THOUGHT FOR THE WEEK
THE LARGEST DROP IN HISTORY!

Global Financial Private Capital

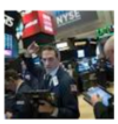
SYNOPSIS

- The Dow is one of the most popular stock market indices used by the media
- Recent volatility can be used to highlight the inherent flaws within the Dow
- The financial media represents for-profit institutions that do not manage money

CHEAP TACTICS

The Dow Jones Industrial Index (DJIA), which is often referred to as just "The Dow," is one of the most popular indexes referenced by the media to report on the state of the U.S. stock market.

After the Dow fell 1,175 points on Monday, February 5th, the media jumped on the story because this represented the worst point decline in the history of the index. They blamed rising inflation expectations for the massive amount of volatility that hit the market that day, which fueled the headlines below.



Dow ends wild day down 1175 points, largest point **drop** in history
USA TODAY - Feb 5, 2018
The **Dow** Jones industrial average suffered its biggest one-day point **drop** in history, plunging 1,175 points on Monday and giving back all its 2018 gains as a flash-crash-style **drop** intensified a free **fall** in stocks that began last week. Fears of spiking inflation and borrowing costs caused investors to rethink ...

Biggest 1-day **drops** for the **Dow** Jones industrial average
Chicago Tribune - Feb 9, 2018

Dow Plunges 1175, The Biggest Point **Drop** In History
NPR - Feb 5, 2018

Dow drops by more than 1000 points twice in week
BBC News - Feb 8, 2018

Dow turns 567-point loss into 567-point gain as stocks rally
In-Depth - Los Angeles Times - Feb 6, 2018

US stock plunge sparks global sell-off
In-Depth - BBC News - Feb 5, 2018

View all

Source: https://www.google.com/search?q=dow+drop

Few tactics by the financial media infuriate me more than their blatant misuse of economic data and math, so here are two reasons why investors should ignore stories like these.

The first is that comparing point declines in an index are completely and utterly meaningless. Instead, investors should always focus on percentage declines. The Dow closed the prior trading day at 25,520.96, so a drop of 1,175 points equates to a 4.6% decline. While this loss may sting, it is by no means the largest or most dramatic daily move in history on a percentage basis.

Let's put this into context by comparing it to the 508-point drop on October 19, 1987. This sell off on what will live in infamy as "Black Monday" appears to be only half as bad as what we experienced last Monday if we compare the actual point decline. However, on a percentage basis, it represented a 22% decline in a single day, which is almost five times larger.

> **"... stories like these are designed to sell newspapers more than educate investors..."**

This is no different than comparing a $500 stock rising $50 to a $50 stock rising $30. The former is a 10% gain, while the latter is a 60% gain. Any rational investor would prefer to own the investment that represented the largest percentage gain even if the absolute increase was smaller (assuming equal investment amounts).

The other reason why these stories get under my skin is because the Dow is a poor barometer for the U.S. stock market for two reasons:

1. **Size**: The Dow only follows 30 large companies, which is a small sample size of the several thousand publicly traded companies in the U.S.

2. **Mechanics**: The Dow is a "price-weighted" index, meaning the price of a stock determines the weight in the index.

Hence, professional investors tend to prefer the S&P 500. This index follows 500 stocks and is "market cap" weighted, meaning the size of the company determines its weight in the index.

Comparing two popular companies that are in both the Dow and S&P 500 will highlight the difference. As of February 12, 2018, the biggest weight in the Dow was Boeing priced at $343.16, or 9.62% of the index. The seventh largest weight is Apple priced at $164.34, which is less than half the weight at 4.55% of the Dow[1].

In the S&P 500, Apple was the largest weight at 3.72%, and Boeing was 24th at 0.84% of the index[2]. Apple is 4.4 times the weight because its market cap is also over four times as large ($833 billion versus Boeing at $202 billion).

Market cap is superior to price because a stock price tells an investor next to nothing about the company or its influence in the global economy. A small company can have a stock price in the thousands, and a multinational conglomerate can be priced under $20 a share.

Furthermore, the fact that only 30 companies are in the Dow creates high concentrations to just a few names. The top five weightings in the Dow accounted for 34.6%[1] of the index on this date, whereas the top five in the S&P 500 totaled 12.75%[2]. The high concentration in the Dow can make it susceptible to large swings from a single stock.

