

What Are Index Funds and How Do They Work?

If you're looking to expand your investment portfolio, several investment products exist. In your research, you may have come across index funds. If you're looking for more information, keep reading for everything you need to know.

What are index funds?

In 1976, Jack Bogle, the founder of Vanguard, created the first index fund to provide a low-cost investing method that valued the investor's interest over the company's.

Index funds track the aggregate trends of a total market index, like the S&P 500, Dow Jones Industrial Average or Nasdaq. It is a type of mutual fund or exchange-traded fund (ETF).

A mutual fund is an investment made by multiple people who purchase stocks, bonds and other securities. The mutual fund manager handles the day-to-day management to ensure the portfolio stays on track with the end-of-day purchase and sales. An ETF is a share or group of shares traded based on the stock exchange, with prices varying throughout the day.

Unlike other investment funds, an index mutual fund is meant to work as a passive investment option rather than one that needs to be monitored against the market at all times. Index funds also tend to be lower maintenance because they offer a low-cost option with fewer management expenses.

Related: The Difference Between Direct Indexing and ETFs

How does an index fund work?

An index fund's performance is meant to mirror the index it tracks. For example, when the index fund manager purchases a stock or bond, they do so in the same proportion as is represented on the financial market index. For the most part, the fund monitors itself and will occasionally be rebalanced to continue mirroring any changes to the index.

When someone decides to invest in an index fund, the shares they buy are essentially a small portion of the stock or bond they purchase, as represented in the index.

An index fund holder's financial returns are determined by that stock's or bond's performance, usually factoring in metrics like the fund companies' market capitalizations.

Again, index funds are built to be a low-risk, low-maintenance investment because they do not require the day-to-day management of other funds.

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How does an index fund compare to mutual funds and ETFs?

While mutual funds exist in the same realm as mutual funds and ETFs, they have some differences.

Management style

Index funds are meant to facilitate a passive management style, meaning they match the market index's performance without the hassle of trying to outperform the market.

Mutual funds and ETFs are a bit more flexible, as they can be managed actively or passively, depending on the fund manager

and investors' investment strategy.

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Investment objective

An index fund gets its name because it is designed to track the performance of a market index. Mutual and ETFs do not necessarily follow that same objective. Mutual funds and ETFs might be an investment to generate income or appreciate capital.

Trading and pricing

ETFs are stock exchange trades, which means they are bought and sold throughout the ebbs and flows of the daily stock market hours. Mutual funds are priced per day, meaning they are the price of the fund's net asset value for that day. Index funds typically work the same way.

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What are the pros of index funds?

Diversification

Because of the nature of index funds, they provide the investor with a diversification of their portfolio.

When an investor chooses an index fund, they buy a piece of each stock or bond on that index, meaning their risk is spread over a larger number of holdings, reducing the risk of individual securities.

Low fees and costs

Because index funds are meant to be passive investments, they

typically have lower management fees than those requiring constant attention. Over time, lower fees can equate to larger returns. Costs you can expect with index funds include:

- Investment minimum.
- Account minimum.
- Expense ratio.
- Tax-cost ratio.

Performance

Index funds are a long-term investment rather than a “get rich quick” short-term decision. They are generally reliable and consistent investments that do not involve the volatility of other assets.

Index funds can work for someone searching for a lower-risk, lower-cost option that will perform well in the long run.

Related: [This Small-Cap Healthcare Name Is Outperforming Its Index](#)

Ease of investment

Index funds are easily accessible and involve a straightforward process. You can purchase them through a brokerage account or a company that handles mutual funds. Because of the low cost, they are available to a wider range of investors than other funds.

Liquidity

High liquidity helps provide ease of buying and selling shares. Investors who want easy and quick access to their funds should consider index funds as an option.

Tax efficiency

Because index funds are straightforward, they usually generate

a lower portfolio turnover than other funds. Lower turnover means lower capital gains taxes.

Market exposure

Again, index funds are low-cost and low-risk, which can be a great starting point for investors looking to get their footing in a particular market.

Index funds allow investors to gain familiarity with market areas without selecting individual stocks. Once they've studied the market enough, investors can move on to higher-cost, higher-risk investments.

What are the cons of index funds?

Limited upside potential

Unfortunately, there is rarely such a thing as low risk, low reward. Index funds are meant to replicate the index's performance, meaning they will likely not outperform the stock market. Investors looking for high returns should look to another type of investment.

No control over portfolio composition

Because an index fund means the investor does not have complete control over the actual portfolio composition, investors might not be happy with the industries or companies involved.

Also, indexes change which can result in removed securities, meaning the fund has to sell that security. This might lead to the investor owing capital gains taxes.

Market risk

While index funds are low-risk investments, that does not mean

they are risk-free. The fund's holding value will fluctuate, which means that the investor is at risk of losing money if the market takes a dip.

Tracking errors

Index funds are designed to replicate the underlying index's performance. However, there is a slight chance that performance differences occur due to tax treatments and the timing of sales and purchases. The performance difference is called a "tracking error," which can negatively affect the index fund.

Lack of customization

The broad market exposure that comes with index funds means that investors with a specific interest or streamlined goals are better off with a different type of investment. Actively managed funds are the types that will better suit investors who want to be able to customize their portfolios.

What are the best index funds of 2023?

If you're ready to take the plunge or want some direction, look at the most popular index funds for S&P 500 and Nasdaq.

S&P 500

1. Vanguard 500 Index Fund – Admiral shares (VFIAX)

- Minimum investment: \$3,000.
- Expense ratio: 0.04%.

1. Schwab S&P 500 Index Fund (SWPPX)

- Minimum investment: no minimum.
- Expense ratio: 0.02%.

1. Fidelity 500 Index Fund (FXAIX)

- Minimum investment: no minimum.
- Expense ratio: 0.015%.

1. Fidelity Zero Large Cap Index (FNILX)

- Minimum investment: no minimum.
- Expense ratio: 0.0%.

1. T. Rowe Price Equity Index 500 Fund (PREIX)

- Minimum investment: \$2,500.
- Expense ratio: 0.15%.

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Nasdaq

1. Invesco NASDAQ 100 ETF (QQQM)

- Minimum investment: no minimum.
- Expense ratio: 0.15%.

1. Invesco QQQ (QQQ)

- Minimum investment: no minimum.
- Expense ratio: 0.20%.

1. Fidelity NASDAQ Composite Index Fund (FNCMX)

- Minimum investment: no minimum.
- Expense ratio: 0.37%.

Related: Should You Bet Against The Nasdaq 100 With This Inverse ETF?

How do you invest in index funds?

Ready to invest in your very own index fund? Take a look below at the step-by-step process for how to get started.

1. Create a goal for your index fund.
2. Complete thorough research.
3. Choose the index fund.
4. Decide where to purchase the index fund.
5. Purchase index fund.

What can index funds do for you?

Index funds are passively managed investments that can be an excellent option for investors looking for a low-cost, low-risk investment that will work towards a diversified portfolio.

A few drawbacks come with index funds, like a lack of customization and limited upside potential.

However, seasoned and novice investors should always complete thorough research, consult with a financial advisor and make the financial decisions that are right for them.

Are you looking for more information about funds, finances or investment strategy? Check out [Entrepreneur.com](https://www.entrepreneur.com/money-finance/what-are-index-funds-and-how-do-they-work/445022) for all the latest need-to-know.

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