Dawn of a New Dow?

What's Driving the Reconstitution of the Dow Jones Industrial Average?

August 2020

- The Dow Jones Industrial Average will undergo a significant reconstitution as of August 31, 2020, adding three companies to replace departing constituents.
- As a price-weighted index, decisions about Dow constituents are often driven in large part by company share prices.
- The Dow's price-weighting methodology and short list of mega-cap U.S. constituents means it is a poor benchmark for today's increasingly accessible financial marketplace.

The Dow Jones Industrial Average (Dow) will undergo a significant reconstitution as of August 31, 2020. Reconstitution is the process of adding or removing the constituent companies that comprise an index.

What's changing?

The Dow will be adding three companies to replace departing constituents:

In	Out
Honeywell International	Raytheon Technologies
Amgen	Pfizer
Salesforce.com	Exxon Mobil

Splitting the Difference

S&P Dow Jones Indices, which oversees the Dow, pointed to Apple's 4-for-1 stock split as a major driver of the Dow's latest changes. The reconstitution was scheduled for August 31 to coincide with Apple's stock split.

Why would the Dow be impacted by Apple's stock split?

An index typically has a weighting methodology, or set of rules by which the weight of each constituent in the index can be determined.

The Dow is a price-weighted index. This means that each company's share price essentially dictates it relative weight in the index. Higher share prices equate to a larger weight.

Stock splits are two-part changes: a 4-for-1 split means that an investor receives three additional shares for each existing share that they own on the date of the split. The second part of the transaction means that the share price will be divided by four.

Tech Ascends

In practice, Apple's much lower share price, as a result of its stock split, would have sharply reduced the Dow's exposure to information-technology-oriented companies given its reliance on share prices to dictate index weights. The addition of Salesforce.com has served to offset most of the reduced exposure to information technology, while also diversifying the type of information-technology exposure away from Apple's luxury retail products and toward Salesforce.com's business services.

Energy Fades

But why has Salesforce.com replaced Exxon Mobil? These two companies admittedly have little in common. Exxon Mobil's departure also represents a milestone of sorts: it's the Dow's oldest constituent, dating back to the 1928 addition of Standard Oil, its predecessor. The Dow itself is the oldest U.S. stock-market index, tracing its inception to 1896.

In short, the U.S. energy sector has not fully recovered from the shakeout that began in 2014 and has lost share in the overall economy. The Dow was designed to serve as a broad representation of U.S. industry; Exxon Mobil's removal is consistent with the fact that energy has shrunk relative to other sectors at the same time that information technology has grown. Chevron will remain as the Dow's lone standard bearer of the energy sector.

Like for Like

As for the other constituent swaps, they're much closer in terms of industry alignment. Honeywell has a broader industrial footprint that extends beyond Raytheon's narrower focus on aerospace and defense (the Dow still includes Boeing). Honeywell's higher share price also means the industrials sector will increase its weight in the Dow.

The replacement of Pfizer in favor of Amgen will enable the Dow to diversify away from traditional pharmaceutical companies (it still includes Merck & Co. and Johnson & Johnson) and toward biotechnology. Amgen also has a higher share price (despite being a smaller company than Pfizer by most measures), which means the healthcare sector will increase its weight in the Dow.

SEI's View

Most investors will not notice any material impact from these changes. Investors can't own an index, so impacts will likely be limited unless investors use a strategy designed to track this index. The Dow's price-weighting methodology has rendered it an imperfect stock-market benchmark, and its short list of mega-cap U.S. constituents means that it only captures a small slice of an increasingly accessible global financial marketplace.

Market-capitalization-weighted indexes supplanted the Dow's price weighting for the purposes of benchmarking long ago. While market-cap weighting has its own inherent quirks, there's a straightforward logic to basing the relative index weights of companies on their overall market value.

Furthermore, the ad-hoc nature of Dow reconstitution decisions contrasts with the regular periodic methodologies employed in most other indexes.

Nevertheless, the Dow's high "price" will remain a go-to reference for the financial media any time they're seeking to highlight stock-market volatility. A 280 point drop will offer greater shock value to most audiences than a 1% decline.

We believe investors would always be better informed if market movements were cited in percentage terms rather than points, but perhaps we have different goals than those tasked with garnering page views.

Index Definitions

Dow Jones Industrial Average: The Dow Jones Industrial Average is a widely followed market indicator based on a price-weighted average of 30 blue-chip New York Stock Exchange stocks that are selected by editors of The Wall Street Journal.

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