Deep Inside the Dow

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By John Mauldin

Tonight (Saturday) some 450 people will come together in San Diego to honor Richard Russell, who has been writing the *Dow Theory Letter* for over 50 years. In that spirit, in today's letter we are going to look deep inside the Dow, back to its very roots. The Dow is a price-weighted index as opposed to a cap-weighted index. Does that make a difference in performance? Specifically, does it affect how the Dow has performed since it was expanded to 30 names in 1928? There are some real surprises we have found, and I think you will find this letter very interesting.

What About the Original Dow Jones 30 Stocks?

The Dow Industrials was expanded to 30 names from 20 on October 1 of 1928. Today, only nine names of the original 30 remain in the Dow. The committee at Dow Jones has replaced the other names as the companies grew out of favor, were merged into other stocks, were considered too small, or the committee felt that other companies better represented the industrial prowess of the US economy.

For instance, in November of 1999, Goodyear and Chevron were removed in order to allow Microsoft and Intel to join the Dow 30, where the two tech giants proceeded to rise handily the next few quarters. However, it has not been that pretty since the end of 2000, with both stocks down approximately 60% from their entry price, and much further from their peak price. Chevron proceeded to move up some 60% in price after it was removed, at which point Chevron was inserted back into the Dow 30 on February 19, 2008, where it is now down about 15%. Not a good run for the selection committee.

But it is not all bad. If you look at the deletions and additions, you find some interesting timing issues. Some additions were excellent in terms of performance. Some avoided later bankruptcies.

Thinking about the Dow, I wondered how much the committee had helped or hurt the Dow performance over the last 80 years. What if we went back to the original 30 stocks and simply bought them and held them until today? Good, bad or indifferent, what would the results be?

I asked that question to good friend Rob Arnott of Research Affiliates. It turns out that he and Jeremy Siegel (of Wharton and *Stocks for the Long Run* fame) were corresponding over that very same question about the S&P 500. Rob helpfully sent my question on to one of his top research associates, Ms. Feifei Li, who spent a lot of time and effort to get me several large spreadsheets, some of which are over 800 pages long. The rest of this letter is based on her research, some very helpful comments, and observations by Rob, with some homework by me. Any wrong conclusions are all mine.

So, the question of the day: would you have been better off investing in the index, or buying the 30 stocks and holding them? Further, would it make any difference if you price-weighted them or equal-weighted them (explanations below)? What about inflation? And how does that compare to the S&P 500?

And before you answer, remember that one stock, Bethlehem Steel, went bankrupt. You would be stuck with Chrysler, which was removed in 1979 for IBM, which itself had been taken out in 1939 for AT&T. There have been 55 changes in the components of the Dow over the last 80 years. Some of the original 30, listed below, we would all recognize. But our kids might not remember Victor Talking Machines or Nash Kelvinator (Nash Auto).

(Sidebar: As a country, we let LOTS of auto companies fail over the decades. My Dad worked at Nash Auto in Wisconsin during the Depression because he could play baseball for their semi-pro team. Remember Rambler or Studebaker? But now we obsess about keeping an auto industry and union jobs.)

The Original Dow 30 Components

The following companies are the original members of the Dow 30 on October 1, 1928:

Allied Chemical, American Can, American Smelting, American Sugar, American Tobacco B, Atlantic Refining, Bethlehem Steel, Chrysler, General Electric Company, General Motors Corporation, General Railway Signal, Goodrich, International Harvester, International Nickel, Mack Truck, Nash Motors, North American, Paramount Publix, Postum Incorporated, Radio Corporation of America, Sears Roebuck & Company , Standard Oil (N.J.), Texas Company, Texas Gulf Sulphur, Union Carbide, U.S. Steel, Victor Talking Machine, Westinghouse Electric, Woolworth, and Wright Aeronautical.

Almost immediately the Dow 30 changed, as Radio Corporation of America bought Victor Talking Machines in January of 1929. Since RCA was already in the Dow, they added National Cash Register instead. Over time, US Steel became Marathon Oil. The remains of what was once mighty Woolworth are now Footlocker. Westinghouse is CBS. So, there have been some changes over time, leaving us only nine of the original Dow 30 still in the index.

