focus

An Index is no more than a **'Rule of Thumb'**

A share market index measures the performance of a basket of stocks. Indices are an important tool in financial markets. They are used to calculate the performance of a market; active investors often benchmark their performance against an index, and passive investors generally try to replicate the performance of an index.

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There are well-known indices such as the Dow Jones Industrial Average, NASDAQ Composite, and the S&P NZX 50, but global research indicates that there are literally millions of different indices. In fact, there are more than 70 times more stock market indices than actual listed stocks[1] (yes, it's true, we checked twice!). A basic understanding of what an index is, when it might be an appropriate benchmark (and when it is not), and how they can affect stock prices can help investors navigate global and local markets.

What is an index?

Simply put, an index is a list of public companies (in the case of an equity index) or other financial instruments that meet certain criteria. For example, the S&P/NZX 50 index comprises the 50 largest and most liquid companies (by market value) listed on the New Zealand stock exchange, while the S&P 500 contains the 500 largest stocks listed on US exchanges.

A good place to start with understanding an index is with one of the most famous indices of all, the Dow Jones Industrial Average, or DJIA for short. Established in 1896 by American journalists Charles Dow and Edward Jones, the DJIA originally included 12 stocks but expanded to 30 in 1928. Its constituents are selected by a committee which identifies companies that have 'an excellent reputation, demonstrate sustained growth and are of interest to a large number of investors'[2]. Importantly, the companies included in the list periodically change with companies added or deleted based on whether they meet the criteria of the index (this is true of all indices). There have been more than 150 different companies in the DJIA throughout its history.

In addition to stock indices that are constructed to represent a single share market, there are also indices that represent specific sectors, thematics (e.g. clean energy, robotics, healthcare), regions, bonds, commodities, cryptocurrencies and many more.

How investors use an index

Indices provide a quick and easy way to describe what the 'market' is doing. They aggregate the performance of many stocks, allowing statements like 'the market is up +7% this month' or 'Fisher & Paykel Healthcare is the largest stock in our market'. Indices also provide an important benchmark for investors to measure themselves against or to replicate. Many active investors compare their own performance against an index to determine whether they have beaten or lagged the market. Passive investors, on the other hand, will generally seek to hold the same, or similar, investments to the index ('index trackers') in order to receive the same return with the same level of risk. The explosion in the availability of low-cost, exchange traded funds (ETFs) provides an easy way for people to invest in thousands of different indices.

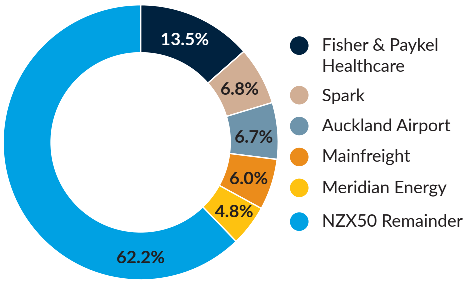
1. IIA 2021 International Survey of Asset Managers, Index Industry Association, 2021. World Bank, 2019.
2. Dow Jones Average Methodology, S&P Dow Jones Indices, 2021.

Whilst indices are a handy tool for investors they have limitations

Stock market indices can be highly concentrated in a small number of stocks or sectors

Diversification ('not putting all your eggs in one basket') is a key tool of portfolio construction. But indices are not necessarily well diversified. Take the S&P/NZX 50 for example, where the top five stocks represent almost 40% of the index. Even the S&P 500 suffers from this limitation, with almost 30% of the index made up of technology stocks.

FIGURE 1. TOP 5 LARGEST STOCKS IN THE S&P/NZX 50 INDEX



Source: Forsyth Barr analysis, SPDJI. Index weightings are free-float adjusted. As at 15/09/2021.

Indices can be inflexible and may not fit with investor Responsible Investment goals

A passive approach, where an investor's portfolio replicates an index, does not traditionally allow the same flexibility as a non-indexed approach. Investors usually have a variety of goals they are trying to achieve, from income, capital growth, capital preservation, to having a portfolio that aligns with their values. As a result there may be some companies that an investor will want to own more of (such as defensive, income stocks), and those they want to own less of, for example, companies involved in certain activities such as gambling or fossil fuels. The multitude of different indices available today is helping to overcome this limitation, with many indices now available that take into account Responsible Investment and Environmental, Social and Governance (ESG) considerations.

