Stock Market Perspective: New High for the Dow

You have certainly heard or read about the Dow Jones Industrial Average making a new all-time high. It did that on October 3 and moved higher in the following days. Given all the hoopla, one would think that a new high for this major index was a truly significant event with important implications. Like much of what is trumpeted by the popular media about stocks and stock prices, the louder the shouting, the less meaningful the substance. Let's take a look at why the new Dow high does not really matter one way or another.

I will not say much about how representative or not the Dow is of the broad U.S. stock market. It is the most widely followed index due to its long history—110 years—and its composition of 30 of the best known companies. Over time, the Dow has shown similar large movements as broader indices such as the S&P 500, so it is a reasonable, if far from inclusive measure, of the broad market.

However, the choice of components has important effects on the level of the Dow. In 1939, AT&T, which had been removed from the index in 1928, replaced IBM. Had IBM remained in the index, it would have been more than twice as high when that company re-entered the Dow in 1979. A recent *Wall Street Journal* article said that had the stocks that were taken out of the index in April 2004—AT&T[1], Eastman Kodak, and International Paper—not been replaced by AIG, Pfizer, and Verizon, then the Dow would have made a new high in May.

> *You can ignore all the hoopla about the new high for the Dow. It would have to move up by about 20% to make a "real" new high.*

▶**Other indices are far below their highs.** In a strong bull market most measures of the market will make new highs more in relatively short periods. That was certainly the case in the late 1990s and into early 2000 at the end of the "secular" bull market that began in 1982. The Dow made its all-time high in January 2000 while the S&P and Nasdaq pushed slightly higher into March when they made their all-time (so far) highs. The Nasdaq is heavily influenced by technology stocks, which had their "bubble" burst six years ago, so it is not surprising that it is nowhere near its high, although being less than half of it is startling. On the other hand, the S&P 500 is a broad based index whose components' capitalization is about 75% of the entire U.S. stock market. If a new Dow high is to be meaningful, we would expect that the S&P should also be close to making one. However, at the end of September, the S&P would have to rise 14.3% to reach its March 2000 high.

(So-called "Dow Theorists" hold that new highs in both the Dow Industrials and Dow Transportation index are meaningful as is the failure of one to make a new high when the other does. The Transports made a new all-time high in May, but fell over 15% from that level into August before recovering to about 10% below the high. That average has been moving up for almost four years. Its prior high was in May 1999, and it had fallen by about 25% in early 2000 when the Industrials peaked. Dow Theorists would say that behavior provided a clear warning that the new Dow high in January 2000 was not all that meaningful and the party was close to being over. Imagine how excited they might have been if the Dow had not been revised in 2004 and also made new highs this past May.)

▶**Inflation adjusted Dow is not near a high.** The primary reason I think a new Dow high is not important is that just looking at levels that

[1] AT&T was later merged into SBC, which had entered the Dow in 1999. SBC, a "baby Bell" took over the historic name of "Ma Bell" and its ticker symbol, T, so once again the Dow has AT&T as a component.

are essentially measured in dollars without adjusting for inflation can be misleading. When I was a child, which admittedly was quite a few years ago, an indication that one was "rich" was driving a $10,000 car and living in a $100,000 house. I don't think ten grand will buy a new car these days. In the Washington area, no house, or even a small condo, that anyone would really want to live in can be obtained for a hundred thou. Using the Consumer Price Index (CPI), it now takes about $7.50 to buy what $1 did then, so the car and house would now cost $75,000 and $750,000.

From January 2000 through August (the September CPI is not yet available as I write this), there has been inflation of over 20%. That works out to about 2.9% a year, and it has been over six and a half years from the prior high. To exceed it in inflation adjusted terms, the Dow would have to move above 14,160. (The S&P 500 would have to rise about 38% from its September level to make a new inflation-adjusted high.)
The graph shows the inflation-adjusted Dow since 1897. The vertical scale is logarithmic, so equal vertical distances correspond to equal percent changes and the slopes of the index and the lines indicate the compound rates of change.

The slanted lines indicate the secular bull and bear markets, and the dashed one on the right is a guess of how the current secular bear market may unfold. Although the Dow is currently above the dashed line, we see that during prior secular bear markets it was not unusual for the index to be above the secular trend line quite frequently.

Even with making a new all-time high, an investor who bought and held "the Dow" has essentially broken even over the past 6.75 years while inflation has eroded about 20% of purchasing power. The dividends, especially if reinvested, would have helped, but during this period the Dow's overall dividends have been less than the rate of inflation.

To me, the best way to deal with a secular bear market is not buying and holding the Dow or any other index. The graph shows the devastating damage that a secular bear can do to the purchasing power of stocks. From the peak in 1966 to the low in 1982, the inflation-adjusted Dow lost about 75% of its value! The prudent course of action is applying a relatively

DJIA in Constant (2002) Dollars vs Time

simple trend following model to avoid the bulk of the down periods and participate in a good portion of the up periods. That is called *tactical asset allocation* (as opposed to *strategic* allocation, which is essentially buy and hold with periodic rebalancing), and that is how I manage accounts in the TAA program. I also apply the same principles to determine how much exposure to stocks is appropriate when trading sector funds.