For the insatiably curious, you can go to http://www.dogsofthedow.com/djdelete.htm and find a trove of data, including the additions and deletions over time.

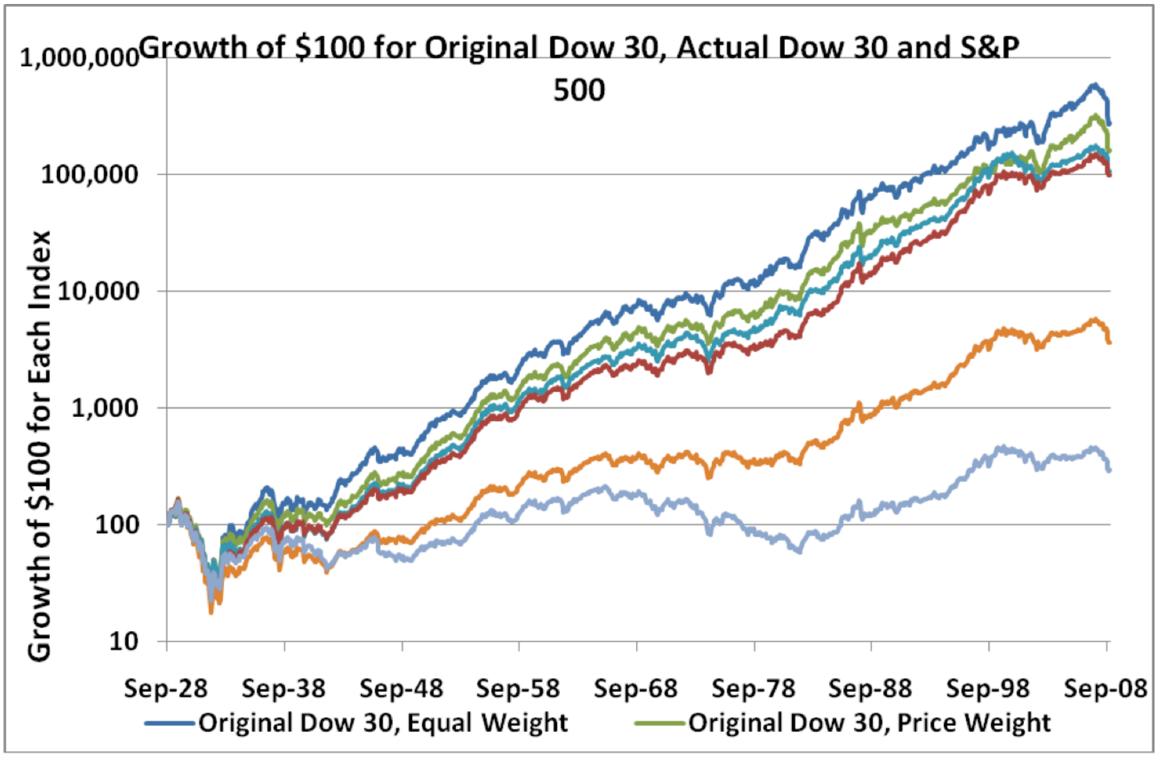
Before we get into the actual data, a little about methodology. There is some subjectivity here. For instance, RCA was bought by GE in 1985. We did not then double-weight GE; we simply had one less component in our model. When Bethlehem Steel went bankrupt, that took away another component. While some stocks have clear trails all the way up until December of 2008, like Woolworth/Footlocker, others were taken private. We made our best effort to rationalize the data with the real world.

Adding and Subtracting Value

Now, the rather stark conclusion. As Rob noted to me in the email he sent with the data, "If Dow Jones hadn't tinkered with the index, the 30 companies would have merged or failed their way down to just 9 survivors. Of the 21 companies in the original 30 that are now gone, 20 disappeared through M&A, some were replaced by successor firms and others not, and only one (Bethlehem Steel) failed outright. But this no-fiddling index would have topped out at just over 30,000 in October 2007 and would have finished 2008 at 14,600. Ugly decline, but not as ugly as a level of 8776 [now down to 7300 as I type this]. This compounds out to a 0.7% per year greater return than the actual Dow 30 results. The difference comes from dropping companies when they're out of favor, and trading at deep discounts, only to replace them with popular large-cap, high-multiple newcomers."

