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STOCKS · BEGINNER · LESSON 13 OF 15

ETFs and Index Funds

What index funds and ETFs are, how they trade, why their low fees matter so much and how to compare one fund with another

12 min read 8 quiz questions with answer key

STOCKS · BEGINNER · LESSON 13 OF 15

ETFs and Index Funds

IN ONE SENTENCE

An index fund copies an index instead of trying to beat it, and an ETF is a fund that trades on an exchange like a stock. One share of an S&P 500 ETF gives you a slice of about 500 companies. Since SPY launched in 1993, ETFs have grown to about $24 trillion worldwide. Their low fees matter, because fees compound over the years, and most active funds have done worse than their index after costs.

One fund, many stocks

Lesson 5 showed that an index, such as the S&P 500, is a list of stocks with a rule for weighting them. You cannot buy an index directly, because it is only a number. What you can buy is a fund that holds the stocks in the index for you.

- An **index fund** is a fund that tries to copy an index rather than beat it. If one company is about 6% of the index, it is about 6% of the fund.
- An **ETF** (exchange-traded fund) is a fund whose shares trade on a stock exchange, just like the shares of a company.

Most ETFs are index funds, but not all index funds are ETFs, and a few ETFs are actively managed. When you buy one share of an S&P 500 ETF, you own a tiny slice of about 500 companies at once, all for the price of a single share.

The fund is run by a provider such as Vanguard, iShares (BlackRock) or State Street. The provider buys the stocks, keeps the fund in line with its index when the index changes, collects dividends and charges a small yearly fee for this work. The stocks are held for the fund's investors, separately from the provider's own money.

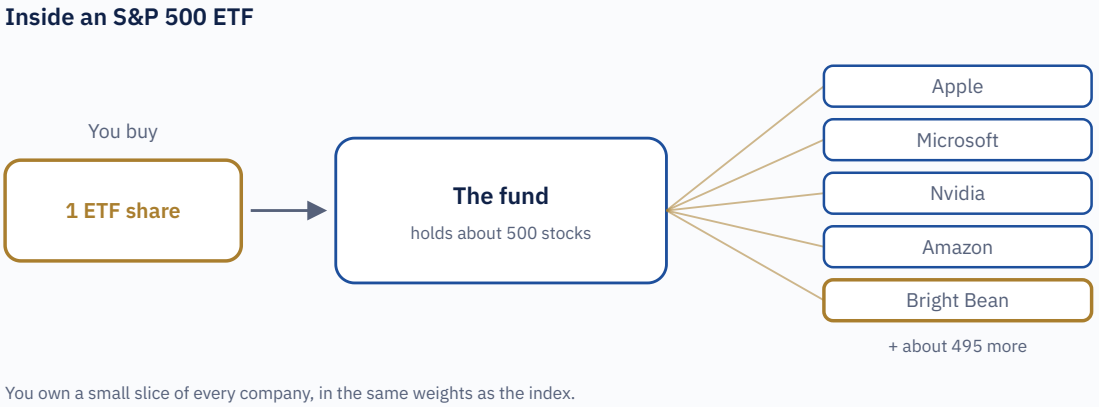


Figure 1. One ETF share is a small slice of a basket that holds every stock in the index.

ETFs and mutual funds

Before ETFs, most people owned funds through **mutual funds**. A mutual fund does not trade on an exchange. You buy and sell directly with the fund, and every order placed during the day gets the same price, the **net asset value** (NAV), worked out once after the market closes.

	ETF	Mutual fund
Where you buy	On an exchange, through any broker	From the fund company or a platform
Price	Changes all day, like a stock	One price a day, after the close
Order types	Market, limit and stop orders	An amount of money, filled at the next NAV
Minimum	One share, or less with fractional shares	Often a set minimum amount
Typical cost	Usually low for index ETFs	Ranges from very low to high

Because an ETF trades like a stock, everything from Lessons 6 to 8 applies to it: it has a bid, an ask and a spread, and you can use limit orders. Special firms called **authorized participants** can create new ETF shares or redeem old ones in large blocks. When an ETF's price drifts away from the value of what it holds, they profit by closing the gap, which keeps the price close to the NAV.



Figure 2. An ETF price changes all day on the exchange. A mutual fund gives every order of the day the same price, set after the close.

From one ETF to thousands

The first US-listed ETF was the **SPDR S&P 500 ETF Trust**, ticker SPY, launched by State Street in January 1993. It was designed so that investors could buy and sell the whole S&P 500 during the day in one trade. More than thirty years later it is still one of the most traded securities in the world.

