Index Funds Essay, Research Paper

With the growing popularity of index funds, one might be confused as whether to choose index funds or to use traditional money managers. If you are looking for an investment with low risk and a long term return that follows the market, then index funds is the choice for you. In fact, most private investors are better off investing in index funds. Try as one might, odds are against beating the market.

Why then should one trust the fluctuating market over someone whose job is to beat the market? A look at a few statistical numbers show that few money managers are able to beat the market. Overwhelmingly, index funds make more money for investors over a term of a few years. There are a few reasons for this phenomenon. First of all, index funds is low risk because of its broad range of stocks. The diversification of stocks balances off the risk of one company with another. Logically, this is much lower risk than investing in just one type of stock. There are two types of risks. One is the market risk, which is the risk that the entire market crashes. This risk is mostly unavoidable by both the index funds and money managers. Another is a risk involved with the successes and failures of one particular stock. With this risk, index funds are better buffered against the regression of one stock since its portfolio is diversified and balanced.

Some are not satisfied with just matching the market. Experts say though, that maybe the best that they can do. The market is so sophisticated that any information will be immediately reflected with the price of the stocks. Thus managers have little advantage unless they conduct insider’s trading.

The index funds are not only low risk; it is also low cost. Its cost advantage over money managers has several factors. One of them is that index funds do not need high managers’ fees. In fact, managers’ fees are as much as seven times what most big index funds charge to invest your money. An actively managed fund trades frequently, thus has capital gains much more often than index funds thus biting into the profits that the managed funds had made. Since index funds trade less, it incurs fewer taxable gains distribution. With index funds, it only adjusts the allocation of money, thus much less expensive. Aside from this, index funds needs little to no research and advertising.

All these advantages are not to say that index funds do not have its rough edges. Some say that index funds rode on the bull market in the past few years, but when the bear market rolls around, index funds will drop like flies. Yet, even when the market goes down, it is still better to invest money in index funds over managed funds simply because of the cost advantages. Even if managed funds are more profitable than index funds; capital gains taxes and manager’s commissions would eat up the gains.

There is a concern that is everyone buys index funds, stocks in the S&P 500 will be overpriced. In spite of the rising popularity of index funds, its impact is still negligible since it comprises only 9% of all equity mutual funds. The value of stock is determined by a particular company’s cash flow divided by the number of shares of stocks available. If values of some stocks are overvalued, the market will readjust the price accordingly, much like what has happened in the past week with the plunge of Internet stocks, after a Microsoft executive said he believes that technology stocks are overvalued.

Thus private investors are much better off with index funds instead of a money manager on a long-term basis. Logically, people’s age is inversely proportional to the amount of risk they want to take. With baby boomers going into retirement in the next century, the popularity of index funds will only rise not fall.