–weighted index serves as a benchmark for small-cap U.S. stocks and could be useful for tracking small companies with growth potential.

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Market indexes are useful for assessing the historical performance of investment portfolios over time, but they don’t reveal important details about the companies they track. They also have certain biases inherent in their statistical calculations. Remember that past performance is not a guarantee of future results.

If your portfolio lags substantially behind a corresponding index, it may be time to reevaluate and reallocate assets. Be sure to select an appropriate index as your benchmark. For example, comparing a small-cap stock portfolio to the Dow Jones Industrial Average may not be very meaningful; comparing it to the Russell 2000 Index would be more appropriate. When selecting stocks, it’s prudent to keep an eye on long-term performance based on certain fundamentals that may or may not be subject to market trends.