L5 – Chapter 1 Index and ETFs

Your goals and time horizon

Consider what goal you are wanting to achieve by investing and your time horizon, the length of time you have to invest before reaching that goal. If the time horizon to your goal is short, investing might not be the best solution for you.

Risk tolerance and diversification

All investments have some level of risk and the market is volatile, it moves up and down over time. It's important for you to understand your personal risk tolerance. This means gauging how comfortable you are with risk or how much volatility you can handle.

When investing, a good rule of thumb is not to put all of your eggs in one basket. Instead, diversify. By spreading your dollars across various investments, you can reduce investment risk. This is why the investments we are discussing today use mutual funds or exchange-traded funds for the most part, which allows investors to purchase baskets of securities instead of individual stocks and bonds.

Index funds

Index funds are like mutual funds on autopilot: Rather than employing a professional manager to build and maintain the fund's portfolio of investments, index funds track a market index.

A market index is a selection of investments that represent a portion of the market. For example, the S&P 500 is a market index that holds the stocks of roughly 500 of the largest companies in the U.S. An S&P 500 index fund would aim to mirror the performance of the S&P 500, buying the stocks in that index.

Because index funds take a passive approach to investing by tracking a market index rather than using professional portfolio management, they tend to carry lower expense ratios — a fee charged based on the amount you have invested — than mutual funds. But like mutual funds, investors in index funds are buying a chunk of the market in one transaction.

Index funds can have minimum investment requirements, but some brokerage firms, including Fidelity and Charles Schwab, offer a selection of index funds with no minimum. That means you can begin investing in an index fund for less than $100.

Exchange-traded funds (ETFs)

ETFs operate in many of the same ways as index funds: They typically track a market index and take a passive approach to investing. They also tend to have lower fees than mutual funds. Just like an index fund, you can buy an ETF that tracks a market index like the S&P 500.

The main difference between ETFs and index funds is that rather than carrying a minimum investment, ETFs are traded throughout the day and investors buy them for a share price, which like a stock price, can fluctuate. That share price is essentially the ETF’s investment minimum, and depending on the fund, it can range from under $100 to $300 or more.

Because ETFs are traded like a stock, brokers used to charge a commission to buy or sell them. The good news: Most brokers, including the ones on this list of the best ETF brokers, have dropped trading costs to $0 for ETFs. If you plan to regularly invest in an ETF — as many investors do, by making automatic investments each month or week — you should choose a commission-free ETF so you aren’t paying a commission each time. (Here’s some background about commissions and other investment fees.)