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April 9, 2001

Special Report: Mutual Funds Quarterly Review

How an Index Fund Works

Many index funds start exactly as one might think -- by buying all the stocks that make up a particular index. But usually not the same number of shares of each because most indexes are "capitalization weighted." That means the portion that one stock makes up of the total value of the index is proportionate to its market capitalization, or share price times the number of shares a company has outstanding.

At the end of March, for instance, **General Electric** was the largest stock in the Standard & Poor's 500-stock index, representing 3.99% of the overall index value, while **American Greetings** was No. 500, at 0.01%. So an S&P 500 index fund then would have 3.99% of its assets in GE stock and lesser amounts of the 499 other stocks.

Some indexes are just too big for index funds to match exactly. The Wilshire 5000 Total Market Index actually incorporates prices for more than 7,000 stocks. But funds can come pretty close to tracking these benchmarks by buying the largest stocks in the indexes and just a sampling of smaller ones. The Vanguard Total Stock Market Index Fund, keyed to the Wilshire 5000, recently held 3,354 stocks, for example.

As market prices change the weightings of stocks within an index, their matching index-fund portfolios adjust automatically, so managers don't have to buy or sell shares. But when stocks are added to or removed from an index, managers must scramble to follow suit. They also must reinvest dividends paid by their portfolio holdings and make adjustments for stock splits and other events.

Unlike most actively run funds, index funds typically don't keep a cash cushion because any money not invested causes dreaded "tracking error" with their indexes. So managers must sell shares in the correct proportion from their portfolios when investors pull cash out of the funds. When money floods in, managers immediately buy stocks or futures contracts.

While most people think indexing is "a simple strategy," it is actually complex and has "very little room for error," says Francis Enderle, chief investment officer for the U.S. index business of Barclays Global Investors.

-- Karen Damato

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