What is a Low-cost Index Fund? Meaning, Returns and Taxation

Planning a trip often comes with questions. Is the tour worth the price? Will you be guided or left to explore alone? Similar concerns are likely to arise when you think about investing your money. You may wonder about the costs and if you need to manage everything yourself. If these worries bother you, a low-cost index fund might be the perfect solution. Let's explore what these funds are and how they can simplify your investment journey.

What is an index fund?

Index funds are mutual funds that work passively. They mimic a benchmark index and invest in the same securities as that index. According to the rules of the Securities and Exchange Board of India (SEBI), a mutual fund scheme must invest at least 95% of its funds in the securities of a specific index to qualify as an index fund.
Now that you know how index funds operate, let's jump onto low-cost index funds.

What is a low-cost index fund?

Low-cost index funds are characterised by their low expense ratios. This makes them a cost-effective investment option. Actively managed funds, like active equity funds, may require extensive research and analysis to select different securities. In contrast, low-cost index funds replicate a benchmark index's holdings by investing in the same proportions as the index. This allows these funds to significantly reduce the need for active decision-making and in-depth research. As a result, operational costs are minimised.

While a low-cost index fund may sound appealing to you at this point, you may want to compare it with some other options.

Low-cost index funds vs. ETFs vs. other mutual funds

Points of difference	Low-cost index funds	Exchange-Traded Funds (ETFs)	Mutual funds
Basic structure	Low-cost index funds replicate a specific benchmark index and invest in the same securities in similar proportions as the index. They follow a passive investment strategy and aim to replicate the performance of the concerned index.	ETFs are a basket of securities that are traded on stock exchanges, similar to stocks. They can track various assets, including indices, commodities, or bonds. ETFs are passively managed like index funds.	Mutual funds can be categorised into many categories, like debt funds, hybrid funds, and equity funds. Mutual funds may follow active or passive management strategies.

Investing process	You can invest in index funds online through an Asset Management Company (AMC) or an online broker. You can also invest offline by filling out an application form and submitting it to the AMC. Index funds allow investments through a Systematic Investment Plan (SIP) or in a lump sum.	ETFs can be bought and sold on stock exchanges like stocks. You can buy and sell them anytime during the trading day.	Mutual fund schemes follow the same investment process as index funds.
Cost efficiency	Index funds generally have lower expense ratios due to their passive approach.	ETFs also follow passive investment strategies and offer relatively lower expense ratios.	The expense ratios for mutual funds can differ based on their types. For instance, actively managed equity funds may have higher expense ratios than others.

Things to consider when buying an index fund

1. **Taxation:** Index funds are subject to the same taxation rules as mutual funds. Any gains made from investments in index funds are treated as capital gains. However, the rules can differ for equity and debt index funds.
    - **Index funds tracking equity indices:** If you redeem your investments within one year of purchase, the gains are considered short-term gains and are taxed at a rate of 15%. However, if you redeem your investments after holding them for more than one year, the gains are considered long-term gains. For long-term gains of up to Rs 1 lakh in a financial year, there is no tax implication. But long-term gains exceeding the limit of Rs 1 lakh in a financial year are taxed at a rate of 10%.
    - **Index funds tracking debt indices:** If a debt index fund allocates 35% or less of its assets in equities, the gains are added to your taxable income and taxed according to the slab rates.. However, if the fund allocates more than 35% but less than 65% in equities, the profits are considered long-term capital gains and are taxed at 20% with the benefit of indexation. This means the purchase price is adjusted for inflation.
2. **Tracking error:** Tracking error indicates how closely the fund's performance follows the underlying index. A fund with a lower tracking error suggests the fund closely mirrors the index and can replicate the index's performance more accurately.
3. **Expense ratio:** Choosing a fund with low expense ratios can potentially maximise your gains by ensuring that you save on fees.

To sum it up

Low-cost index funds mirror benchmark indices and offer a cost-effective, passive solution to investing. However, index funds also carry common risks associated with all mutual funds. Therefore, make sure to understand your goals and research well.