Index trading explained: How to trade indices

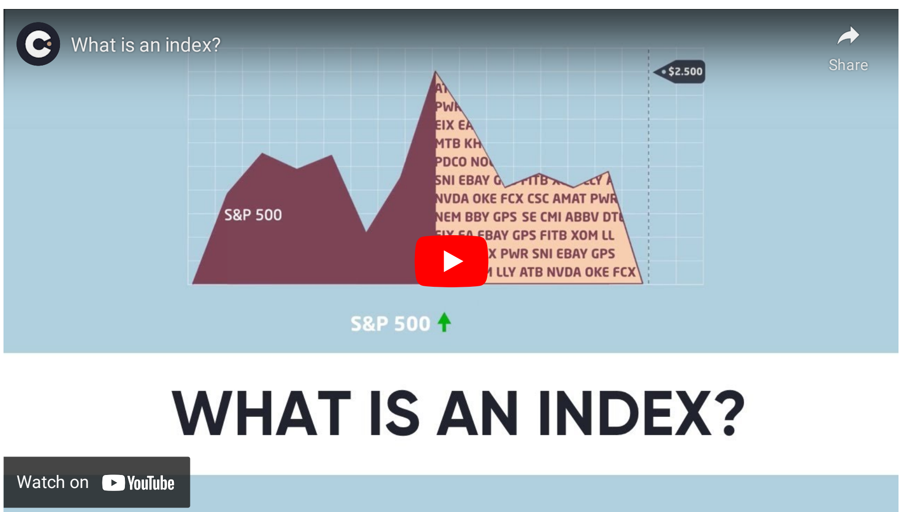
Learn more about indices, from what they are, how they're calculated and what drives prices to different indices trading strategies and instruments available. Continue reading to find out how to trade indices via CFDs on Capital.com.

Content

Illustration of the financial stock market chart, business investment concept and future stock trading. Photo: whiteMocca / Shutterstock.com

Index trading is the buying and selling of financial instruments that are linked to stock market indices that track the performance of groups of assets based on certain characteristics such as industry, sector, country or growth rate.

What is index trading?



What are indices in trading?

Index trading is a popular way for traders to gain exposure to financial markets without having to invest in individual company stocks, bonds, commodities or other assets directly.

Those who are new to financial markets often start with index trading, meaning they trade an index-tracking fund or a basket of shares, instead of buying and selling individual company stocks.

By tracking the performance of a large group of shares, a stock index aims to reflect the state of a broader market, for example, the stock market of a country or a specific sector. This means that indices tend to be diversified.

Every one of the world's major financial markets has at least one stock index to represent it. For example, the S&P 500 (US500) is an index of the 500 largest companies in the US. As these benchmark indices often reflect the performance of the overall stock market, movement in the benchmark's value indicates the health of the economy or industry sector it tracks.

Another benchmark index, the Euronext 100 (N100) tracks the performance of the largest stocks on Europe's Euronext exchange, comprising companies listed in the Netherlands, France, Belgium, Portugal and Luxembourg. Other major indices include the UK's FTSE 100 (UK100), Germany's DAX 40 (DE40), Hong Kong's Hang Seng (HK50) and Japan's Nikkei 225 (J225).

Equity indices provide benchmarks for fund managers to measure their actively-managed fund performance against. Fund providers also create passive index-linked funds, associated derivatives are also available for

Most traded

US100	US Tech 100 ...	13538.3	-0.230%
US30	US Wall Stre...	33707	-0.170%
DE40	Germany 40 ...	13852.9	-0.210%
US500	US 500 (S&P)	4272.7	-0.210%
J225	Japan 225	28768	-0.130%

investors to buy and sell.

Passive funds, also known as tracker funds, hold stocks in the same proportion as the index to match its performance. Active funds are managed by fund managers, who aim to outperform the index. Fund managers charge an annual fee as a percentage of the fund's value.

Exchange-traded funds (ETFs) are an increasingly popular way for investors to get started with stock indices trading. ETF fund managers, such as Vanguard, charge relatively lower fees, allowing investors to keep more of their returns.

As they are traded on exchanges, the price of these funds fluctuates throughout the trading session, unlike a mutual fund for which the price is settled once daily. ETFs can be bought and sold quickly and easily through stock trading platforms.

Dividends paid on the company stocks in an index-tracking fund can be distributed to investors, known as a distribution fund, or reinvested back into the fund, known as accumulation fund.

