Investing 101: When All Else Fails, Invest in Index Funds

Description

The stock market is on steroids. First came the tech bubble, and now there are fears of a house price bubble and an energy crisis. Many investors lost significantly in the tech stock sell-off as virus stocks lost their pandemic gain. These investors are now fearful as stock losses, rising inflation, and interest rate hikes are drying up liquidity. Energy and commodity stocks are trending hot. But jumping in and buying them at this price is a risk I won't take. When all else fails, invest in index funds or ETFs.

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The theory behind why index funds don't fail

The very design of an index fund is to leverage the market wisdom and get average returns in the long term. The **S&P 500**'s average annual return since its inception in 1957 is around 10.5%. But rarely has the index delivered this return in a given year. The return is either higher or lower because of the corrections (10%-20% dip) and downturns (over 40% dip).

The steeper the dip, the longer the recovery phase. Taking the average of the last 41 years, the S&P 500 index recovered from a 10%-20% dip in four months and a 20%-40% dip in 15 months. However, it took about 58 months to recover from 40%-plus downturns like the dot.com bubble and the 2009 financial crisis.

You may say all these historical dips show a loss. But the fact that the index always recovered no matter how deep the dip shows growth. It shows there are no failures, only opportunities. Those who bought the dip and kept holding it surpassed the index average of 10.5%.

How can index funds work for you?

The S&P prepares a list of stocks trading on a particular stock exchange and ranks them based on market cap. It updates the index every quarter to ensure its list covers the overall market's performance. Funds and ETFs tracking the index also update their holdings accordingly. Marketwhales like pension funds invest in index funds for the long term, which gives them stability comparedto small-cap stocks.

Whenever a stock is trending, its market cap surges. For instance, **Shopify** stock became the highest valued stock on the TSX in 2020 and commanded the largest holding on the index. Also, S&P removed **Bombardier** and **BlackBerry** from the **S&P/TSX 60 Index** in June 2020 because of prolonged declines.

In 2020, the **Horizons S&P/TSX 60 Index ETF** (TSX:HXT.U) surged 8.21%. If I take the rally from the March 20, 2020, bottom, the ETF surged 66.86%. This shows how buying the dip of an index fund can benefit you. If you are using the buy-the-dip strategy on individual stocks you may compound your losses with the wrong stock like **Facedrive** or **Air Canada**. These stocks are in a long-term downturn, and the rewards are not worth the risk.

But with index funds, you can use the buy-the dip-strategy without worrying about compounding your losses. The index, by design, will recover, if not in four months, then in a year or two. It has the strongest stocks, and it eliminates the weak stocks. At present, the HXT.U ETF has 20% of its holdings in the **Royal Bank of Canada**, **TD Bank**, and **Bank of Nova Scotia**. It has reduced its holding in Shopify to 4.1%, thereby booking profits when the stock fell over 60%.

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Two index ETFs to buy the dip

- The Horizons S&P/TSX 60 Index ETF
- The **Vanguard S&P 500 Index ETF** (TSX:VFV)

The two indexes worth investing in are the S&P 500 index, which includes Nasdaq and NYSE stocks, and the TSX 60 index. While many other ETFs are tracking these two indexes, I chose these ETFs for their low management expense ratios (MER).

CATEGORY

1. Investing
2. Stocks for Beginners

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1. TSX:HXT (Horizons S&p/tsx 60 Index ETF)
2. TSX:VFV (Vanguard S&P 500 Index ETF)

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