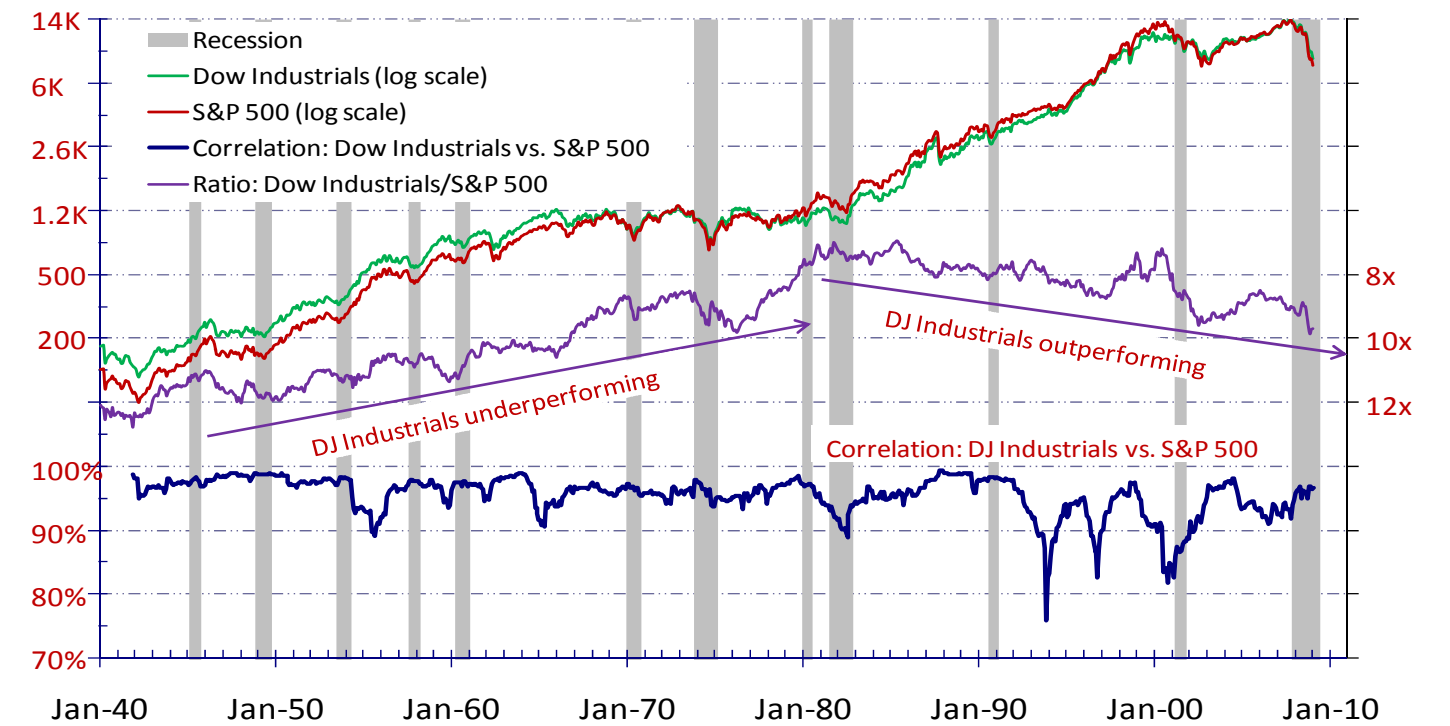


## Dow Components: A Useful Microcosm for Market Themes

- Ever since Wall Street Journal publisher Charles Dow first summed the prices of a representative sample of blue chip stocks more than a century ago, investors have relied on the Dow Jones Industrial Average as a simple gauge of the performance of the U.S. stock market. Despite competition from newer indexes designed to meet the needs of traders and portfolio managers on Wall Street, those on Main Street and the mainstream media are still content with the day-to-day stories of the market being told in terms of the Dow Industrials.
- In today's contracting global economy, we favor some of the high quality, large capitalization growth stocks that have been long-time members of the Dow Industrial Average ("the Dow"). Many of these are the market's "innocent bystanders" that we have discussed previously; they are neither "perpetrators" (directly involved in the housing market meltdown that has apparently caused the downturn), nor are they the "direct victims" (companies whose business model is square in the sights of downturn). Instead, they have strong balance sheets, diversified, stable cash flows and — thanks to the market sell-off — attractive valuations.
- What makes the Dow unique among a wide range of competing indexes is the "price weighting" of the component stocks. Currently, the highest-priced issue International Business Machines (NYSE: IBM \$91) "weighs" nearly as much in the index as the 9 lowest priced issues, including Microsoft (NASDAQ: MSFT-\$17.10), American Express (NYSE: AXP-\$16.73), Pfizer (NYSE: PFE-14.58), Intel (NASDAQ: INTC-\$12.90), General Electric (NYSE: GE-\$12.13), Alcoa (NYSE: AA-\$7.79), Bank of America (NYSE: BAC-\$6.58), Citigroup (NYSE: C-\$3.55) and General Motors (NYSE: GM-\$3.01). The price weighting means that the Dow has distinctly differing "personalities" over time, depending only on the prices of the underlying issues. If a low-priced stock is removed to make way for a higher-priced one, or if a company should declare a stock split or spinoff, the entire index is reweighted to adjust for the new prices.
- While the Dow average is clearly not a perfect representation of the U.S. equity market, its status as a major benchmark is very useful for anyone trying to follow the market's major themes. One needn't be concerned with the weightings of the individual stocks to look at the Dow components as a microcosm for the market. Barron's and The Wall Street Journal provide helpful summaries of key statistics for companies in the Dow averages, so it is easy to find data for earnings estimates, dividends, book value, sales, etc.
- Last week was a very busy one for companies in the Dow. Chevron (NYSE: CVX-\$70.52) and Exxon (NYSE: XOM-\$76.48) announced lower earnings and trimmed their share repurchase programs, so they can direct their substantial cash flow toward investments in their underlying businesses. Pfizer unveiled a strategic acquisition for a package of stock and cash (some of which will be raised in a debt offering). Pfizer also halved its dividend, an important reminder that dividends can be reduced or eliminated at any time, without warning. Clearly, even some companies that can afford to continue dividends may seek to reset investor expectations and redirect cash flow back into the business.