How are stock market indices calculated?

The first trading indices were calculated as simple averages. The share prices of all the constituents were totalled and divided by the number of companies. However, today some major indices such as the Nasdaq 100 (US100) and the Hang Seng are weighted averages.

Stock indices are calculated in different ways based on the types of companies they track and the goals of the index. Some index calculations give more weight to stocks with higher prices, while others base the weighting on market capitalisation, and others weigh all constituent stocks equally. The two major formulas used to calculate the value of a weighted index are price weighted and market cap weighted.

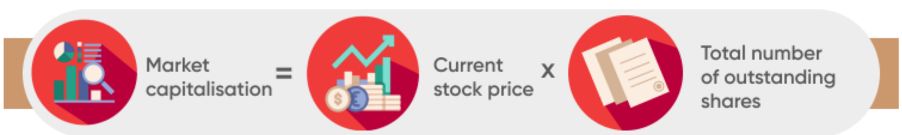
- **Price weighted**

In price-weighted indices, the stocks are weighted in proportion to their share price rather than the size of the company. This means that companies with the highest share prices have a stronger impact on the value of the index.

Price-weighted indices are less common than those based on market cap. The Dow Jones Industrial Average (US30) in the US and Nikkei 225 are both price-weighted indices.

- **Market capitalisation-weighted**

A market capitalisation weighted index uses the value of its constituent companies to rank them. Market cap is calculated by multiplying a company's stock price by the number of outstanding shares. Companies with the largest market capitalisation will have the highest influence over the index's value.



The market cap of each company is calculated based on free float shares publicly available for trading. A company's free float market cap is lower than its total market cap, as it excludes shares held by company insiders. The FTSE 100 and DAX 40 are examples of market-value-weighted indices.

- **Unweighted**

An unweighted, or equal weight index gives the same weight to each of its constituent companies. This limits the influence that one stock can have on the overall performance of the index, reducing volatility while also dampening the effect of a sharp rally in a particular stock.

The S&P 500 Equal Weight Index (EWI) is an equal-weight version of the S&P 500 that offers an alternative for traders looking into trading indices with more price stability.

How are indices compiled?

Indices are managed by committees, which set the criteria that company stocks must meet to be eligible for inclusion.

These committees meet regularly to review the index rules and decide whether to add or remove companies. Some committees hold reviews quarterly, while others do so annually.

Committees can remove stocks that no longer meet the eligibility criteria, while others allow them to remain, or give them time to return to compliance.

Types of indices

There are many different types of stock indices catering to trader needs: global, regional, national, exchange-based, industry, currency and sentiment-based.

However, in addition to stock index trading, you can also trade commodity and bond indices.

- **Stock**

A stock index is calculated from the price of its constituent stocks. Any index lists the criteria a company must meet to qualify for inclusion.

Benchmark stock market indices are often referred to in financial news reports. They're considered indicators of business confidence, performance and economic health.

Trading indices linked to specific industries is also popular among traders. For example, the NASDAQ 100 lists the biggest non-financial companies listed on the NASDAQ stock exchange. As its composition is tech-focussed, it's often used as a barometer of the US technology sector's performance and is one of the go-to choices for stock index trading.

- **Commodity**

Indices that track commodities tend to follow spot or futures contracts representing the price of a commodity, such as crude oil, gold, silver, copper, coffee, sugar.

For example, the S&P GSCI Crude Oil Index provides investors with a benchmark while the United States Oil Fund tracks the daily price changes for West Texas Intermediate (WTI) crude oil.

There are also commodity-linked stock indices that represent stocks in companies involved in the commodity sector, such as mining companies or oil and gas producers.

The Energy Select Sector SPDR Fund (XLE) tracks the Energy Select Sector index, which is composed of large-cap US companies in the oil and gas market, as well as energy equipment firms. The VanEck Junior Gold Miners ETF (GDXJ) invests in stocks of small gold mining companies, with the MVIS Global Junior Gold Miners Index as its underlying index.

- **Bonds**

Bonds are fixed-income securities that represent a unit of debt. When investors buy bonds, they essentially lend money to the bond-issuer, with an interest charge included in repayments.

Bond indices are designed to measure the performance of certain sectors of the bond market, such as corporate bonds, government bonds and municipal bonds. The S&P 500 Bond Index, which follows corporate bond performance, is designed to be a counterpart to the S&P 500 Index in gauging market returns.

