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## INVESTING IN INDEX FUNDS AS AN EFFICIENT METHOD OF MANAGING RISKS IN PERSONAL FINANCE

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**Abstract:** Index funds have developed efficient methods of risk management, whereby they represent a low-risk and moderately profitable class of investments in their theoretical basis. But index funds offer many advantages to investors, especially individual investors who manage their own funds. Freed from the complexity of other types of investment funds that are dedicated to active trading of securities, investment funds are based on a weighted investment in all shares of a certain index. Therefore, their average rate of return on assets is almost always equal to the average rate of return on assets of the index in which these funds invest.

Through this way of investing, a large number of risks arising from investing in individual securities are avoided, among which idiosyncratic risk, industrial risk and others appear. Investment funds thus protect individual investors from risks arising from a lack of knowledge of the markets and the inability to predict market movements in a precise and consistent manner.

**Keywords:** index, investment, funds, risks, individual

### 1. INTRODUCTION

Investing in index funds is beneficial for individual as well as institutional investors, as well as for the corporate sector. Therefore, it is necessary for these investment funds to be well analyzed by investment experts, in order to familiarize the general public with the benefits they offer as an investment alternative to active investing.

This paper will analyze some of the characteristics of index funds, their advantage over other investment alternatives, as well as their risk management methods.

### 2. DEFINING THE TERM INDEX FUND

Index funds are funds in which multiple investors invest and come in two forms, mutual funds and exchange traded funds. These funds aim to track the performance of the indices in which they invest and provide the same or similar investment returns to investors in them. These funds aim to trade and invest in large blocks of shares of these funds, but do so based on the representativeness of those shares in the movement of the value of the index.

The most famous index funds in the US are the S&P 500 and the Dow Jones Industrial Average, which are the most famous examples of index funds. These funds invest in companies that meet the parameters of the holding funds whose performance they monitor. If those companies fall outside the parameters established by the index fund managers, those stocks are sold and efforts are made to identify and buy stocks that correspond to the funds' parameters.

The main advantage of these funds for investors is that they do not require a lot of management time and do not require active management. On the contrary, by eliminating the need to analyze stocks with different characteristics, they invest only in companies that meet the parameters of the funds.

As we mentioned, there are parameters that must be met and which are most easily and precisely achieved by weighting the investment funds in the fund in the same way as they are weighted in the index. But there are other synthetic ways of investing that combine investments in stock futures that meet the fund's parameters and investments in low-risk bonds in order to replicate the performance of the index without consistently investing in the exact assets.

There is a third type of index fund that invests in assets that meet the parameters established by the index fund managers, but also uses active strategies. These index funds are known as outperforming index funds, which is why they often offer investors higher rates of return than other index funds.

Classic index funds usually invest in assets that are an exact replication of the representation of individual stocks in the indexes, where they can expect the same returns relative to the indexes. (Bebchuk, Hirst, 2019)

### 3. BENEFITS FOR INVESTORS REGARDING ACTIVE INVESTMENT

#### Low investment fees

According to research by experienced financial analysts, investing in index funds is associated with lower financing costs. Investing in active investment funds often incurs higher investment costs, with investment fund managers' fees being high and representing a high percentage of the assets invested and acquired through investment.

The best metric for measuring the costs of financing investments through investment funds is the ratio between invested assets and profits and costs. According to financial analysts, traditional hedge funds, despite the high initial demands from individual investors of a minimum of \$1,000,000 in investment funds, charge 2% of total invested funds and 20% of earned funds.

On the other hand, index funds charge very low percentages of invested funds, and do not charge additional compensation from earned funds. It is this advantage that makes index funds very attractive to all individual investors.

*Table 1: Data on compensations in index funds with the most affordable prices for 2024*

Symbol in the stock market	Fund name	Cost to capital ratio
FXAIX	Fidelity 500 Index	0.015%
FSKAX	Fidelity Total Market Index	0.015%
SWPPX	Schwab S&P 500 Index	0.02%
WFSPX	iShares S&P 500 Index	0.03%
SWTSX	Schwab Total Stock Market Index	0.03%
VFIAX	Vanguard 500 Index	0.04%
VIGAX	Vanguard Growth Index Fund Admiral Shares	0.05%

Source: Morningstar 1 November 2024 Report

As we can see in the table 1, there are extremely low costs associated with the index fund industry. This runs contrary to the general knowledge about the investment funds, because they usually carry high costs of capital and bring various risks to the investors.

#### Successful management of risks in personal finance

Index funds enable the management of risks arising in the domain of personal finance. First of all, this refers to the payment of high amounts for asset management, which can lead to low profitability of the investment portfolio and earnings of assets that are not sufficient to compensate for inflationary losses in one investment cycle. Because of this, index funds offer opportunities to pay compensations on an annual basis throughout the entire investment cycle, where those compensations are as a rule lower than the inflation rate, and the average earnings of these funds move to a rate that is significantly higher than inflation. (Bono, Pedro, Eid, 2015)

On the other hand, through index funds it is possible to avoid the idiosyncratic risk. Idiosyncratic risk refers to the risk of individual investments, ie investing in one company. Moreover, given the impossibility of quality financial analysis in relation to other market participants, individual investors are faced with a large idiosyncratic risk with each investment. (Colwell, El-Hassan, Kang, 2007)

There is also sector risk, which refers to the risk of investment in a certain sector of the economy. Individual investors are often exposed to sector risk because of their tendency to group their investments in sectors where they have some expertise and knowledge. But in the face of a sector downturn, their investment portfolios would see a significant decline.

That's why index funds are an ideal solution to this problem, as they offer broad diversification across multiple bases. They are not exposed to idiosyncratic risk, as well as industry risk, and also offer investment in assets that meet parameters determined by financial experts. (Gaivoronski, Krylov, Van Der Wijst, 2005).

Index funds offer the following advantages when it comes to managing risks in personal finance for individual investors:

- Low turnover
- Low trading costs
- Avoiding losses due to frequent trading etc. (Goetzmann, Massa, 2003)

### 4. CONCLUSION

Index funds allow investors to overcome most of the risks associated with personal finance. First, they help investors find investments where there is a system of annual fees at no extra cost, and those fees are very low. It is crucial to

note that these fees are the lowest of all investment alternatives and that this is what allows individual investors to reduce the risk of illiquidity.

By diversifying investments, index funds enable investors to overcome idiosyncratic and industry risk, and also help them optimize their portfolios and achieve average and above-average market returns that are higher than inflation. With that, they also overcome the inflation risk and help overcome the need for active portfolio management.

Reducing the need to actively manage investment portfolios helps individual investors reduce the risk of making wrong investment decisions based on wrong information. All these benefits make index funds very attractive to individual investors as evidenced by the high number of index fund investors worldwide.

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