Like Intel and Microsoft, as a prime example. And in the graph below, there was an almost immediate difference between the returns as RCA bought Victor, as mentioned above. But RCA was already in the Dow, so we did not double down on RCA but simply rebalanced with one less component for our 30.

The graph below is going to be hard to read for those who print it out in black and white, but I will try and talk you through it.



We track the original Dow 30 equal-weighted, the original Dow 30 using the Dow price-weighting methodology, and the S&P cap-weighted, for comparison. Also the Dow Total Return Index, the Dow price-only (no dividends), and the Dow 30 Real Price Index, or inflation-adjusted.

So, looking at the lines from the bottom and going up. First, let's see how you would have done on an inflation-adjusted basis with just the actual Dow 30. It's not pretty. The price-only inflation-adjusted index returns for the last 80 years are only a mediocre 1.4%! The price level of the Dow 30 is currently less than twice that of its August 1929 peak, net of inflation. Sadly, we last saw the 1929 peak level as recently as October of 1992. That means that an investor in the Dow 30, in August 1929, would have pocketed only the dividends, with no real price appreciation, for some 63 years.

Rob couldn't resist writing Jeremy, "Net of taxes on the dividends and cap gains taxation on the inflation "gains," the real after-tax return would have been awfully skinny. Jeremy, I hope you'll forgive me for saying so, but that's a 'Long Run' indeed!"

The next line is the Dow 30 price-only index (without dividends). That gives us a 4.6% annual average return. The next line up is the Dow 30 total returns, including dividends, which is 8.9%; this shows how important dividends are to the total return of the Dow. And with dividends now fairly skinny and being cut almost monthly by some component or other, we are left to wonder what total return will be over the next few years.

Next, we find that the S&P 500 cap-weighted index outperforms the Dow by about 0.2% annually, for a total return of 9.1%. Not much difference there.

Now we come to the interesting part. The next-to-the-top line is the original Dow 30, using a price-weighted index, just like the current Dow 30 uses. The only changes in the next 80 years are companies getting bought or dying. That "Original 30" gives us an annual return of 9.6%. Just 0.7% a year, so you might think, not much difference. But if you start with $100 and compound it for 80 years, that 0.7% becomes a quite large differential. With the Dow 30, your $100 would have grown to $96,993 as of December 2008, but the Original 30 would have grown to $161,603.

And there is an even bigger differential if you simply equal-weight the components rather than use a price-weighting methodology. Your $100 grows at a 10.4% clip and becomes $272,554, or almost three times the actual Dow 30. This is probably due to the fact that, whenever a change was necessary, it would be natural to add one of the more popular and respected large-cap growth stocks that wasn't already on the list. It's hard to earn a "risk premium" on assets that are not seen as having much risk!

What accounts for the difference? There were 34 changes in Dow components in the first five years. Many were dropped and then added back in. It was a VERY fluid index. There were two changes in 1939. IBM was dropped for AT&T, and Nash Kelvinator was again dropped for United Technologies. (NK was dropped the first time in 1930, only to be added back in 1932.) But, most of our Original 30 survived the Depression, so the Original 30 was largely unchanged during those tumultuous years.

Then, from 1939 there were no changes until 1956, when International Paper was added, followed by four changes in 1959. There were only three changes in the late 1970s and five in the '80s, but since then there have been 17 changes. The past two decades hardly qualify for buy and hold.

And we may see more changes. Anyone care to speculate on when General Motors gets replaced? Can you have a bankrupt component of the Dow, which typically removes a stock below $10? GM is now at $2, which is basically a call option on the Obama administration not completely wiping out shareholders in a bankruptcy. GE was down to $5.89 before rebounding today to $10.89. Could you really replace GE?

Can we find some nuggets of investing wisdom here? I think the thing that stands out most to me is how the slight difference of value over growth builds up over time, which is what a number of other studies show. This goes along with my numerous exhortations that the valuations you start with when you invest in stocks have a great influence on the long-term returns.