- **Currencies**

Currency-based indices aim to track the performance of the underlying currency. For example, the US Dollar Index (DXY) measures the value of greenback against a basket of other currencies. It is a leading international benchmark for the value of the US currency.

Other examples include Euro Currency Index (ECY) and British Pound Currency Index (BXY), and many more.

- **Sentiment**

Sentiment-linked indices follow a measure of sentiment in the markets, such as volatility. One of the most famous sentiment indices is the Chicago Board of Options Exchange (CBOE) Volatility Index (VIX), which measures volatility in S&P 500 index option contracts.

When VIX rises, it means that there is increased volatility in the stock market, typically associated by market fear and sell-off. When VIX is low, the equities tend to be relatively stable.

What moves the index price?

The factors shaping an index price would largely depend on what assets the index consists of.

For example, stock market index prices fluctuate based on constituent companies' share prices. For commodity indices, on the other hand, commodity prices are crucial drivers.

Economic news

Gross domestic product (GDP) data, which is announced quarterly, as well as monthly data on industrial production and consumer prices, are important drivers for the stock and FX markets. Positive economic releases in the US, for example, could boost the US dollar index higher.

Interest rates set by central banks, such as the US Federal Reserve (Fed), Bank of England (BoE) and European Central Bank (ECB), also affect the broad performance of stocks and currencies.

Expansionary monetary policy, including lower interest rates and active asset purchases, tends to drive stock market rallies triggering risk-on sentiment, whereas increased interest rates tend to weigh on stocks.

Company financial results

Companies that are publicly listed on stock exchanges are required to release their financial statements quarterly or half-yearly, depending on the exchange.

The period after the end of a quarter, when companies announce their results, is known as the earnings season. Stock index volatility tends to increase during reporting as traders react to the financial results of the companies.

Company announcements

Along with earnings reports, other announcements from companies – such as new product announcements, mergers and acquisitions (M&A), and changes in the top management – can have an impact on stock prices. This, in turn, can move a stock market index.

Changes to index composition

Some stock market indices rebalance on a regular basis to ensure all their constituent companies continue to meet the listing requirements. The S&P Dow Jones and MSCI indices are rebalanced on a quarterly or annual basis following a review by their index committees.

There may be a higher volatility around an index rebalancing event, yet those changes are typically known in advance and are likely to be priced in.

Currency movements

Currency movements affect both stock market and currency indices. Stock indices weighted towards companies that generate most of their revenues abroad can be influenced by currency exchange rates.

For example, the FTSE 100 (UK100) includes companies that have benefited from weakness in the value of the British pound (GBP) in recent years, as they received higher income when converting sales revenue in foreign currencies into pounds.

Geopolitical events

Elections and other political events can affect stock and FX market performance. US presidential elections exert an influence over markets internationally, as investors consider the impact the policies of an incoming administration are likely to have on the world's largest economy.

Russia's invasion of Ukraine has had a strong impact on markets amid Western sanctions on Russia and disrupted supply chains, driving up prices for energy and food.

Investor sentiment

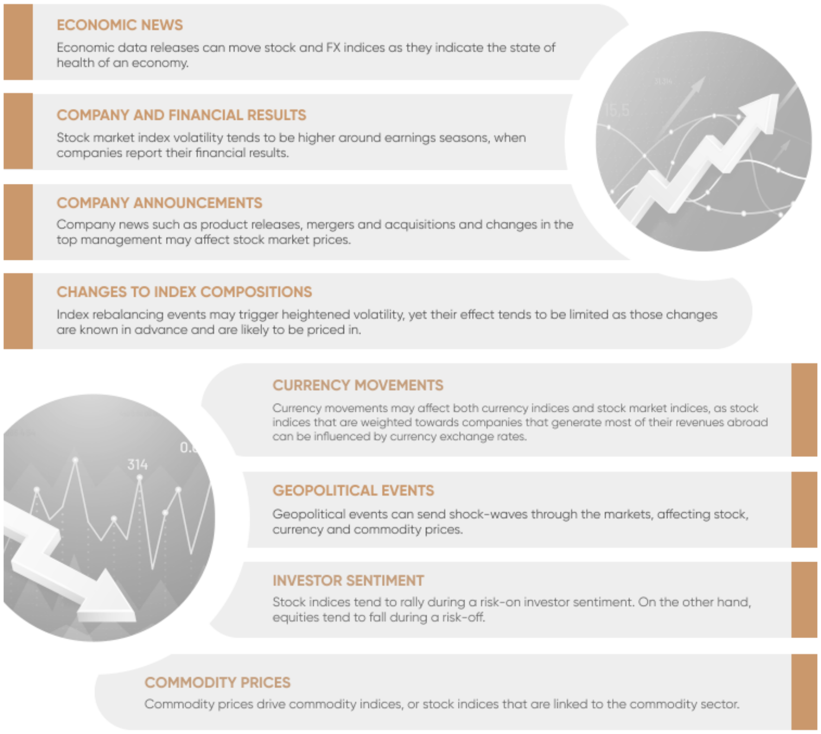
Sentiment among stock market investors has a strong impact on index values. Indices sold off across the board at the start of the Covid-19 lockdowns, as investors anticipated the collapse in demand causing a recession. They started to rebound once vaccines were trialled successfully.

