Why should you invest in index mutual funds

There are many people who have discovered that often the returns that they make on their investments are less than the returns generated by the market. This means that while market returns can be fairly good over the long-term, at an individual level you might not be making the same returns. Selecting the right investments, holding on to them through the ups and downs of the market, and the constant buying and selling can have a big impact on your portfolio returns. However, there is a simple solution for this – index mutual funds.

What are index mutual funds?

In index mutual funds, the fund manager will construct a portfolio of stocks that exactly mirrors the index (Nifty or Sensex or any other benchmark index) in the same proportion. The fund manager does not use his or her discretion in stock selection. Because these are passively managed funds, the portfolio manager ensures that the index funds' composition remains consistent with the securities in the underlying index. These funds invest at least 95% of their total assets in the equity and equity-related instruments of companies listed on a specific index, with no change in composition. Thus, in simple words, an index mutual fund is an open-ended scheme that invests the majority of its investible corpus in underlying securities that comprise a benchmark, such as the NIFTY 50 or the SENSEX 100.

Reasons to invest in index funds

Index mutual funds can potentially add a great deal of value to your investment portfolio and help you achieve your long-term goals. Some of the primary benefits of investing in index mutual funds include:

1. Diversification: The most obvious advantage of investing in index funds is that your portfolio is instantly diversified, reducing the possibility of losing all of your money. By diversifying your portfolio across so many companies, you ensure that the value of your portfolio is not overly correlated with the fortunes of any one company listed in the index.

2. Lower transaction costs: Another significant advantage of investing in index funds is that the costs, including taxes and management fees, may be lower than for other types of investment funds. The first cost to consider is the management fee that each fund manager receives each year. The expense ratio of the fund determines the amount of the fee, which varies depending on the value of your holdings. Actively managed mutual funds typically have expense ratios between 1% and 2%. The majority of that fee is used to pay portfolio managers to make buy-and-sell decisions in order to outperform the overall market.

3. Lower expense ratios: Index mutual funds are managed in a passive manner. The index fund's holdings rarely change because they simply track an index by purchasing and holding all of the stocks in that index. The expense ratio is low because the index fund manager is not required to actively try and beat the market. The expense ratios for index funds typically range between 0.05% and 0.07%, with some index funds having expense ratios as low as 0%.

4. Risk mitigation: Individual companies outperform and underperform the market, but the overall stock market gains value over time. As a result, index funds generally provide high returns at a low cost, making them an excellent value for any investor. In the case of index funds, risks become more limited and transparent. The Nifty and Sensex are already well tracked, and taking a macro view based on historical data is much easier than picking individual stocks. The universe is less difficult to track and estimate.

You must ensure that you have a long-term investment horizon before investing in index mutual funds. To allow an equity linked scheme, such as an index fund, to perform to its full potential, you should stay invested for the long term. Short-term investing in equity-oriented index funds may not be optimal because equity investments are constantly affected by market fluctuations and may even produce negative returns in the short run. Because index funds are more likely to outperform in the long run, you can use index funds to target your long-term financial goals. If you want to build wealth, index funds can give your portfolio a much-needed boost. Index funds may even be considered for goals such as retirement planning. Index funds are well-known for having a favourable risk-return trade-off making them an ideal investment choice for both first time as well as seasoned investors.

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Mutual Fund investments are subject to market risks, read all scheme related documents carefully.