

What is an index fund? What are the disadvantages?

When you invest in an index fund, the fund manager of that index fund uses your money to invest in stocks in the same proportion as the index that he is tracking.

Example -

A NIFTY Index Fund invests in stocks of companies comprising the NIFTY 50 Index in the same proportion and aims to achieve a return equivalent to the NIFTY 50 Index.

For instance, as Reliance has a 10.3% stake in the NIFTY 50 index, the fund manager of a NIFTY Index Fund will build a portfolio where the weightage of stocks of Reliance company will be 10.3%.

Similarly, stocks of other companies will be held in equal proportion to the index.

Due to this style of investment, Index Funds have some advantages. And like any other investment product, it has some limitations as well. Let's look at the disadvantages first.

Disadvantages of Index Funds

The fund manager in an Index Fund must invest in all the stocks in the same proportion as it is in the index.

So if the index has only limited stocks or one stock has higher weightage, then the portfolio might not be optimally diversified.

Besides, even as the fund managers know that a stock will fall due to certain circumstances, they cannot take any immediate action to remove that stock from their portfolio.

Advantages Of Index Fund

1. Low Fees

Index funds replicate an index; therefore, there is no need for a team of analysts for research and helping fund managers find stocks to build a portfolio. Moreover, there is no active buying and selling.

All these factors reduce the expense of managing the fund. And these low expenses translate into low fees for investors.

2. No Bias In Investing

Index funds follow an automated, rule-based investment methodology. The fund manager has a defined mandate on where the money goes and how much he/she needs to follow. This removes the human bias/discretion while taking investment decisions.

3. No Need To Find The Best Fund Manager

Given the minimal involvement of the fund manager, investors do not need to scout for the best fund managers. As an investor, this is a big relief because you do not need to check the track record of several fund managers, their investing style, etc.

Fund Name	Expense Ratio (%)	3 Year Returns (%)
<u>Nippon India Junior BeES FoF Regular Growth</u>	0.28	13.80
<u>ICICI Prudential Sensex Index Fund Growth</u>	0.29	13.80
<u>UTI Nifty Index Fund Regular Plan Growth</u>	0.31	13.70
<u>IDFC Nifty Fund Growth</u>	0.35	13.60
<u>ICICI Prudential Passive Strategy Fund(FOF) Growth</u>	0.36	13.50
<u>HDFC Index Sensex</u>	0.4	13.80
<u>HDFC Index Nifty 50</u>	0.4	13.80
<u>Nippon India Index Fund Growth</u>	0.4	13.50
<u>ICICI Prudential Nifty Index Plan Regular Growth</u>	0.4	13.50
<u>DSP Nifty 50 Index Fund Regular Growth</u>	0.41	13.40
<u>SBI Gold Fund Regular Plan Growth</u>	0.42	15.90
<u>Nippon India Gold Savings Fund Growth</u>	0.42	15.80

How to Select Best Mutual Funds with Lowest Expense Ratio

The expense ratio is an important factor to consider before shortlisting a fund for investment. Since a high expense ratio can have an impact on the net return. The expense ratio is the per-unit cost of managing a mutual fund. It is the ratio of a mutual fund's total expenses to the fund's total assets under management. When a fund's asset under management is smaller, the expense ratio will be higher. Alternatively, if a mutual fund has a high asset under management, the expense ratio will be lowest.

For example, a total expense ratio of 2.25% means that 2.25% of the fund's assets will be utilized to cover its operating expenses every year.

You can explore our article on [Mutual Fund Charges](#)

As per SEBI's guidelines, mutual fund houses can charge a certain fee to cover operational expenses such as management fees, administrative charges, marketing and distribution expenses.

Building and managing a mutual fund requires thorough and continuous research. The fund manager and his team of professionals are on the job to ensure that investors generate significant returns from their investments.

When a fund's asset under management is smaller, the expense ratio will be higher.

Alternatively, if the fund has a bigger asset under administration, the expense ratio will be lower.

Is Expense Ratio an Important Factor to Consider While Investing?

Yes, the expense ratio is one of the important factors to consider while investing in a mutual fund. To elaborate, if a fund is able to generate a 13% return, but the expense ratio is 2.25%, the net return for the investment would be 10.75%.

While a fund that generates the same returns but has a lower expense ratio of 1.5%, the net return from this fund will be 11.5%.

Thus, it is often preferable to invest in a fund with a low expense ratio to enjoy maximum returns from your investment.

A higher expense ratio indicates that the management is using higher funds to manage the mutual fund. On the contrary, a lower expense ratio indicates lower resources are used to manage the mutual fund.

Say you are investing INR 10,000 in a mutual fund. The expense ratio of the fund is 2%. You will be paying INR 200 to the fund house. This sum may appear insignificant if you are considering a short-term investment, but this amount will be compounded if you invest for the long term (10 years or more). You will notice that you could have had better results if you had invested in a fund with a lower expense ratio.

Therefore, it is important to consider the expense ratio as one of the parameters while choosing a fund to invest in.

How To Reduce Expense Ratio on Your Investment?

It is quite certain that the expense ratio will lower your returns. Thus, a lower expense ratio translates to lower expenses and higher returns. Even a 1% difference in expense ratio might significantly impact the final corpus. You have no control over how much a fund house can charge.

However, the choice of fund is definitely in your control to pick a fund with a low expense ratio. Following are the ways to lower the expense ratio on your investments:

1. Pick Funds with Low Expense Ratio

Select funds with the lowest expense ratio in that category. The information is available from both the fund and AMFI. While shortlisting funds belonging to a category, give some weightage to the expense ratio as well. In other words, say you have shortlisted 2 funds belonging to one category. Both the funds perfectly align with your investment goals. Now, to choose between the two, you can pick the fund with the lowest expense ratio to maximize your returns.

2. Invest on Passive Mutual Funds

Passive investing is another way to invest in funds with the lowest expense ratio. Actively managed funds often have a higher expense ratio because the fund manager constantly churns the portfolio to generate higher returns. Therefore, passive funds such as index funds or ETFs that aim to track a benchmark index have a lower expense

ratio. These funds just try to replicate the benchmark index as closely as possible, and therefore, fund management expenses are lower.

3. Select Direct Mutual Fund Schemes

Instead of regular plans, you can choose direct plans to lower your expense ratio. This eliminates the need to pay for marketing and commissions, lowering the expense ratio. However, direct plans are suitable only for those investors who have knowledge about mutual funds and have the time to manage their investments. If you lack any of the two, it is better to invest in regular plans.

Since the right choice of funds, right entry and exit strategies suggested by an advisor will help you generate higher returns. Thus, a small percentage of expense becomes negligible in comparison to the returns you will be generating with professional advice.

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