In 2022, rising concerns about the potential for a new recession caused by rising interest rates and high inflation have weighed heavily on stock indices.

Commodity prices

Commodity indices are naturally driven by prices of the commodities they track, whether they measure prices directly or track companies involved in the industry, therefore having an impact on commodity-linked stock market indices too.

For example, share prices for the major oil and gas companies have climbed as crude oil prices have rallied, lifting the indices that follow their stocks.



Trading indices vs stocks and forex

Index trading gives traders exposure to a range of assets in one basket. For example, for stock indices, while some share prices fall over time, others rally. Diversification therefore can even out some parts of volatility.

Index values fluctuate each trading session, but they do not lose or gain large amounts unless there's a major change, like a market crash, a geopolitical event or a natural disaster.

Stock index trading poses a lower risk than trading individual stocks due to diversification. If you trade a company stock and the company goes bankrupt, you can lose your investment. But if one company in an index rebalances regularly, the failing stock would be replaced by the next largest company outside the index.

Depending on the size of the failed company and the performance of the other constituents, the value of the index may dip temporarily, or it may have no significant effect at all.

On the other hand, stock index trading limits the returns you may earn from a high-growth company. Individual growth stocks can outperform an index by large multiples, although they carry higher risk.

Index trading can also pose a lower risk than foreign exchange (forex) trading. In the forex markets, traders speculate on currency pairs – aiming to profit from the rise or fall in the value of one currency against another with the risk of loss if the trade moves against them.

While stock trading speculates on the value of an individual stock, forex trading speculates on the value of a currency. Note that the forex market is highly liquid and available 24 hours a day except weekends as currencies trade across time zones.

	Indices	Stocks	FX
Underlying asset	Basket of different assets such as stocks, bonds, commodities, FX	Company stocks	Currencies
Factors moving prices	Investor sentiment, economic releases, underlying asset prices, geopolitical events	Corporate earnings, company announcement, investor sentiment, geopolitical events	Economic releases, geopolitical events
Instruments available to trade or invest in	Exchange traded funds (ETFs), mutual funds, derivatives: contracts for difference, futures, options	Buying and selling underlying stocks, derivatives: contracts for difference, futures, options	Buying and selling underlying currencies, derivatives: contracts for difference, futures, options

How to trade indices

If you are interested in learning how to trade indices, there are three main ways traders could gain index exposure in their portfolios.

Cash indices

For traders looking to speculate from a short-term position, cash indices are used to trade an index intraday. Cash indices tend to have tighter spreads than futures markets and trade around the spot price, which applies fair value to the month-ahead futures price. Cash indices are subject to additional overnight charges, so traders tend to close their positions before the end of day.

Index futures and options

Trading index futures and options can be more suitable than cash products for a longer-term position, as they have wider spreads, but they still include the overnight fees. Index futures are derivative products based on the value traders expect the index to reach in the future. At expiry, you can settle the futures contract for cash, or roll it forward into the next period and continue to hold.

ETFs

One of the most popular ways of index trading is buying and selling ETFs and other index-traded funds that track the value of a specific index. ETFs invest in the index constituent assets using the same weighing. ETFs will state which index they benchmark and provide charts comparing their performance with that of the index. This makes ETFs a straightforward way for new investors to gain exposure to indices and start stock index trading. They are also more suitable for long-term index investing.