A market-cap-weighted index will tend to perform better than a price-weighted index over time, again because of the value orientation of the cap weighting. But equal weighting or, better yet, weighting and indexing according to valuation fundamentals like price to earnings, price to sales, price to book, etc. is even better. We don't have time to delve back into the research on fundamental indexes, but the letters I have written on it are in my archives at www.2000wave.com.

A Few Thoughts from Richard Russell

As noted above, well over 400 guests will honor Richard Russell this weekend for 50 years of writing the incomparable *Dow Theory Letters*. A lot of people ask him how can they succeed as writers. He recently made some comments which I thought I would pass on, because they are so right. Also, he gives us a few fascinating moments, looking back over his career.

But first, let me thank the following firms and people for their generous support of this evening as sponsors, which will allow us to make a donation in Richard's name to his favorite charity, the Autism Foundation in San Diego:

Matthew Connors of ProFunds (www.profunds.com)
Ian McAvity of Deliberations
Bill Bonner, founder of Agora and editor of *The Daily Reckoning* (www.dailyreckoning.com)
Monex (www.monex.com)
Frank Trotter of Everbank (www.everbank.com)
Martin Zweig
Robert Prechter (http://www.elliottwave.com/)

And now, let's turn to Richard:

"I've been in this business a l-o-o-o-n-g time, and I've known a lot of great people, mostly through their subscriptions. Stanley Kubrick, the genius movie producer and director, was a subscriber for many years. Stan was a gold man, and we used to correspond. Stanley would tear off a piece of yellow paper and write notes to me. He invited me to visit his studio, 30 miles outside of London. When I visited England years ago, damn it, I completely forgot to visit him, a mistake I've always regretted.

"Marlon Brando's dad was a subscriber for years. I had met his Marlon while he was shooting *On the Waterfront.* I exchanged services with the great Hamilton Bolton, genius writer for *The Bank Credit Analyst.* Marty Zweig is a good friend of mine, and when Marty retired I took over his advisory -- this was years ago, and I still have many of Marty's subscribers on the books. I knew Garfield Drew, the original interpreter of the odd lots. I also knew E. George Schaefer, who authored his famous *Dow Theory Trader* advisory during the 1940s through the '70s. George used to run four-page ads in *Barron's.*

"John Magee was a friend of mine. John had a sign posted on his wall. It said, 'Don't tell me what to buy, tell me WHEN to buy it.' Bob Bleiberg, the brilliant editor of *Barron's,* was my friend and mentor. Bob was responsible for popularizing technical analysis of stock trends. General Marion Cooper was a subscriber. Coop invented the concept of King Kong and he produced the original movie. Coop was also adjutant general to Claire Chennault of the famous Flying Tigers, in Asia. The Tigers, with their outdated P-40s (painted like sharks), played hell with the Japanese off China.

"I'm very friendly with that fabulous pair, the gifted Aden sisters. I count Jim Grant *(Interest Rate Observer)* as a good friend (Jim is probably the best writer in the business). Then there's Robert Prechter of Elliott Wave fame (I originally urged Bob to go into business, and he's built up a wide following since). A few years ago, I took over Julian Snyder's business when Julie wanted to retire. I still talk with my old buddy Joey Granville. Other old-timers I keep in touch with are Jim Dines and Mister International -- the one and only Sir Harry Schultz.

"I guess my strangest subscriber was a priest who worked in a leper colony in West Africa. I never could figure out why he was interested in the stock market. The Bank of China was a subscriber; I don't know whether they still are. Many Arab organizations are subscribers. I used to say that I was the only Jew who the Arab big-wigs really listened to. Paul Penner, CEO of Agnico-Eagle, was a good friend of mine. Paul devoted his life to that gold mine, which is now one of the leading gold mines in Canada.

"The tireless, peripatetic John Mauldin is a good friend, and how John gets it all done (he has a million readers for his famous column) is a mystery to me.

"And it goes on and on. I did find that the stock market and finance was a totally democratic business. On Wall Street they don't give a damn who you are or what color or religion you are -- they only care about whether you know anything, which I believe is one of the best things about the money business.

