INDEX FUNDS

An "index fund" is a type of mutual fund or exchange-traded fund that seeks to track the returns of a market index. The S&P 500 Index, the Russell 2000 Index, and the Wilshire 5000 Total Market Index are just a few examples of market indexes that index funds may seek to track. A market index measures the performance of a "basket" of securities (like stocks or bonds), which is meant to represent a sector of a stock market, or of an economy. You cannot invest directly in a market index, but because index funds track a market index they provide an indirect investment option.

What Is In An Index Fund?

Index funds may take different approaches to track a market index: some invest in all of the securities included in a market index, while others invest in only a sample of the securities included in a market index.
Market indexes often use a company's market capitalization to decide how much weight that security will have in the index. Market capitalization (or "market cap") is a measure of the total value of the company's shares. The total value is equal to the share price times the number of shares outstanding. In a market-cap-weighted index, securities with a higher market capitalization value account for a greater share of the overall value of the index. Some market indexes, such as the Dow Jones Industrial Average, are "price-weighted." In this case, the price per share will determine the weight of a security. Some index funds may also use derivatives (like options or futures) to help achieve their investment objective.

How Do Index Funds Invest?

Index funds have generally followed a passive, rather than active, style of investing. This means they aim to maximize returns over the long run by not buying and selling securities very often. In contrast, an actively managed fund often seeks to outperform a market (usually measured by some kind of index) by doing more frequent purchases and sales.

What Are The Costs Associated With Index Funds?

Because index funds generally use a passive investing strategy, they may be able to save costs. For example, managers of an index fund are not actively picking securities, so they do not need the services of research analysts and others that help pick securities. This reduction in the cost of fund management could mean lower overall costs to shareholders. ***However, keep in mind that not all index funds have lower costs than actively managed funds. Always be sure you understand the actual cost of any fund before investing.***

Fees and expenses reduce the value of your investment return. If the holdings of two funds have identical performance, the fund with the lower cost generally will generate higher returns for you. For more information, see our Updated Investor Bulletin: How Fees and Expenses Affect Your Investment Portfolio.

What Are Some Risks Of Index Funds?

Like any investment, index funds involve risk. An index fund will be subject to the same general risks as the securities in the index it tracks. The fund may also be subject to certain other risks, such as:

- ***Lack of Flexibility.*** **An index fund may have less flexibility than a non-index fund to react to price declines in the securities in the index.**
- ***Tracking Error.*** **An index fund may not perfectly track its index. For example, a fund may only invest in a sampling of the securities in the market index, in which case the fund's performance may be less likely to match the index.**
- ***Underperformance.*** **An index fund may underperform its index because of fees and expenses, trading costs, and tracking error.**

Before You Invest

Before investing in any fund, you should carefully read all of the fund's available information. This includes the fund's prospectus and most recent shareholder report. In addition, funds disclose their portfolio holdings quarterly in Form N-Q and shareholder reports. You can typically get this information from the fund's website or your financial professional, as well as on EDGAR.
Asking the following questions might help:

1. **What fees and expenses can I expect to pay for buying, owning, and selling this fund?**
2. **What specific risks are associated with this fund?**
3. **How is the makeup of the fund's index determined?**
4. **How does the fund's investment strategy fit with my investment goals?**