CFDs

Contracts for difference (CFDs) are another popular approach to speculate on the index value fluctuations. They are a form of a contract between a trader and a broker aimed at speculating on the price difference between when the position is opened and when it closes. Traders can open a long position if they expect prices to rise or go short if they expect prices to fall.

CFDs are leveraged products that allow you to trade on margin to maximise the returns on your position with a smaller initial capital. Note that using CFDs for stock index trading is risky, as leverage could also maximise your losses.

What is an index trading strategy?

Before you start indices trading, you should have a clear trading strategy in place.

As with any other asset, there are different index trading strategies that can help you make consistent decisions on when to open and close a position. That way, you can minimise emotional bias from decision-making and avoid panic selling or buying.

Your stock index trading strategy could incorporate both fundamental and technical analysis to give you a balanced view of the market.

Some of the technical indicators you can use include price trends or oscillators to gauge direction, momentum indicators to show the strength of a trend, trading volumes to show how high or low volumes are on a price move, and volatility to show how much a price moves over a certain period.

Here are three example strategies available when trading indices.

Trend trading

A trend-based strategy for stock index trading uses technical analysis tools to identify trends – when an index price moves in a single direction for an extended period.

Based on what the technical indicators signal, a price may be expected to continue moving in line with the current trend, or the trend may be reversing. This can potentially help you identify the best index to trade at any given time. You can then buy or sell the index accordingly.

Support and resistance trading

Technical analysis tools can also help an indices trader identify the support level likely to represent the bottom for the index price and the resistance level, where the index may have difficulty breaking through. Once you have identified support and resistance, you could set up take-profit, stop-loss and limit orders if you want to automate buying and selling the index within the trading range.

Breakout trading

By using technical analysis to identify support and resistance levels, you can also follow a breakout strategy for indices trading, which aims to speculate on the price once it breaks through resistance or support levels.

Breakouts could provide strong signals that the price may continue to trend in that direction, potentially offering traders an opportunity to go long on resistance breakouts or sell indices that have fallen through support. Based on these signals, traders can then choose the best indices to trade.

How to trade index CFDs

A CFD is a type of contract between a broker and a trader, where one party agrees to pay the other the difference in the value of an asset or security. The trader aims to speculate on the difference between the price of the asset when they open and close the trade.

Using CFDs for indices trading allows you to try to capitalise on market fluctuations in both directions, yet it also can magnify your losses. For example if you are trading FTSE 100:

Long – if you think the FTSE 100 will rise, you can take a long position.

Short – if you believe the FTSE 100 will fall, you can take a short position.

In contrast, if you buy an index fund directly, you only make a profit if the value rises, whereas if the index falls, you can lose money.

You can trade directly with your CFD broker for stock index trading rather than using an exchange or mutual fund provider.

To start trading indices CFDs follow these simple steps:

1. Create a CFD trading account.
2. Choose the underlying index you want to trade.
3. Use your trading strategy to identify potential trends.
4. Open your first trade. You may use risk-management tools such as stops and limits, as well as take-profit orders.
5. Monitor your trade using technical and fundamental analysis.
6. Close the position based on the exit point in your trading strategy.

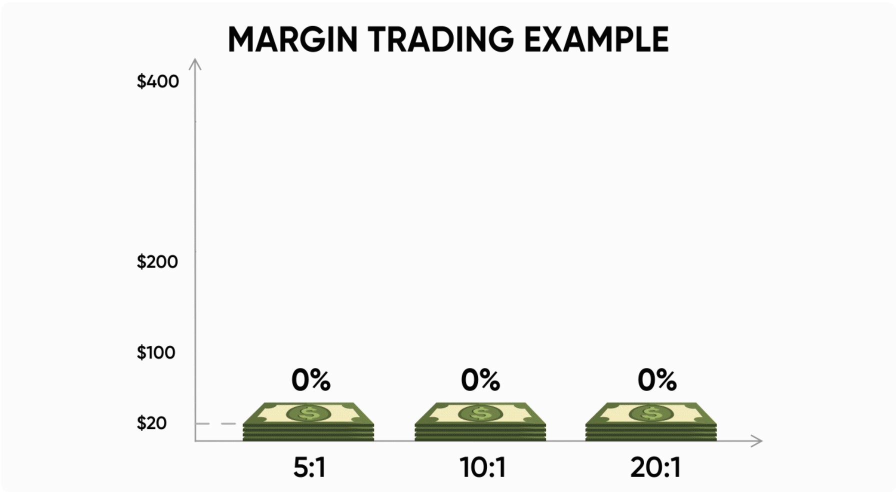
Pros and cons of trading index CFDs

Trading index CFDs allows you to gain broader exposure to the financial markets and potentially profit from price trends without owning the underlying indices. Note that the chance of making large profits goes hand in hand with the risk of large losses.

