

What Is An Index Fund?

ONE DAY IN JULY

What is an Index?

An index is a group of companies that make up a specific market sector or asset class. One of the most well-known indexes is the S&P 500. The S&P 500 is an index made up of 500 of the largest public companies in the U.S.

What is an Index Fund?

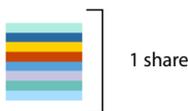
A fund that is designed to track the performance of a specific index and provide exposure to the market returns of all the different companies within that index. The fund is what you are actually purchasing shares of; the index is what you are trying to track. If you want exposure to the S&P 500 index, you might purchase shares of the Vanguard S&P 500 ETF (VOO). The goal of this fund is to match the returns of the S&P 500.

An Example: "The Color Block Index Fund"

"The Color Block Index"
(comprised of 8 companies)



"The Color Block Index Fund"
(one share of "The Color Block Index Fund" is made up of shares of each of the 8 companies in the "Color Block Index")



An index fund is made up of shares of the companies in the index that the fund tracks. However, exposure to each company is not always evenly weighted within the index. At One Day In July, we predominantly use "Market Capitalization Weighted" index funds.

Market Capitalization

Market capitalization is the total value of all outstanding shares of a company. This value is constantly changing as share prices fluctuate throughout the day.

Share Price X Number of Outstanding Shares = Market Capitalization

Market Capitalization weighting is a type of index fund construction where the weightings of companies within the fund are based on the market capitalization of each company relative to the cumulative market capitalization of the entire index.

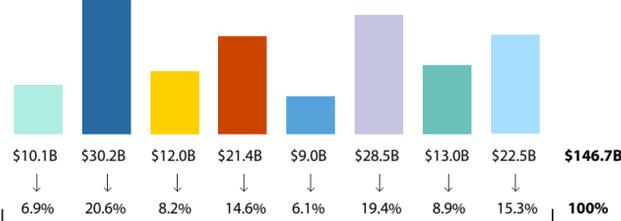
Market Capitalization Weighting in the Construction of an Index Fund

"The Color Block Index"

(comprised of 8 companies, each with a different weighting based on market capitalization)

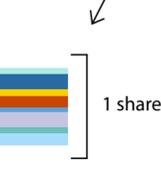
Market Capitalization (\$)

Market Capitalization (%)



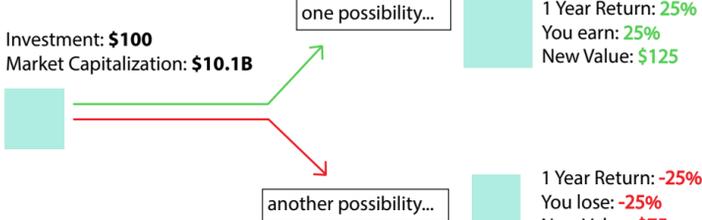
"The Color Block Index Fund"

(Each share of "The Color Block Index Fund" is made up of proportional amounts of exposure to the individual stocks of each company in the index, weighted based on market capitalization)

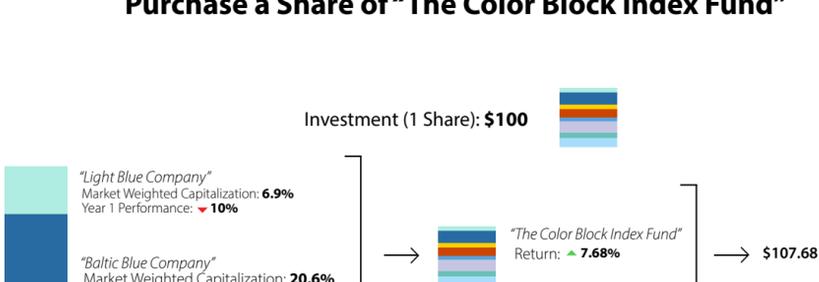


When you purchase shares of an individual company you are exposed to only that company's gains or losses. When you purchase shares of an index fund you are purchasing exposure to all of the companies in the index it tracks.

Purchase a Share of "The Light Blue Company"



Purchase a Share of "The Color Block Index Fund"



"Light Blue Company"	Market Weighted Capitalization: 6.9%	Year 1 Performance: ▼ 10%
"Baltic Blue Company"	Market Weighted Capitalization: 20.6%	Year 1 Performance: ▲ 20%
"Yellow Company"	Market Weighted Capitalization: 8.2%	Year 1 Performance: ▲ 6%
"Orange Company"	Market Weighted Capitalization: 14.6%	Year 1 Performance: ▼ 3%
"Plain Blue Company"	Market Weighted Capitalization: 6.1%	Year 1 Performance: ▲ 17%
"Purple Company"	Market Weighted Capitalization: 19.4%	Year 1 Performance: ▲ 4%
"Teal Company"	Market Weighted Capitalization: 8.9%	Year 1 Performance: ▼ 6%
"Ocean Blue Company"	Market Weighted Capitalization: 15.3%	Year 1 Performance: ▲ 19%

In this scenario, if you had only invested in "The Light Blue Company" you would have lost 10% over the year. But because you invested in "The Color Block Index Fund" your one year return is based on all of the companies in the index, not just one. Therefore you were still able to come away with a 7.68% return, even though some companies in the index had a negative return.

Studies show that any given individual stock is unlikely to outperform the index over any long period of time. In fact, based on Hendrick Bessembinder's study¹, the overwhelming majority of individual stocks did not outperform a one month U.S. Treasury bill during the years between 1926 and 2016. In other words, many investors took on the risk of the stock market and achieved returns less than those achieved from what is generally considered to be a risk-free investment.

1. Bessembinder, H. (2017, November). Do Stocks Outperform Treasury Bills? universal-instrument.com. <https://www.universal-investment.com/media/document/Do%20Stocks%20outperform%20Treasury%20Bills>.

"Index funds eliminate the risks of individual stocks, market sectors, and manager selection. Only stock market risk remains."

JOHN BOGLE

2007 | The Little Book of Common Sense Investing

ONE DAY IN JULY

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