ETFs have grown much faster than almost any other part of the investment industry. According to the research firm ETFGI, at the end of August 2026 the global ETF industry held about **$24 trillion** in assets, in **17,713** ETFs from 1,044 providers, listed on 86 exchanges in 66 countries.

Three funds that track the S&P 500 show the scale. The Vanguard S&P 500 ETF (VOO), the iShares Core S&P 500 ETF (IVV) and SPY together held close to **$2.7 trillion** by mid 2026. Each one owns the same 500 companies, so the main differences between them are their fees, how heavily they trade and small details of how they are built.

Global ETFs, August 2026

$24 trillion	17,713	1,044	86
in assets	ETFs	providers	exchanges in 66 countries

The first US-listed ETF, SPY, launched in January 1993.

Figure 3. The global ETF industry at the end of August 2026, according to ETFGI.

Why fees matter so much

Every fund charges a yearly fee called the **expense ratio**, shown as a percentage of your money. It is taken out of the fund little by little, so you never see a bill, but the fund's return is lower by that amount.

- VOO and IVV charge **0.03%** a year, which is $3 for every $10,000 invested. SPY charges 0.0945%, about $9.45.
- According to the Investment Company Institute (ICI), the average index equity ETF cost **0.14%** in 2025, weighted by assets. The average equity mutual fund, including active funds, cost **0.40%**.
- Some actively managed funds still charge 1% or more.

A difference of less than one percent a year sounds tiny, but fees compound just like returns do, because money paid in fees is no longer there to grow. Over decades, the gap becomes very large, as the example below and Figure 4 show.

Fees are not the only cost. You also pay the spread when you buy and sell, and possibly a broker commission. For popular ETFs the spread is usually one cent, but for small, rarely traded ETFs it can be much wider.



Figure 4. $10,000 growing for 30 years at 7% a year before fees, with three different yearly fees. Illustration only.

EXAMPLE: EMMA AND DAVID INVEST $10,000

Emma and David each invest **$10,000** and leave it alone for 30 years. Both funds earn 7% a year before fees. Emma's index ETF charges **0.03%**. David's fund charges **1.00%**. After 30 years, Emma has about **$75,500** and David has about **$57,400**. David paid around $18,000 more for owning almost the same stocks. These numbers are only an illustration, since real returns change every year, but the effect of fees works the same way.

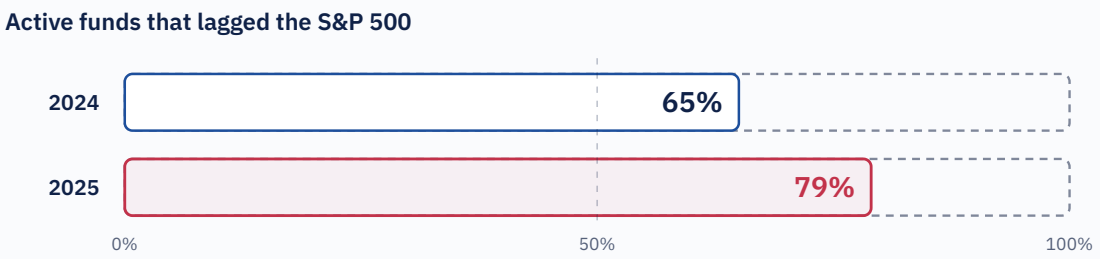
Active or passive?

A **passive** fund copies an index. An **active** fund has managers who pick stocks and try to beat the index. Active funds charge more for this skill, so the question is whether it pays off.

S&P Dow Jones Indices measures this twice a year in its SPIVA reports. In 2025, **79%** of active large-cap US stock funds did worse than the S&P 500, up from 65% in 2024. Over 25 years of SPIVA data, there were only three years in which most active managers beat the index. Over longer periods the record is worse, partly because many poor funds are closed and disappear.

Why is it so hard? The market is made up of all investors together, so before costs the average investor earns the market return. After fees and trading costs, the average active dollar must earn less. Some managers do beat the index, but it is very hard to know in advance which ones will keep doing it.

This is the main reason index funds have become so popular. They do not promise to beat the market. They promise to match it, minus a very small fee.



Large-cap US stock funds. Source: S&P Dow Jones Indices, SPIVA US Year-End 2025.

Figure 5. Share of active large-cap US stock funds that did worse than the S&P 500, according to SPIVA.

Kinds of ETF

There are ETFs for almost everything, from very safe to very risky:

- **Broad market**: a whole index, such as the S&P 500, the total US market or the whole world.
- **Sector**: one of the sectors from Lesson 11, such as technology or energy.
- **International**: a region or country, such as Europe, Japan or emerging markets.
- **Dividend**: companies with higher or growing dividends.
- **Bond**: government or company bonds, usually less volatile than stocks.
- **Commodity**: gold, oil and similar, often through futures rather than the real goods.
- **Thematic**: a story, such as artificial intelligence or clean energy. These are often narrow and more expensive.