How to Succeed at Writing

"I've been asked a thousand times, 'What's the secret of success in the advisory business?'

(1) You've got to be an obsessive nut to start with.

(2) You have to be able to write in a way that people understand and like to read.

(3) You can't come across as a phony who knows it all. Readers know that nobody knows it all.

(4) It helps if you have a long life and don't want to retire.

(5) You need a wife who can put up with a husband whose head is full of the markets 24 hours, day and night.

(6) Woody Allen said the 90% of success in life is just showing up. If you can show up for the markets 250 days a year, you're ready to start an advisory service (but I wouldn't wish this business on my worst enemy -- it's the closest thing to absolute madness. No wonder nobody else has lasted in the business 50 years).

(6) This is a lonely business. So be prepared. Need a friend? Get a dog. Need two friends? Get two dogs.

(7) One last thing -- you must have thick skin, because no matter what you write, some subscriber will send an e-mail calling you a moron or brain-damaged, and the scary thing is, that makes you think, because they may be right."

Conversations on Banks

This week I recorded a special conversation with Chris Whalen and Rich Lashley, two of the real experts on the US banking system. I learned a lot and found it a fascinating time. The Conversation will be up for subscribers the early part of next week. We will send you a notice. If you would like to know more about Conservations with John Mauldin, you can go to https://www.johnmauldin.com/newsletters2.html. The regular price for a yearly subscription is $199, but you can subscribe now for $109 and still get access to the previous timely Conversation with Ed Easterling and Lacy Hunt, as well as one with Nouriel Roubini. Don't wait, as I am sure my staff will only keep raising the price. To find out more, just click on the link and put in code JM77, which will give you the discounted price.

And for organizations that would like to purchase a discounted multiple subscription for all their brokers or partners, just drop Tiffani a note at conversations@2000wave.com and she will get back to you.

Copenhagen, London and Orange County, etc.

I will report at some point on the fascinating afternoon I had with Dr. Hans Keirstead, a professor at the University of California, Irvine, and one of the leading stem cell researchers in the world. We are on the cusp of amazing changes in medicine. Real therapies for numerous major killers like MS and spinal cord injuries are around the corner. It was a very upbeat session.

Today, I am in La Jolla for my Strategic Investment Conference, co-hosted with my partners Altegris Investments. I will be talking on how I see the global economy shaping up over the next few years. Eventually, that talk will make it into this weekly letter. Saturday night is the Richard Russell Tribute Dinner. Then home for a week. Easter weekend, all seven kids will be home. Then the following week I go to Copenhagen for a board meeting; and I will be in London, Thursday April 16 to meet with my European partners, Absolute Return Partners, and clients. The next weekend I go back to California for a conference sponsored by Rob Arnott, and then the next week I'll be a day or so in Orlando, where I'll speak at the CFA conference on the state of the alternative investment industry.

At the end of May (29-31), I will be in Naples, where I will be doing a seminar with Jyske Global Asset Management and Gary Scott. You can see more at www.jgam.com.

A quick note: There has been a lot of writing on mark-to-market. There were a few bloggers who said I was wrong (some rather rudely) about the mark-to-market changes that were coming. I hope by now they see they were wrong and have edited their remarks. And for a sense of what the mark-to-market controversy is all about, I suggest you look at this video presentation by Barry Habib of Mortgage Market Guide. Barry was on top of the issue months ago as the source of a lot of problems. It is done in a way that everyone can understand.
http://www.mortgagesuccesssource.com/go/markmarket/index.html

This is a fun weekend. Almost 300 clients and friends are at my sold-out conference in La Jolla. And because of the Russell dinner, so many writers and publishers are here as well. And my business partners from around the world. And Tiffani is her usual well-dressed self. She rarely buys new clothes, but for whatever reason she goes all out for this weekend, and her attire is now subject to oohs and aahs, and she has a reputation to live up to. Dad is proud.

Have a great week, and find a few friends, at least over the phone, to share some time with. It is about the healthiest thing you can do.

Your ready to listen and learn this weekend analyst,

John Mauldin