Want to Invest? Scared of Risk? Consider Index Funds

Description

Are you considering investing in the stock market but are concerned about the risk? If so, there's a relatively straightforward solution: index funds.

Index funds are pooled investment funds that invest in the entire stock market, rather than any one stock. They have been proven to have much less risk than individual stocks. While a company can go bankrupt, an un-levered index fund can't. That's not to say that there is no risk in index funds — they are subject to market risk — but there is much less risk in index funds than in stocks.

In this article, I will make the case that index funds are a suitable solution to stock market risk and mention another low-risk investment that's even safer.

How index funds reduce risk

The way index funds lower risk is by reducing *specific risk* to near zero.

All investments have two types of risk:

1. Market risk
2. Specific risk

Market risk is the risk in the market as a whole. Hawkish central bank policy, mass panic, systemic overvaluation — these are all "macro" risks that impact the total stock market.

Then we have specific risk. That is, the risk impacting a specific stock. For a pharmaceutical company, an example of a specific risk is having its patent application rejected. If that happens, then the pharma company won't recover its R&D costs and will have to contend with an avalanche of competition.

Index funds reduce total risk by taking the second form of risk out of the picture. Or, almost out of the picture, anyway. If you look at an index fund like **iShares S&P/TSX Capped Composite Index Fund** (TSX:XIC), you will see that it is very diversified. It contains a full 240 stocks, which means that the vast majority of stocks in it have a small weighting. If any one of the stocks in XIC goes bankrupt, the fund as a whole will survive.

There is still the issue of weight — most index funds are market cap weighted, which means that the bigger stocks in them make up an outsized percentage of the portfolio. That does introduce a little concentration risk, but it's not as severe as with individual stocks. Also, there are "equal weighted" funds, like **BMO Equal Weight Banks Index ETF**, that weigh all stocks equally, reducing concentration risk.

Still too risky? Consider GICs

The paragraphs above establish a pretty simple way to reduce the risk inherent in stocks: buy index funds instead of individual equities.

With that strategy alone, you will avoid the fate of having your investment go to $0 — and you may even get a decent return!

But if even that's too risky for you, it's not game over. There are plenty of *extremely* low-risk assets out there to suit your needs. GICs are among the best. A GIC is a guaranteed return product offered by banks. They historically have yielded next to nothing, but today, some yield north of 4%. That's not quite beating the inflation rate, but it's very safe and will exceed what you get in a savings account.

CATEGORY

1. Investing

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