Simply put, reporting on an absolute move in an index that is rarely used by professionals offers little value to investors.

IMPLICATIONS FOR INVESTORS

If the Dow is a poor benchmark for the broader stock market, then why does the financial media use it so frequently? Furthermore, why would the editors of some of the largest publications in the world give their staff hall passes on such an egregiously poor use of math to support page one headlines?

One of the most fundamental economic principles is that we are all self-interested. We operate our lives and base our decisions on what will best serve us and the people we love. Recognizing this principle is critical to understanding the motivations behind most decisions by not just people but also corporations.

Within this context, the media represents a group of for-profit institutions that are in business to make money. The bulk of their revenues come from advertising, so they are highly incentivized to attract as many eyeballs and website clicks as possible.

More viewers translate to more advertising dollars, so they need to keep their audience hooked to prevent changing the channel. The Dow just so happens to be ideally suited to achieve the media's goal for three reasons:

1. **Unpredictable**: The inability to predict what will drive the market on a daily or even monthly basis means that a never-ending supply of storylines is readily available. Much like watching a great mystery, viewers never know what to expect next.

2. **Highly Volatile**: In the short-term, emotions drive stock prices, and few subjects make investors more emotional than their money. The sharp ups and downs cause investors to become fixated on what is moving their nest egg.

3. **Big Number**: The Dow has grown over the years and is now the largest index level when compared to other stock market indices such as the S&P 500 and Russell 3000. A higher index level equates to bigger absolute moves on a daily basis, which creates better headlines for the media.

Now that we better understand why the media loves the Dow, the next step is to hypothesize why they ran this story in the first place. All good stories require a villain or some type of catalyst, and financial markets rarely offer these up on a silver platter because nobody really knows why markets move in the short-term.

Making matter worse, nearly all economic data are pointing to an accelerating economy, so assessing blame becomes even more difficult. But this reality does not sell newspapers, and they need to create a story that sounds plausible.

Fortunately for the writers, rising inflation expectations swooped in to save the day. This single data point happens to be one of the most closely watched economic indicators right now because if there is any sign that inflation could rise faster than anticipated, then the Federal Reserve could raise rates faster than expected and risk pushing our economy closer to a recession.

Economic data pointing to higher wage growth that were released the prior trading day became the culprit. While this sounds like a good outcome for our economy (and it is), this fits nicely into their story because the more money we make, the more we spend, which causes inflation to rise as the demand for products and services exceeds existing capacity to produce.

Rather than dig deeper into the headline numbers to see that this highly volatile economic report was massively skewed to managerial wages rising versus a more broad-based wage gain scenario, they stuck with the "rising wages leading to higher inflation" story.

The next step is to quantify the impact. Normally, they would just take the percentage drop in the market as a way to show the severity. The problem is that while a 4% drop is certainly big for a single day, it is by no means the largest ever. Hence, they looked at the absolute change in popular stock market indices.

The S&P 500 index fell over 113 points, which is a triple-digit move down and certainly newsworthy. However, the Dow fell over 1,600 points during the day to then close down 1,175 points. A four-digit decline is way more interesting than a triple-digit decline for page one, so they ran with the Dow.

Said another way, the "drama" in the market that day was not indicative of a failing economy, impending recession, or any other fundamental crack in the future for long-term asset prices. This led the media to have very little to report, and in their desperation, this is the best they could concoct.

THE BOTTOM LINE is that stories like these are designed to sell newspapers more than educate investors, so the next time the media embarks on their next scare campaign, simply refer to the cartoon below.

Source: http://awealthofcommonsense.com/2018/02/some-random-observations-on-the-market-correction/

SINCERELY,

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[1] http://indexarb.com/indexComponentWtsDJ.html

[2] http://portfolios.morningstar.com/fund/holdings?t=SPY

Dow is defined as the Dow Jones Industrial Average, a stock market index that tracks the daily price of shares of stock of 30 large publicly-owned companies sold on the US stock exchanges.

The Standard & Poor's 500, often abbreviated as the S&P 500, or just the S&P, is an American stock market index based on the market capitalizations of 500 large companies having common stock listed on the NYSE or NASDAQ.

The Russell 3000 Index is a market capitalization weighted equity index maintained by the FTSE Russell that provides exposure to the entire U.S. stock market. The index tracks the performance of the 3,000 largest U.S.-traded stocks which represent about 98% of all U.S incorporated equity securities.