

What is an Index Fund?

Own funds with low fees

An index fund is a collection of stocks that mirror stocks in a particular index. For example, the 500 Index Fund offered by the Vanguard Group and the Spartan 500 Index Fund from Fidelity Investments are index funds that include the 500 largest publicly-traded companies in the Standard & Poors 500 index. So when you own one or more shares of these funds you own a little bit of each company in the S&P 500. Because index funds do not have to select and buy and sell stocks, they do employ highly paid professionals and consultants for advice. Therefore, index funds charge very low annual fees so their performance is not significantly reduced by the amount of their fees. Thus, index funds are said to be low-cost alternatives to managed mutual funds.

With an index fund you receive dividends that you can reinvest to buy more shares. And since index

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funds to not ordinarily buy and sell stocks, your tax liability is zero or nearly zero each year.

Some popular index funds and what they track include: Vanguard Total Stock Market Index Fund tracks the largest 5,000 companies, Schwab 1000 Investor tracks the largest 1,000 companies, TIAA-CREF Equity Index tracks the largest 3,000 companies and the Fidelity Nasdaq Composite Index Fund tracks the 3,159 companies listed on the Nasdaq stock exchange.

What is and Exchange-Traded Fund?

ETFs trade like stocks

An exchange-traded fund (ETF) is a pre-packaged group of stocks that you buy and sell through a broker. ETFs are similar to index mutual funds in that both track an index and offer diversification at a low cost. But ETFs have many characteristics of individual stocks. For example, you can buy and sell an ETF at its current market price anytime during a trading session of a major stock

exchange. Like stocks you pay a commission to your broker to buy and sell an ETF. With some ETFs you can reinvest dividends.

Because ETFs are not managed, they have very low service fees. But if you are a buy-and-hold investor, buy an index fund to avoid the commissions required to buy an equivalent EFT. The fees for the index fund are less than the commissions and fees you'll pay for the ETF.

Popular ETFs

ETFs come in all varieties

ETFs track broad U.S. and international markets, specialized industry sectors and even gold. Four popular U.S. market ETFs and what indices they track are: SPDRs, or Standard & Poors' Depository Receipts (SPY) track the S&P 500, Diamonds Trust Series (DIA) track the Dow Jones Industrial Average, QUBEs (QQQQ) track the Nasdaq-100 index and MidCap Spider (MDY) tracks the S&P MidCap 400, a group of mid-size stocks that offer good growth opportunities. None of these ETFs are managed so they have very low service fees.

iShares from Barclays track major U.S. indices, some industry sectors and over twenty foreign countries. For example, iShares MSCI Australian Index (EWA) includes Australian stocks that make up the Morgan Stanley index for Australia. Like any exchange-traded fund, single-country ETFs have very low annual expenses. The iShares FTSE/Xinhua China 25 Index Fund (FXI) mirrors the FTSE/Xinhua China 25 Index that contains the 25 biggest and most liquid publicly-traded companies in the People's Republic. iShares MSCI EAFE Index Fund (EFA), one of the most popular ETFs, tracks Europe and Asia markets.

PowerShares Capital Management offers a variety of industry exchange-traded funds (ETFs). These low-cost funds let you own diversified portfolios of stocks in the following sectors: biotech, energy, media, retail, semiconductors, software, utilities and more.

Then there are SPDRs (Spiders), Vipers, HOLDERS, streeTracks and BLDRS. These ETFs with funny sounding names are composed of groups of stocks from foreign countries, different market indices and about every industry sector imaginable. Some of the categories are: emerging markets, large companies, small companies, growth stocks, consumer staples, financial, healthcare, technology, telecommunications and many more.

For comprehension lists of exchange-traded funds see etfinvestor.com and etfconnect.com.

“ETFs let you own every type of stock imaginable – domestic and international.”

Buying and Selling Index Funds and ETFs

Own Funds with Low Fees

You can buy index funds from mutual fund companies like the Vanguard Group, Fidelity Investments or T. Rowe Price. Also some index funds are available through full-service and online brokers. Index funds are meant for buy-and-hold investors because most mutual fund companies do not let you frequently trade their funds. If you plan to frequently trade funds, buy exchange-traded funds instead.

Many mutual fund companies offer index funds that track major market indices like the S&P 500. Before you decide which index fund to buy compare their annual fees and select the index fund with the lowest fee. Since the holdings of all S&P 500 index funds are the same, the lowest cost fund will perform the best.

You can buy ETFs from a full-service or online broker. You'll pay a commission each time that you buy or sell an ETF. If you're concerned about the amount of your commissions, negotiate them with your broker or pick a lower-cost online broker.

About the Author

Richard Howard maintains *buyupside.com*, a free site for individual investors. He has written numerous articles about investing and he is the co-author of *Buy on the Upside*, a book which discusses the principles of investing. It is available from major Internet book sellers.

"Buy and hold an index fund."

"Buy and sell an ETF like a stock."

More Information

For more information about investing see *buyupside.com* and other *buyupside.com* investing guides:

- *Beginner's Guide to Investing in Stocks*
- *Beginner's Guide for Young Investors*
- *Beginner's Guide to Dividend and Dividend Reinvestment*
- *Beginner's Guide to Retirement Investing*