



Market Indices...

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There are a growing number of market indices listed on the major stock exchanges. Each index tracks the performance of a specific "basket" of stocks considered to represent a particular market, or sector of a stock market, or an economy. They may differ with respect to their weighting rules.

Weighting

"Weighting" is a commonly used term when discussing indices. It is used as a method to assign a value, based in proportion, to various securities within a given index. An index can be valued according to one or several factors and will therefore be listed as having a certain 'weighting' such as

Price-weighted : An index may be classified according to its pricing methodology. In a Price-weighted index such as the Dow Jones Industrial Average, the price of the component stocks determines the value of the index. The DJIA weighs each security based on the stock's price relative to the sum of all the stock prices. The index thus gives proportionately more weight to higher priced shares, ignoring their market cap altogether.

Economists turn up their nose at price weighting because it allocates assets in an arbitrary manner. If company A shares sell at \$20 a share and company B shares sell at \$10 but are twice as plentiful, the index will hold twice as much of A as B, regardless of the fact that both companies are the same size. There is no theoretical reason why a stock with a higher price, all else being equal, ought to perform better than one with a lower price.

Market-value weighted : A market-value weighted or capitalisation-weighted index such as the Hang Seng Index is calculated from the market values of the constituent companies. Thus, a relatively small shift in the price of a large company will heavily influence the value of the index. These indices are often adjusted for free float, ie the number of shares used to calculate the market values of each company are reduced by the number of shares not really on the market (for example shares held by a government, cross holdings etc).

Market-share weighted : In a market-share weighted index, price is weighted relative to the number of shares, rather than their total value.

Market capitalisation weighted : The Nasdaq is a market capitalisation weighted index with each company weighting being proportionate to its market value.