

Index Funds and Exchange Traded Funds (ETFs)

Investors several times wonder what could be the best stock or the best fund to buy. They like the idea of investing in equity as they get to hear how the market index like the Nifty has been going up or down, but cannot make up their mind on which stock or fund to buy. They can then simply buy the index. An index fund is a product that helps investors to do just that. Using an index fund investors can stay invested in say, the top 50 stocks of the Nifty and earn the return associated with such a portfolio.

Replicating the index

Passively managed portfolios such as those of an index fund invest only in the stocks that form the index that the fund is tracking. The proportion of each of these stocks in the portfolio is also maintained at the same weight that the stock has in the index. This enables the fund to generate returns that closely track the returns of the index. The fund manager does not make any stock picking or timing decisions for the portfolio. The securities in the portfolio change only when there is a change in the shares that constitute the index. All market indices are periodically reviewed and recast periodically. By replicating an index, an index fund gives the investors the exposure to these index stocks.

Exchange Traded Fund (ETF)

A variation to a passive index fund is an exchange traded fund (ETF). It has all the operational features of an equity fund, but a different structure. Investors can first buy units of the ETF at the time the fund is launched. The ETF is then listed and traded on a stock exchange like any other stock. Investors can buy and sell units from the stock exchange through brokers. There is no need to fill up an application form or receive an account statement. ETFs are bought like shares and credited to a demat account. To do so they need to have a broking account and a demat account. The price of the ETF is close to the value of an underlying index, which could be an equity index or a commodity like gold.

Gold ETF

An investor who likes to invest in gold need not buy and hold the precious metal. Such a strategy will involve storage costs. Investors may also find that they are not able to sell the gold coins and bars that they have acquired, at fair prices. If acquired in the form of jewellery, buying and selling gold involves making charges and other costs. Instead, an investor can buy gold ETFs. Each ETF represents one gram of gold and is available at the current market price of gold. Whenever the investor needs to buy actual gold for consumption, the ETFs can be sold at the then prevailing prices, and used to buy physical gold in the markets. Gold ETFs are an excellent way for parents to accumulate gold for the wedding of their children.

ETF vs Index Funds

Unlike units of an index fund where transactions happen based on the NAV at the end of the day, units of the ETF are bought and sold at real-time basis, at prices which are determined by the demand and supply of the units with the NAV of the fund as the underlying value. This allows investors to act on information immediately without having to wait for the price at the end of the day. ETFs also feature lower costs on the investor in terms of expenses and loads. Passive strategies like indexing enable a fund to reduce the costs of fund management. These are passed on to the investor in the form of lower costs. ETFs and index funds offer simple low-cost options to investors who like to participate passively in a market.

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