
# Index fund: Meaning, advantages, and more

Often you must have seen this among kids - the younger sibling follows the older one in everything, be it eating, clothing, or playing. Do you know there is a type of mutual fund too that believes in following rather than leading? Yes, we are talking about an index fund. Let's find out what is an index fund and what it follows.

**What is an index fund?**

Index funds are like those younger siblings who replicate someone. They track and mirror the performance of a particular index such as Nifty and Sensex. Such funds aim to generate similar returns as the benchmark index rather than trying to outperform it. These funds invest a minimum of 95% in the companies listed under the underlying index without changing their composition. For example, if a particular index fund is tracking the Nifty 50 index, then it will have the same 50 stocks that constitute the benchmark, and that too in the same proportion.

**How does an index fund work?**

Index funds follow a passive investment strategy. Unlike actively managed funds, the role of the fund manager is limited in the case of passively managed funds like index funds. This is because they do not buy and sell securities actively and only replicate what the benchmark does. They do not have the flexibility to pick stocks or decide their proportion. Because of their minimal involvement, such funds have a low expense ratio.

It is the duty of the fund manager to track the underlying index for any changes over time. Whenever the composition of the index changes, the fund manager must rebalance the portfolio to match the new composition.

**Pros and cons of index funds**

Every coin has two sides. Likewise, every investment has its pros and cons. Index funds are no different. Let's have a look at their pros and cons.

**Pros of index funds**

1. **Low cost:** These passive funds aim to replicate market performance rather than beat it. Thus, the fund management expenses are comparatively low. Transaction costs are low too because of low trading activity.

2. **Diversification:** Spreading your money across different securities is a good way of minimising investment risks. Thanks to index funds, you can invest in multiple securities by making a single investment.

3. **No human intervention:** Fund managers must follow the index. Their limited role eliminates the possibility of making faulty judgements and decisions while trading.

**Cons of index funds**

1. **No investment flexibility**

In the case of active funds, fund managers are actively involved in asset allocation decisions. They can, thus, rebalance the portfolio as per changing market conditions and capitalise on market opportunities. However, index fund managers do not have this liberty. They must invest as per the underlying index.

2. **Tracking error**

Although an index fund tries to mirror the performance of its benchmark, the returns generated by both may not be entirely similar. This difference between their returns could be due to a tracking error.

**To sum it up**

Mutual funds offer enough variety and flexibility. You not only get to choose from different asset classes but also get to choose between active and passive funds. An index fund is one such passive fund that tries to align its returns with the returns of the index it tracks.