# INDEX FUNDS

vEcoSys

# Understanding Index Funds

– By Prof. *Simply* Simple ™

# INDEX FUNDS

- An index fund is a portfolio constituted of stocks belonging to some market index such as the Sensex or Nifty.

- You can invest in an index fund either through a mutual fund or an exchange-traded fund (ETF).

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**Now…**

- **The Sensex, as you may be aware, consists of 30 stocks in proportion to their free-float market capitalization.**
- **Likewise, the Nifty consists of 50 stocks in proportion to their free-float market capitalization.**
- **These stock market indices help us in gauging the overall mood of the market because they capture the price movements of the majority of stocks by market capitalization belonging to different sectors.**

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An index fund tries to track a particular index by including all stocks belonging to that index in its portfolio in exactly the same proportion as used by that index.

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**Okay, but how does it work?**

- **Say, for instance, if one particular stock has a weightage of 10.86% on the Nifty, then an index fund tracking the Nifty would use 10.86% of its funds to buy that particular stock.**
- **If another stock has a weightage of 8%, then the index fund would allocate 8% of its funds for buying that stock.**
- **The end result is that you have a diversified portfolio, consisting of some of the best known firms, and your portfolio mimics the rise or fall of the chosen index.**

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**What are the other advantages of an index fund?**

- **The main advantage of an index fund lies in its cost.**
- **Since index funds require only passive fund management, they are much cheaper than more actively managed funds in which portfolio managers make an effort to choose the right stock.**
- **The expense ratio, which represents the value of total expenses as a percentage of the value of total assets under management, of most of the index funds in India is usually less than that of more actively managed funds.**

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## What about its disadvantages?

- One of the drawback which some of the index funds suffer is in the form of tracking errors.
- Theoretically, the return produced by an index fund should closely mimic the rise or fall of the concerned index.
- But in reality, due to what we call tracking errors, the fund may sometimes generate a return higher or lower than the actual movement in the index.
- Tracking errors could happen due to a variety of reasons. Let me quickly tell you about some of them…

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- First, some discrepancies might creep in at the time of allocation of funds itself, leading to greater or lower allocation of funds in different stocks.
- Second, any change in the composition or weightage of the index requires rebalancing of the portfolio by the fund manager, which increases further the scope for discrepancies.
- Third, it is often difficult for fund managers to trade at the market closing price, which means that the final value of the index and the value of the index fund portfolio on that day might show some difference.
- Finally, the fund managers may have to keep some cash ready to take care of redemptions by investors. Spare cash reduces the overall return of the fund.

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## To Sum Up

- **What: An index fund tries to track a particular index so that its returns mimic the rise or fall of that specific index.**

- **How: An index fund includes all the stocks of a particular index in its portfolio in exactly the same proportion as used by the index.**

- **Why: Index funds are popular due to lower expenses and better performance.**

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**Hope you have now understood the concept of Index Funds**

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**Mutual Fund investments are subject to market risks, read all scheme related documents carefully.**