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Hazel S. Kienitz

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KEEPING UP WITH THE JONESES

Hazel S. Kienitz
Grand Rapids, Michigan

Up or down. High or low. Falling out of bed or soaring to new highs. Good news or bad, the activities of the stock market each day are followed with personal interest by a constantly increasing percentage of the nation's population.

The authority most quoted as to these activities is the Dow Jones and its industrial averages. There are many other lesser known sources, but the Dow is the grand daddy of them all.

The Pioneer

This pioneer of stock indexes was first computed on May 26, 1896, using a list of only twelve stocks. It was printed sporadically in the Wall Street Journal beginning in June of that year, and some months later began appearing on a daily basis. The economy was different then. Automobiles were an oddity, Orville Wright's first airplane flight was yet to come, and radio broadcasting was more than twenty years away. The population of the United States was around seventy-six million.

The list now consists of thirty stocks including only two of the original twelve—American Tobacco Company and General Electric Company. Missing are the newer giants in the aeronautics, space, computer, and business machine industries.

Criticisms

Despite the fact that the Dow Jones uses only thirty of the approximately 1,300 listed issues of common stock on the New York Stock Exchange, the industrials actually cover a broad sector of the investing public. The total market value of the stocks on the list average one-third of the total of all listed stocks.

Over half have more than 100,000 shareholders while only four have fewer than 50,000. Of all companies listed on the New York Stock Exchange, only 8.5% have 50,000 shareholders.

American Telephone and Telegraph Company has more shareholders than the city of Philadelphia has people, and General Motors Stockholders number more than the population of Baltimore or Cleveland.

A second critical observation is that Dow Jones is predominately made up of large companies, which weight the averages. These large companies account for the widest interest of the stockholding public because they are also of the high quality stocks known as blue chips. Therefore, they justly deserve spots in the averages.

A third criticism, which is perhaps most meaningful to our average stockholder, is that the averages do not reflect the action of individual stocks. Since there are at least 17,000 stocks being traded daily on the various exchanges and in the over-the-counter market, no average could possibly reflect the movement of each one individually. And, even if all of them were used in computing the averages, someone would still own the stock that went down while the averages went up.

Computing the Averages

Computing the averages also posed some problems. Originally a simple averaging of the closing prices of the stock list was used. However, it soon became obvious that distortions would occur unless some adjustments were made from time to time. Some of the companies started splitting up their stocks. When a corporation feels that the per share price of its stock has risen too high to appeal to the majority of the investing public, it arbitrarily decides to split the stock by decreasing its par value and issuing new shares to the existing stockholders to keep their equity in the company proportionate. The market price is then adjusted in the same proportion.

The necessity for stock splits will continue. It has to. Otherwise as companies grow, individual share prices would get beyond the reach of most investors. It is estimated that the price of General Motors would have been somewhere around $12,000 a share if it had been left unsplit.

When these splits occur, an adjustment needs to be made in the price used for the averages. An oversimplified illustration follows: On a given day, company A closed at $5, company B closed at $10, and company C closed at $15. The average is $10. On the next day, company C split its stock three-for-one which

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HAZEL S. KIENITZ, Grand Rapids Chapter, ASWA, is a Registered Representative of the New York Stock Exchange with H. B. Shaine & Co., Inc. of Grand Rapids, Michigan.

changed its per share price to $5. That day was a good one in the market place and all three stocks advanced in price $1 per share. Without an adjustment for the split, closing prices would have been $6, $11, and $6, for an average of $7.67, which was $2.33 less than on the previous day, though each stock was actually higher.

Continuing with the basic illustration—on the day that the closing average was $10, it was known that company C was splitting its stock. Using the adjusted prices of $5, $10, and $5 we arrive at a total of $20. Dividing this total by the actual average of $10, we arrive at a conversion factor of 2 which will be used as the divisor the next day in place of the actual 3. When the new closing prices of $6, $11, and $6 are totalled and divided by our new divisor of 2, we show a new average of $11.50, up $1.50 from the previous day.

Substitutions

The new divisor will continue in use until another split or large stock dividend, or until a substitution is made in the list. Substitutions are made when a stock becomes too inactive, when its movements become so small as to have little effect on the average, or when for some reason a stock ceases to be representative of a substantial sector of American industry. When a substitution is made, the divisor is adjusted just as when a split occurs.

The divisor is not changed unless the net effect on the averages exceeds five points. When a component of the average does not sell on any day, the last previous closing price is used.

Currently the conversion factor from dollars to points is 2.278. To convert the point change to dollars, multiply the change by this factor and divide by thirty. A point change of one is comparable to about eight cents, and a point change of ten is only about seventy-six cents per share. The actual average of the thirty industrial stocks would be about $60. Using the conversion rate, the average is over 800 points. This is not a dollar average of the market, but it is a market movement indicator, undistorted by the many stock splits since its inception.

The Individual Investor

The concern of the individual investor is not with the averages. He must be interested in individual prices and trends. When the average falls twenty points, it is headline making news, but the market has not fallen out of bed. A twenty point drop from 900 is approximately 2%. If an individual stock, priced at $50, dropped 2%, the net change would be $1. A ten point rise on the Dow Jones from the 900 level would be little more than 1%, which would compare with a fifty cent rise in a $50 stock.

All stock indexes constitute statistical yardsticks for professional analysts, brokers, and students of the market. The investment industry as a whole feels that because of its historical continuity and basic principles, the Dow Jones is a reliable index.

CONGLOMERATES

(continued from page 4)

University of Illinois, relied upon the responses of hundreds of U. S. corporations and financial analysts.

"Management, because of its familiarity with company structure", states the study, "is in the most informed position to separate the company into realistic components for reporting purposes. To require reporting on some rigid basis might fractionalize a company into unnatural parts which could not fairly reflect the results of its operations".

The report suggests that companies which are unitary in nature, that is, which operate almost completely within a single broadly-defined industry, or which are highly integrated, should not be expected to fractionalize themselves for reporting purposes but companies which to a material degree have activity in more than one broadly defined industry should meet the extended disclosure requirements.

According to the study, a "material degree" means 15% or more of a company's gross revenue. No present system of industry or product classification appears ideally suited to the identification of broad industry groups so considerable discretion to management in defining broad industry groupings is essential.

The study recommends that disclosures may be included in parts of the annual report other than the formal financial statements. Whether in narrative or tabular form, they should be grouped and should carry a clear indication of the limitation of their usefulness.

The findings released are in summary form. The full report, including voluminous statistical data, will be released in the late spring of 1968.

The Financial Executives Research Foundation enlisted the assistance of representatives of the American Bar Association, the New York Stock Exchange, the Securities and Exchange Commission, the Investment Bankers Association, the Financial Analysts Federation, the National Association of Accountants and the American Institute of Certified Public Accountants in providing information in the course of the study.