Investment GUIDE with Eric Tyson

Questions & Answers for Financial Success

Stock Indexes

Q I read a criticism of the Dow Jones Industrial Average, which I understand is made up of 30 big companies, for not being broad or representative of all the different types of stock one can buy. What are the other major stock market indexes you follow?

A You're correct that the Dow isn't representative of many types of stocks—especially smaller-company stocks in the U.S. Here are some other important market indexes and the types of stocks they track:

- **Standard & Poor's 500.** Like the Dow Jones Industrial Average, the S&P 500 tracks the performance of larger-company U.S. stocks. As the name S&P 500 suggests, this index tracks the prices of 500 stocks. The S&P 500 is a much broader and more representative index of the larger-company stocks in the U.S. than the Dow Jones Industrial Average.
- **Russell 2000.** This index tracks the performance of 2,000 smaller U.S. company stocks of varying industries. Small-company stocks tend to move in tandem with larger-company stocks. It's unusual for one to fall while the other is rising, although in some years this does happen. Smaller-company stocks tend to be more volatile, often rising more when the stock market increases and falling more precipitously when the market declines.
- **Wilshire 5000**. Despite its name, the Wilshire 5000 index actually tracks the prices of more than 6,000 stocks of U.S. companies of all sizes—small, medium and large. Thus, this index is considered the broadest and most representative of the overall U.S. stock market.
- **Morgan Stanley EAFE.** Stocks don't just exist in the U.S. This Morgan Stanley EAFE index (EAFE stands for Europe, Australia and Far East) tracks the prices of stocks in the other major countries of the world.
- **Morgan Stanley Emerging Markets.** This index follows the price movements of stocks in the less economically developed but "emerging" countries, which tend to concentrate in Southeast Asia and Latin America. These stock markets tend to be more volatile than those in established economies. During good times, emerging markets usually reward investors with higher returns.

Indexes allow you to compare or benchmark the performance of your stock market investments. If you invest primarily in large-company U.S. stocks, for example, you should be comparing the overall return of the stocks in your portfolio to a comparable index—in this case, the S&P 500.

Literally hundreds of other indexes exist. Many financial service and news companies, largely out of desire for publicity, develop their own indexes. If the media reports on these indexes, the index developer effectively gets free advertising. Many of the other indexes out there essentially replicate the ones I've just discussed, which are considered the major and best ones to follow.

Some other types of indexes you may hear about are more narrowly focused, tracking the performance of stocks in particular industries: advertising, banks, computers, drugs, restaurants, semiconductors, textiles, and utilities. Other countries, such as Japan, the United Kingdom, Germany, France, and Canada, have stock indexes that track the performance of their own stock markets. It's dangerous to focus your investments in the stocks of just one or two industries or smaller countries. Thus, I think you should ignore narrow indexes.

Investing

Q We work full-time and contribute the maximum to our 401(k)s. We own a home, thanks to the advice in your *Home Buying for Dummies* book, which I read more than a decade ago. We live frugally, and have accumulated plenty of money in our bank accounts. I have the confidence to make investment choices with mutual funds, but I certainly would appreciate your advice. Some of our goals are: to pay for a home renovation next year; for me to be able to work part-time when we start a family in the next several years; and to accumulate money toward our retirement, which won't happen for quite some time, as we are in our 30s. What do you recommend?

A As your question concerns investing outside of retirement accounts, be sure to pay attention to taxes when selecting funds suitable for your situation.

For your one-year goal, a money market fund appropriate to your tax situation makes sense. If you expect to need money in five years, you could invest some in intermediate term bonds. On the other hand, since it sounds like you save a large portion of your income, maybe you'll just reduce your new savings rather than needing to tap any specific investments. For retirement, keep filling up your 401(k)s. Also, consider paying down your mortgage and/or investing in tax-friendly stock funds. Index funds are a logical starting point, as are so-called "tax-managed" funds. For a great selection of both types of these funds, start with mutual funds and exchange-traded funds offered by the Vanguard Group. N

*Eric Tyson is a best-selling author (*Personal Finance for Dummies, Investing for Dummies, Mutual Funds for Dummies, Home Buying for Dummies*). He is read by more than four million people nationwide. A management consultant to Fortune 500 financial service firms, he also founded a counseling firm providing financial advice to non-wealthy investors, teaching that "one must live within one's means as a prerequisite to building wealth."*