



Figure 4.17 Historical values of the Dow Jones Industrial Average, 1900 through 2011. Note that the vertical axis uses an exponential scale in which the value doubles with each equivalent increment in height; this makes it easier to see the changes that occurred when the DJIA was low compared with its value today. Chart courtesy of StockCharts.com.

one has ever found a way to make reliable forecasts, and most economists now believe that such forecasts are impossible.

The futility of trying to forecast the market is illustrated by the story of the esteemed Professor Benjamin Graham, often called the father of “value investing.” In the spring of 1951, one of his students came to him for some investment advice. Professor Graham noted that the DJIA then stood at 250, but that it had fallen below 200 at least once during every year since its inception in 1896. Because it had not yet fallen below 200 in 1951, Professor Graham advised his student to hold off on buying until it did. Professor Graham presumably followed his own advice, but the student did not. Instead, the student invested his “about 10 thousand bucks” in the market right away. As it turned out, the market never did fall below 200 in 1951 or any time thereafter. And the student, named Warren Buffet, became a billionaire many times over.

QUESTIONS FOR DISCUSSION

1. The stock market is still considered a riskier investment than, say, bank savings accounts or bonds. Nevertheless, financial advisors almost universally recommend holding at least some stocks, which is quite different from the situation that prevailed a century ago. What role do you think the DJIA played in building investors’ confidence in the stock market?
2. The DJIA is only one of many different stock market indices in wide use today. Briefly look up a few other indices, such as the S&P 500, the Russell 2000, and the NASDAQ. How do these indices differ from the DJIA? Do you think that any of them should be considered more reliable indicators of the overall market than the DJIA? Why or why not?
3. The 30 stocks in the DJIA represent a sample of the more than 10,000 actively traded stocks, but it is not a *random* sample because it is chosen by particular editors for particular reasons that may include personal biases. Suppose that you chose a random sample of 30 stocks and tracked their prices. Do you think that such a random sample would track the market as well as the stocks in the DJIA? Why or why not?
4. Create your own “portfolio” of 10 stocks that you’d like to own, and assume you own 100 shares of each. Calculate the total value of your portfolio today, and track price changes over the next month. At the end of the month, calculate the percent change in the value of your portfolio. How did the performance of your portfolio compare to the performance of the DJIA during the month? If you really owned these stocks, would you continue to hold them or would you sell? Explain.