Using CFDs rather than futures or ETFs gives you the opportunity to trade in both directions. You can open a long position on an index if you are bullish on the outlook, or go short if you are bearish.

Moreover, stock index trading through CFDs is often commission-free, with brokers making profit from the spread and traders speculating on the overall change in price.

Margin trading means that traders need less funds to take larger positions. For example, the 5% index margins allowed traders to deposit only 5% of the value of the trade they want to open, and the rest is covered by the CFD provider.



However, you should be aware that using CFDs for stock index trading also carries risks as they are leveraged products that magnify the size of losses if the price moves against your position, as well as gains if the price moves in the same direction. It is important to do your own research and understand how leverage works before you start trading.

Trading tips for beginners and experienced traders

Whether you are just getting started or are an experienced trader, it's important to keep on top of market developments in order to make informed decisions in your trading.

You would benefit from staying ahead of the market by following commentary and analysis about the index and its constituents, whether they are stocks, bonds, commodities or currencies.

Follow macroeconomic data that can have an impact on the index, as well as government policy announcements, and keep an eye on major geopolitical events that can drive markets higher or lower.

You can also enhance your trading by learning how to analyse price charts by using oscillators and other technical indicators. This could help you to identify potential entry and exit points.

Why trade index CFDs with Capital.com?

Capital.com's trading platform offers several important features for trading stock market index CFDs:

Advanced AI technology at its core: A personalised news feed provides users with unique content depending on their preferences. The neural network analyses in-app behaviour and suggests videos and articles which fit your trading strategy.

Trading on margin: Providing trading on margin, Capital.com gives you access to the US100, DE40, UK100, US30, US 500, FR40, HK50, AU200, EU50 and many more indices without the need to have a large amount of funds in your account. Keep in mind that CFDs are leveraged products, which means both profits and losses can be magnified.

Trading the difference: By trading CFDs on indices, you don't buy the underlying asset. You only speculate on the rise or fall of its market value. A CFD trader can go short or long, set stop and limit losses and apply trading scenarios that align with his or her objectives. CFD trading is similar to traditional trading in terms of its associated indices trading strategies. However, CFD trading is usually short-term in nature, due to overnight charges.

All-round trading analysis: The browser-based platform allows traders to shape their own market analysis and forecasts with sleek technical indicators. Capital.com provides live market updates and various chart formats, available on desktop, iOS and Android. Follow live indices quotes within the platform, while browsing tailored news based on your trading behaviour.

Sign up at Capital.com and use our web platform or download the mobile app to trade CFDs on the go. It will take you just three minutes to open an account and view the world's most traded markets.

Indices trading hours

The trading hours for various indices depend on the time zone where the exchanges are located. Here are some of the top stock indices and their trading hours.

Index	Market open (GMT)	Market close (GMT)	Market open (ET)	Market close (ET)
US 500	14:30	21:00	09:30	16:00
US Tech 100	14:30	21:00	09:30	16:00
FTSE 100	08:00	16:30	03:00	11:30
Germany 30	08:00	16:30	03:00	11:30
France 40	08:00	16:30	03:00	11:30
Hong Kong HS50	01:15	16:59	20:15	01:59
Japan 225	00:00	06:30	18:00	01:30

At Capital.com, index CFDs are available for trading depending on the asset. You can always check the trading hours for the index you want to trade on its market page on our website or mobile platform. For example, US500 CFDs are traded around the clock on Monday to Wednesday (with a one-hour break from 21:00 to 22:00), and Thursday 00:00 - 21:00 (UTC).

FAQs

What does it mean to trade an index?

How to trade indices

What is the best time to trade indices?

How does index trading compare to stock trading?


Shares trading guide


Commodities trading guide


Forex trading guide


Cryptocurrency trading guide

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CFDs are complex instruments and come with a high risk of losing money rapidly due to leverage. **81.40% of retail investor accounts lose money when trading CFDs with this provider**. You should consider whether you understand how CFDs work and whether you can afford to take the high risk of losing your money.