Both index funds and actively managed funds can be a convenient way to diversify your investments.

Of these two broad types of funds, index funds have gained tremendously in popularity over the last few decades. Stock index funds, according to cnbc.com, make up almost half of all stock investing in the U.S.

Their popularity is due in part to their typically lower expense ratios, and the fact that many actively managed mutual funds struggle to perform better than passively managed index funds.

Basically, "if you can't beat 'em you might as well join 'em".

But how do you determine if index funds are right for you?

As with almost all investing the starting point should be your own goals. Your investment selection should be a result of your goals, not the other way around.

If you seek long-term growth stocks may the better choice.

If you wish to avoid sudden large account drops fixed income may be the way to go.

But before you pick e.g. a broad stock index fund tracking an index like the S&P 500 make sure you understand what may lie ahead.

In my experience, whenever a broader stock market measure like the S&P 500 tanks most index investors suddenly don't give a hoot about how little they're paying for their index fund.

Recently, S&P 500 index funds dropped 34%. If you started with $1 million you would in a matter of five weeks see your investment go down by $340,000.

Cold comfort knowing you may have saved a few hundred dollars in fund fees.

Will you keep faith in stocks and hold on to your low cost index fund if your account gets decimated?

And on the topic of index funds, one quick word on Exchange Traded Funds (ETFs). The vast majority of ETFs track a specific index. In other words, investing in ETFs likely means investing in index funds.

As the name indicates ETFs are traded all day long on an exchange. Unlike for most mutual funds you don't have to wait until after the markets close to get your price. For most investors I imagine that doesn't matter.

In the end, stock index funds can be a great way to invest. But whenever you read articles suggesting stock index funds is the way to go keep in mind you may have to suffer some horrendous drops along the way in order to enjoy potentially great long-term results.

Good luck.

Jorgen Vik, CFP® CAP®
CERTIFIED FINANCIAL PLANNER™
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Stocks are subject to market risk which means their value may fluctuate in response to general economic and market conditions, the prospects of individual companies, and industry sectors. Investments in equity securities are generally more volatile than other types of investments.

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Past performance is not a guarantee of future results.

Investments in fixed-income securities are subject to market, interest rate, credit and other risks. Bond prices fluctuate inversely to changes in interest rates. Therefore, a general rise in interest rates can result in the decline in the bond's price. Credit risk is the risk that an issuer will default on payments of interest and/or principal. This risk is heightened in lower rated bonds. If sold prior to maturity, fixed income securities are subject to market risk. All fixed income investments may be worth less than their original cost upon redemption or maturity. Bond ratings, issued by private independent ratings services, are a grade given to bonds which is designed to indicate the credit quality of the bond. Bonds rated Aaa through Baa3 by Moody's and AAA through BBB- by S&P, are typically considered to be investment grade. Investors should note that these ratings are subject to change and that an investment grade rating does not insure the bond against default or guarantee the return of principal.

There is no guarantee that dividend-paying stocks will return more than the overall stock market. Dividends are not guaranteed and are subject to change or elimination.

Asset allocation and diversification are investment methods used to help manage risk. They do not guarantee investment returns or eliminate risk of loss including in a declining market.

Exchange-Traded Funds are subject to risks similar to those of stocks. Investment returns may fluctuate and are subject to market volatility, so that an investor's shares, when redeemed, or sold, may be worth more or less than their original cost. Exchange Traded funds may yield investment results that, before expenses, generally correspond to the price and yield of a particular index. There is no assurance that the price and yield performance of the index can be fully matched.

S&P 500 Index: The S&P 500 Index consists of 500 stocks chosen for market size, liquidity, and industry group representation. It is a market value weighted index with each stock's weight in the Index proportionate to its market value.

Dow Jones Industrial Average: The Dow Jones Industrial Average is a price-weighted index of 30 "blue-chip" industrial U.S. stocks.

This information is hypothetical. It is not intended to represent any specific return, yield or investment. It is provided for illustrative purposes only and does not constitute a recommendation to invest in any particular asset class or strategy and is not a promise of future performance or an estimate of actual returns a client portfolio may achieve. Hypothetical and past performance do not guarantee future results.

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