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How to Invest in Index Funds

Dan Caplinger | Updated: Oct. 2, 2020, 2:41 p.m.

An index fund is an investment that tracks a market index, typically made up of stocks or bonds. Index funds typically invest in all the components that are included in the index they track, and they have fund managers whose job it is to make sure that the index fund performs the same as the index does.

Your 3-step process to investing in index funds

1. **Pick the index** that you want to track.
2. **Choose a fund** that tracks your selected index.
3. **Buy shares** of that index fund.

1. Pick an index

There are hundreds of different indexes you can track using index funds. The most popular index is the S&P 500 Index, which includes 500 of the top companies in the U.S. stock market. Here's a short list of some additional top indexes, broken down by what part of the market they cover:

- *Large U.S. stocks:* S&P 500, Dow Jones Industrial Average, Nasdaq Composite
- *Small U.S. stocks:* Russell 2000, S&P SmallCap 600

- *International stocks:* MSCI EAFE, MSCI Emerging Markets
- *Bonds:* Bloomberg Barclays Global Aggregate Bond

In addition to these broad indexes, you can find sector indexes that are tied to specific industries, country indexes that target stocks in single nations, style indexes that emphasize fast-growing companies or value-priced stocks, and other indexes that limit their investments based on their own filtering systems.

2. Choose the right fund for your index

Once you've chosen an index, you can generally find at least one index fund that tracks it. For popular indexes like the S&P 500, you might have a dozen or more choices all tracking the same index.

If you have more than one index fund option for your chosen index, you'll want to ask some basic questions. First, which index fund most closely tracks the performance of the index? Second, which index fund has the lowest costs? Third, are there any limitations or restrictions on an index fund that prevent you from investing in it? And finally, does the fund provider have other index funds that you're also interested in using? The answers to those questions should make it easier to pick the right index fund for you.

3. Buy index fund shares

To buy shares in your chosen index fund, you can typically open an account directly with the mutual fund company that offers the fund. Alternatively, you can open a brokerage account with a broker that allows you to buy and sell shares of the index fund you're interested in.

Again, in deciding which way is best for you to buy shares of your index fund, it pays to look at costs and features. Some brokers charge extra for their customers to buy index fund shares, making it cheaper to go directly through the index fund company to open a fund account. Yet many investors prefer to have all their investments held in a single brokerage account. If you anticipate investing in several different index funds offered by different fund managers, then the brokerage option can be your best way to combine all your investments under a single account.

Image source: Getty Images

Why invest in index funds?

Investing in index funds is one of the easiest and most effective ways for investors to build wealth. By simply matching the impressive performance of the financial markets over time, index funds can turn your investment into a huge nest egg in the long run -- and best of all, you don't have to become a stock market expert to do it.

Investors find index funds especially useful for many reasons:

- ***Minimize your time spent*** researching individual stocks. Instead, you can rely on the fund's portfolio manager to invest in an index that already includes stocks you want to invest in.

- You can ***invest with less risk***. Most indexes include dozens or even hundreds of stocks and other investments, and the diversification leaves you less likely to suffer big losses if something bad happens to one or two companies in the index.
- Index funds are available for ***a wide variety of investments***. You can buy stock index funds and bond index funds, which cover the two big parts of most people's investment strategies. But you can also buy more focused index funds that drill down into certain parts of the financial markets.
- It's a lot ***less expensive***. Index funds are usually far less costly than alternatives like actively managed funds. That's because an index fund manager just has to buy the stocks or other investments in an index -- you don't have to pay them to try to come up with stock picks of their own.
- You'll ***pay less in taxes***. Index funds are quite tax-efficient compared with many other investments. For instance, index funds don't have to do as much buying and selling of their holdings as actively managed funds, and so index funds avoid generating capital gains that can add to your tax bill.
- It's a lot easier to stick with your investing plan. When you use index funds, you can ***automatically invest*** month after month and ignore short-term ups and downs, confident that you'll share in the long-term growth of the market.

Why *not* invest in index funds?

As simple and easy as index funds are, they're not for everyone. Some of the downsides of investing in index funds include the following:

- You'll never beat the market. Index funds are designed solely to *match* the market's performance, so if you want to prove your mettle as a superior investor, index funds won't give you that chance.
- You don't have any loss protection. Index funds track their markets in good times and bad, and when the market plunges, your index fund will plunge as well.
- You won't always own stocks you like. Depending on the index you choose, you can end up owning some stocks you'd rather not own, while missing out on others you'd prefer.

To address some of these shortcomings, you can always keep a mix of index funds and other investments to give you greater flexibility. If you plan on solely using index funds, however, you'll have to get comfortable with their limitations. For more on your other investment options: How to Invest Your Money

Other Investment Options

Stocks

Owning shares of individual companies can be especially rewarding, but you'll need to do some research.

Exchange Traded Funds

ETFs are collections of stocks that trade just like a stock, bought and sold throughout the day with fluctuating prices.

Mutual Funds

Mutual funds are also collections of stocks, and they can be actively or passively managed.

managed.

4 index funds to get you started

If you're looking for some index fund ideas to help you invest better, the following four are a good place to start.

- **Vanguard 500 Index** (NasdaqMutFund:VFIAX): Tracks S&P 500 index; $4 annual cost for a $10,000 investment
- **Vanguard Total Stock Market** (NasdaqMutFund:VTSAX): Tracks index of U.S. stocks of all sizes; $4 annual cost for a $10,000 investment
- **Vanguard Total International Stock Market** (NasdaqMutFund:VTIAX): Tracks index of global stocks, excluding the U.S.; $11 annual cost for $10,000 investment
- **Vanguard Total Bond** (NasdaqMutFund:VBTLX): Tracks index of various bonds; $5 annual cost for a $10,000 investment

Source: Vanguard Group

Vanguard funds are widely regarded as an easy entry point for new index fund investors, but you can find similar funds from other providers, as well. By incorporating different broad categories of stocks along with a fund concentrating on bonds, these four funds let you invest using asset allocation strategies to help you manage risk while getting as good a return as possible.

Let index funds help you get rich

Index funds offer investors of all skill levels a simple, successful way to invest. If you're interested in growing your money but aren't excited about doing a lot of research, then index funds can be a great solution to achieve your financial goals.

Dan Caplinger has no position in any of the stocks mentioned. The Motley Fool has no position in any of the stocks mentioned. The Motley Fool has a disclosure policy.

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