- Other companies are indicating a strong desire to maintaining their payouts, but rating agencies like Moody's may have a say, too. By week's end, investors were pondering which would be the first to go: GE's "Aaa" long-term debt ratings or its \$1.24 annual dividend.
- Procter & Gamble (NYSE: PG-\$54.50) suggested that inventory destocking, price increases and consumers' "trade down" to less expensive products were pressuring sales. P&G noted that common shares were trading in the market to offer the highest yield seen in 20 years, and suggested both dividends and buybacks were likely to continue.
- The chart overleaf compares the Dow and its nearest competitor — the S&P 500 — over the past 70 years, focusing on performance trends and correlation. Over the past 10 years, the S&P 500 has provided a negative return (-2.6% per annum, including dividends) while the Dow is barely positive (+0.57% per annum, including dividends). Of course, past performance is not an indicator of future returns.

## The Dow Industrials and the S&P 500: A 70-Year Perspective of Performance and Correlation



Note: Recession periods shaded. S&P and Dow indexes are on a log scale. Correlation measure shown is calculated over a 24-month rolling period. Past performance is not a guarantee of future results. An index is not managed and is unavailable for direct investment. Price returns only; excludes dividends. Source: Bloomberg, Dow Jones Indexes, Standard & Poor's.

At today's level near 8000, the Dow trades close to 10x the level of the S&P 500, near the middle of the range over the past 70 years (see middle section of chart). Even though the committee that administers the Dow tries to avoid changing component stocks just to keep up with the latest investment fad, a noticeable underperformance in 1998-99 contributed to the decision to add Intel and Microsoft just a few months before the top of the technology bubble in 2000. While those two stocks were hurt badly in the ensuing tech collapse, the Dow managed to outperform the S&P 500 by falling less steeply.

The introduction of financial companies into what had originated as an index of industrial stocks was much more gradual. American Express was added in 1982, near a major market low. JP Morgan (NYSE: JPM-\$25.51) entered the group in 1991, followed by Travelers' (now Citigroup) in 1997, American International Group (NYSE: AIG-\$1.28) in 2004, and Bank of America in 2008. Of course, long-time components General Electric and General Motors also had substantial exposure to financing markets. The heavy exposure to financial activities within the Dow pulled the index sharply lower in 2008, but once again, it outperformed the S&P 500 by falling less sharply. The main reason is a lighter weighting of financial companies. Today, the financial stocks in the Dow account for 5.2% of the index, only half as large as their representation in the S&P 500.

Despite efforts to "fine-tune" the Dow to keep it closely in-line with other market indexes, its correlation to the S&P 500 has experienced some significant swings in the past 15 years. These swings underscore the difficulty of tracking the market with a relatively narrow portfolio.

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