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## Best Stock

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### Types of indices

Stock market indices may be classed in many ways. A broad-base index represents the performance of a whole stock market — and by proxy, reflects investor sentiment on the state of the economy. The most regularly quoted market indices are broad-base indices comprised of the stocks of large companies listed on a nation's largest stock exchanges, such as the British FTSE 100, the French CAC 40, the German DAX, the Japanese Nikkei 225, the American Dow Jones Industrial Average and S&P 500 Index, the Indian Sensex, the Australian All Ordinaries and the Hong Kong Hang Seng Index.

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### Index versions

Some indices, such as the S&P 500 have multiple versions. These versions can differ based on how the index components are weighted and on how dividends are accounted for. For example, there are three versions of the S&P 500 index: price return, which only considers the price of the components, total return, which accounts for dividend reinvestment, and net total return, which accounts for dividend reinvestment after the deduction of a withholding tax. As another example, the Wilshire 4500 and Wilshire 5000 indices have five versions each: full capitalization total return, full capitalization price, float-adjusted total return, float-adjusted price, and equal weight. The difference between the full capitalization, float-adjusted, and equal weight versions is in how index components are weighted.

### Weighting

An index may also be classified according to the method used to determine its price. In a Price-weighted index such as the Dow Jones Industrial Average and the NYSE ARCA Tech 100 Index, the price of each component stock is the only consideration when determining the value of the index. Thus, price movement of even a single security will heavily influence the value of the index even though the dollar shift is less significant in a relatively highly valued issue, and moreover ignoring the relative size of the company as a whole. In contrast, a market-value weighted or capitalization-weighted index such as the Hang Seng Index factors in the size of the company. Thus, a relatively small shift in the price of a large company will heavily influence the value of the index. In a market-share weighted index, price is weighted relative to the number of shares, rather than their total value.

Traditionally, capitalization- or share-weighted indices all had a full weighting i.e. all outstanding shares were included. Recently, many of them have changed to a float-adjusted weighting which helps indexing.

A modified market cap weighted index is a hybrid between equal weighting and capitalization weighting. It is similar to a general market cap with one main difference: the largest stocks are capped to a percent of the weight of the total

stock index and the excess weight will be redistributed equally amongst the stocks under that cap. Moreover, in 2005, Standard & Poor's introduced the S&P Pure Growth Style Index and S&P Pure Value Style Index which was attribute weighted. That is, a stock's weight in the index is decided by the score it gets relative to the value attributes that define the criteria of a specific index, the same measure used to select the stocks in the first place. For these two stocks, a score is calculated for every stock, be it their growth score or the value score (a stock cant be both) and accordingly they are weighted for the index .

#### Criticism of capitalization-weighting

The use of capitalization-weighted indices is often justified by the central conclusion of modern portfolio theory that the optimal investment strategy for any investor is to hold the market portfolio, the capitalization-weighted portfolio of all assets. However, empirical tests conclude that market indices are not efficient. This can be explained by the fact that these indices do not include all assets or by the fact that the theory does not hold. The practical conclusion is that using capitalization-weighted portfolios is not necessarily the optimal method.

As a consequence, capitalization weighting has been subject to severe criticism (see e.g. Haugen and Baker 1991, Amenc, Goltz, and Le Sourd 2006, or Hsu 2006), pointing out that the mechanics of capitalization weighting lead to trend-following strategies that provide an inefficient risk-return trade-off.

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#### Indices and passive investment management

There has been an accelerating trend in recent decades to create passively managed mutual funds that are based on market indices, known as index funds. Advocates claim that index funds routinely beat a large majority of actively managed mutual funds; one study claimed that over time, the average actively managed fund has returned 1.8% less than the S&P 500 index – a result nearly equal to the average expense ratio of mutual funds (fund expenses are a drag on the funds' return by exactly that ratio). Since index funds attempt to replicate the holdings of an index, they obviate the need for — and thus many costs of — the research entailed in active management, and have a lower "churn" rate (the turnover of securities which lose fund managers' favor and are sold, with the attendant cost of commissions and capital gains taxes).

Indices are also a common basis for a related type of investment, the exchange-traded fund or ETF. Unlike an index fund, which is priced daily, an ETF is priced continuously, is optionable, and can be sold short.

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A notable specialised index type is those for ethical investing indices that include only those companies satisfying ecological or social criteria, e.g. those of The Calvert Group, KLD, FTSE4Good Index, Dow Jones Sustainability Index and Wilderhill Clean Energy Index.

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