Passive index approaches can disregard fundamental value

Investing legend Warren Buffet's old adage 'Price is what you pay, value is what you get' comes to mind when considering passive investing. An investor replicating an index pays no attention to whether the price they are paying is reasonable for the business they are buying — they simply buy the stock because it is in an index. In contrast, active investors can consider how the current price compares to their view of the underlying value of the stock.

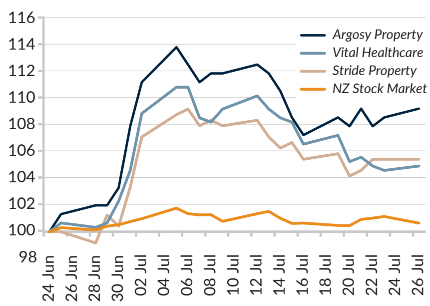
Index changes can push stock prices away from fundamentals

The more well-known an index, the more likely it is to have many investors following it, and the more investors following an index, the greater the potential effect it can have on the stocks within the index. There are two main ways inclusion in an index can affect share prices: 1) a company enters/exits the index, forcing investors that follow that index to buy or sell the stock, or 2) the number of investors following a particular index increases (or decreases) dramatically, leading more investors to buy (or sell) the stock. Both impacts have recently influenced the New Zealand market.

For example, in early July 2021 there was speculation that three New Zealand property stocks — Argosy Property, Stride Property and Vital Healthcare — would be included in a large global property index run by FTSE Russell, after the necessary company size for index inclusion was lowered. The anticipation of substantial forced index buying boosted share prices — they jumped around 8–9% over the first five days of the month, a substantial lift for traditionally stable stocks.

Another example occurred over December and January after Joe Biden won the US Presidential election. The prospect of him being able to implement his green infrastructure plan compelled some to pile into clean energy investments. What most probably did not realise was that when purchasing two popular clean energy ETFs, around 8% of their money was buying shares in two New Zealand utilities — Contact Energy CEN and Meridian Energy MEL. Index buying caused the share prices of these companies to surge, only then to fall once demand faded.

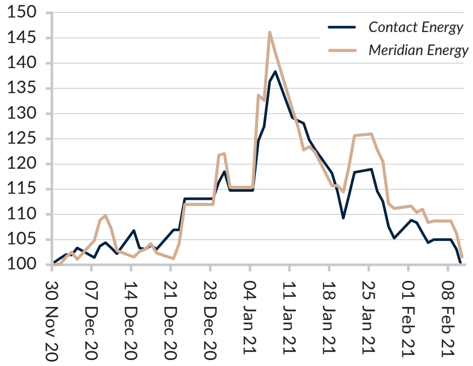
FIGURE 2. SHARE PRICES OF NZ PROPERTY NAMES JUMP ON GLOBAL INDEX NEWS



Source: Forsyth Barr analysis, Refinitiv. Rebased to 100.
NZ Stock Market = S&P/NZX 50 Capital Index

...indices' effects on share price are temporary...

FIGURE 3. SHARE PRICES OF CONTACT ENERGY AND MERIDIAN ENERGY THROUGH PASSIVE BUYING



Source: Forsyth Barr analysis, Refinitiv. Rebased to 100.

For the most part indices' effects on share price are temporary. However, having a grasp of the impacts of index inclusions and passive investment flows will help investors look through instances of short-term share price volatility and to remain focused on their longer-term investment goals.

Indices are a helpful tool for investors. As with any tool, however, they have their strengths and weaknesses. They can be a good rule of thumb when thinking about the performance of a market, or benchmarking performance. But they can be inflexible, price insensitive, and are not necessarily a substitute for building a well-diversified portfolio, particularly one that considers the needs and objectives of each individual investor. Like any tool an investor needs to ensure they're using the right one for the job.

Understanding that sudden changes in financial markets can cause concern or indicate opportunity, your Forsyth Barr Investment Adviser is available to provide you with advice and assistance at any time.

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