Index Funds

An index fund is a type of mutual fund, exchange-traded fund, or unit investment trust whose primary investment objective is to mimic the performance of a specified market index, such as the S&P 500 Index or the Wilshire 5000 Index. To achieve this, an index fund will hold all (or a representative sample) of the securities in the chosen index, in the same proportions as those securities making up the index.

Investing in an index fund is often referred to as "passive" investing, since changes in the portfolio are generally made only when there is a change in the underlying index. Index funds owners generally believe that it is impossible to "beat" the market; the primary goal is to come as close as possible to a "market" return. Mutual funds that are "actively" managed seek to beat the market, often by frequently trading individual stocks or bonds.

Advantages of Index Funds

For many investors, index funds have several distinct advantages:

- **Lower management costs:** Without the need for expenses such as investment research and the costs of buying and selling, index funds typically have lower management costs.
- **Lower portfolio turnover:** With a passive investment strategy, there is less portfolio turnover in index funds than with actively managed funds. Such trading activity can generate taxable capital gains.

Disadvantages of Index Funds

By their nature and design, index funds will never "beat" the market.

Possible Risks

Shares in an index fund involve the same risks as owning the underlying securities:

- **Funds holding stock investments:** The value of a stock can fluctuate up and down. If shares purchased at a higher price are sold when the market is down, a loss will result.

- **Funds holding bonds or other debt instruments:**
  - **Market Risk:** the value of a bond will fluctuate, usually in response to changes in interest rates. If a bond is sold before it matures, an investor may receive more or less than originally paid;
  - **Default Risk:** the issuer of a bond may not pay principal or interest when due;
  - **Inflation Risk:** as fixed-return investments, bonds are subject to inflation risk – over time the dollars received have less purchasing power.

Before investing in an index fund, you should carefully read all of the fund's information, including its prospectus and most recent shareholder report.