

# Behind the Blue Chips of the Dow Jones Industrial Average

Date : September 14, 2013



On Thursday morning, the papers and news stations reported that stocks were off to a weak start on Wall Street as a September rally began losing steam. The Dow Jones industrial Average (DJIA) fell eight points, less than 0.1%, to 15,322 after the first few minutes of trading Thursday. The Dow had gained 3.5% so far in September.

The DJIA is the revered veteran of financial reports; the old reliable of the major U.S. stock indices. Chances are you've heard and read reports of its rise and fall many times on the radio, the evening news and in the newspaper. A stock index of 30 "blue-chip" publicly traded U.S. companies that are thought to be leaders in their industries, the DJIA is a favorite index among financial reporters and market watchers alike because it is meant to measure the strength and weakness of the entire stock market.

This week the DJIA – also referred to as "The Dow" – got more ink than usual. Dow Jones & Company announced that Goldman Sachs, Visa and Nike are joining the index, while Hewlett-Packard, Bank of America and Alcoa are out. It is considered the biggest shakeup of The Dow in about a decade. The changes will take effect at the opening of trading September 23.

## **American Express, Coca-Cola, Wal-Mart**

What's the significance of the comings and goings of Dow members? While these decisions are somewhat subjective on the part of the index editors because there are no pre-determined criteria for a stock to be added or deleted, the arrival of new companies does provide some insight into the U.S. economy.

First, though, it helps to understand a few Dow basics. The index, which began in 1896 with 12 industrial stocks – stocks of companies that manufactured products – now includes 30 stocks from high-profile American companies in a variety of industries, from manufacturing to entertainment and information technology. Companies in The Dow include American Express, AT&T, Boeing, Caterpillar, Coca-Cola, IBM, Microsoft, Procter & Gamble and Wal-Mart. "You are a bona fide blue-chip stock when you are in the Dow Jones 30," notes Robert Stambaugh, a Wharton professor of finance. "It lends cache and star quality to a company to be in The Dow. The companies they have put in over the years have had recent upward movement and have increased their prominence in the economy and in their sectors."

The Dow average has seen lots of movement in recent years. The index closed above 15,000 for the first time earlier this year on May 7, 2013. This was encouraging news given The Dow's downward trend during the economic recession that began in 2008. On July 19, 2007, The Dow closed just above 14,000 for the first time. But then on September 29, 2008, the same day the U.S. House rejected the \$700 billion financial bailout package to help Wall Street, the Dow had the worst single-day point drop in history, plunging 777.68 points. The week of October 6 that year, the index continued a steep decline, closing at 8451.19. These days it is on the rebound as the economy improves.

Stambaugh, who teaches finance to undergrads at Wharton, is often surprised by how few of his students understand the math behind the DJIA. A stock index is a method of measuring the value of a section of the stock market. Other indices include the S&P 500 and the Russell 3000. The Dow index is the sum of its 30 stock prices divided by a number, which is known as the divisor.

However, the addition of three new stocks with varying stock prices, which will happen on the 23<sup>rd</sup>, does not change the value of the index. "Every time there is a change in terms of an addition or subtraction of stocks, or a stock in the index splits so that its price is dropped in half, they have to adjust the divisor," notes Stambaugh. "By adjusting the divisor, the overall index is not affected."

### **Skewed Financial**

And speaking of numbers, some have questioned why the DJIA continually takes a pass on adding some of the country's largest businesses, namely Apple and Google. Apple, which is based in California and makes the Mac line of computers, iPhones, iPads and other popular products, is the largest publicly traded corporation in the world by market capitalization (a determinant of a company's size, other than total sales, that is arrived at by calculating a company's shares outstanding by the market price of one share). Apple's stock is trading at about \$465 a share, which, as it turns out makes it just too big for The Dow. "Companies like Apple and Google are excluded because of their share price," says Stambaugh. "A stock that has a very high price will end up dominating movements in the index. If you put a very high-priced stock in the index, then the day-to-day up and down movements would reflect largely the movements of this very high stock."

The arrival of Goldman Sachs, Nike and Visa to the DJIA does say something about the U.S. economy, suggests Stambaugh. "They have tilted the index more toward financials. It's called the Dow Jones Industrial index, but if you look at what they've done, two of the companies they've tossed out, HP and Alcoa, actually make things and sell them. They replaced those with Goldman, Visa and Nike. Goldman and Visa are financial services firms and Nike makes stuff and sells it. This reflects that financial services firms have a bigger presence in our U.S. economy."

Nike's new home among the Dow 30 is also noteworthy because it marks the inclusion of the first apparel maker since International Shoe was replaced in 1933. And while real money managers prefer to use other indices as their benchmarks of investment performance, The DJIA will continue to be a stalwart symbol of Wall Street. "Its popularity stems from the fact that it is the oldest, best-known index, and the popular press tends to quote it first," says Stambaugh. It will forever be considered the barometer of America's stock market.

### **Questions**

What is the Dow Jones Industrial Average?

Why did The Dow get more ink than usual this week?

What is the significance of the announced changes to The Dow?

### **Related Links**

- [Reuters: Dow Jones Index Announces Biggest Shake-up in a Decade](#)
- [The Washington Post: The Dow Jones Industrial Average Is Ridiculous](#)
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