What are Index Funds?

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An index, for example, the S&P 500, measures the performance of stocks across different industries. While indexes have different criteria for which stocks are included, the end result is an average measure of how stocks in that index sector are performing. The S&P 500 measures the 500 largest companies listed on the NYSE or NASDAQ, giving us an overview view of some of the most well known companies.

An index fund is a type of mutual fund designed to mimic an index, however the actual composition of the fund may be different then the index. The index may be a broad market index or may be concentrated in one sector of the market such as health care or technology.

Advantages Of Investing In Index Funds

- Range of Market Exposure

An index fund gives you the advantage of a diversified portfolio that spreads the risk among multiple companies. Some companies may do very well, a handful more could do moderately, and a couple could perform poorly.

- Low Fees

Index funds tend to have lower fees than other investment options because they are often passively managed instead of actively managed. We will look more at passively managed investments in a moment, but one reason they may be attractive is that they take less work to manage, meaning they may have lower costs and fees.

- Low Tax (Low Turnover)

Holding investments for longer than one year may give you a tax advantage compared to holding an investment for less than 12 months. Index funds tend to have a lower turnover, which means they are not constantly buying and selling holdings. At the end of the day, this may result in a more stable asset with less tax liability.

Index Funds and the Greater Investment Strategy

Index and other types of mutual funds are a common asset class for investors seeking a diversified portfolio to put their money where they may earn a higher return than placing it into a savings account. Depending on how aggressive or conservative the investor want to be, funds may make up a larger or smaller percentage of a portfolio.

Passive Vs Active Management

An actively-managed investment is one where a financial professional, like a fund manager, is more heavily involved in running the investments. The fund manager spends more time evaluating the holdings and deciding whether it is time to buy or sell the stock. In contrast, a passively-managed investment is more hands off.

Conservative Vs Aggressive Investments

The goal of an index is to recreate the market average, not to seek the gamble of incredible returns.

A more aggressive investment is looking in a specific place to earn a return. For example, a fund that invests only in small cap companies in the tech sector could make the right choices and end up holding the next major company at just the moment when it skyrockets in value. But, there is also the chance that the wrong selections could bring the investment crashing down.

The advantages of the index fund make it an attractive asset for investors who either do not have a tolerance for losing money in more aggressive investments or for those who want to strike balance between the two strategies.

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Westport Capital Markets, LLC :: 257 Riverside Avenue **?** Westport, CT 06880 **?** Phone: 203.222.8933 **?** Fax: 203.222.8898

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