Be very careful with **leveraged** and **inverse** ETFs, which aim for two or three times the daily move of an index, or the opposite of it. They reset every day, so over weeks and months their results can be very different from what people expect, especially in a choppy market. US regulators warn that they are designed for short-term trading by experienced traders, not for holding.

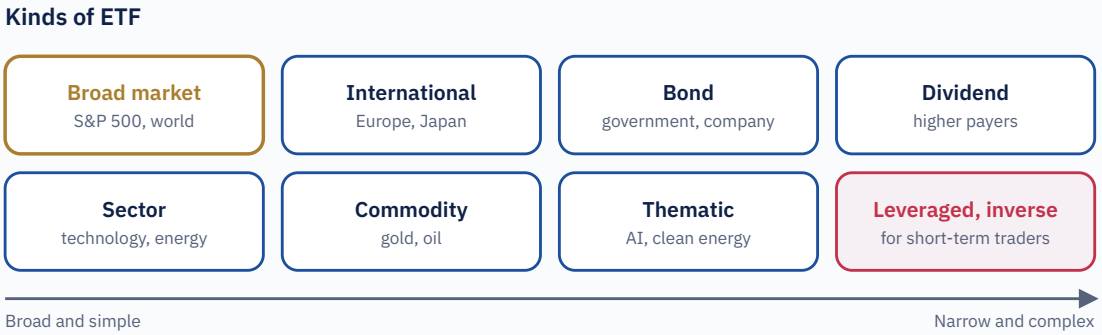


Figure 6. Common kinds of ETF, from broad and simple to narrow and complex.

Buying ETFs outside the US

Investors in Europe usually buy **UCITS ETFs**. UCITS is the European Union rulebook for funds sold to the public, and most UCITS ETFs are based in Ireland or Luxembourg. Retail investors in the EU and the UK generally cannot buy US-based ETFs such as SPY or VOO, because those funds do not publish the standard key information document that European rules require. Instead, they buy a UCITS version of the same index, for example an S&P 500 UCITS ETF listed in London, Frankfurt or Amsterdam.

UCITS ETFs often come in two versions:

- **Distributing** (Dist): pays dividends out to you in cash.
- **Accumulating** (Acc): keeps the dividends inside the fund and reinvests them, so the share price grows instead.

Both hold the same stocks. The choice depends on whether you want income and on how your country taxes funds, which differs a lot from place to place. Where a fund is based can also change how much tax is withheld on US dividends before they reach the fund. Lesson 15 explains the tax form that US brokers ask non-US investors to sign.

How to compare ETFs

When two ETFs claim to do the same thing, compare them on a few simple points, all of which can be found on the provider's website and in the fund's documents:

- **The index.** Make sure you know exactly what it holds. A "world" ETF and a "US" ETF behave very differently.
- **The expense ratio.** Lower is better, all else being equal.
- **Size and trading.** Larger, heavily traded ETFs usually have tighter spreads. Very small ETFs are more likely to close.

- **Tracking difference.** How closely the fund's return has followed its index after costs.
- **Where it is based and whether it pays out dividends**, if you are outside the US.

Alex, for example, wants one fund for the long term. He compares two S&P 500 UCITS ETFs and finds that they hold the same stocks and charge similar fees. He picks the larger one, because its spread is tighter, and the accumulating version, because he does not need income yet.

Why this matters for traders

- **ETFs are trading tools too.** Many traders use SPY, QQQ and sector ETFs to trade the whole market or one sector in a single order, without picking individual stocks.
- **Use limit orders.** At the open, near the close and in small ETFs, the price can drift away from the value of the holdings. A limit order protects you from a bad fill.
- **Know what you hold.** Leveraged and inverse ETFs lose value over time in choppy markets, even if the index ends where it started.
- **Watch the flows.** Very large money moving into or out of popular ETFs can move the stocks inside them, especially around index changes.

Key terms

Index fund	A fund that tries to copy the performance of an index rather than beat it.
ETF	Exchange-traded fund. A fund whose shares trade on a stock exchange all day, like a stock.
Mutual fund	A fund bought and sold directly with the fund company, at one price a day.
Net asset value (NAV)	The value of everything a fund holds, minus its costs, divided by the number of fund shares.
Expense ratio	The yearly fee a fund charges, as a percentage of the money invested.
Passive investing	Owning funds that copy an index instead of trying to beat it.
Active fund	A fund whose managers choose investments in order to beat an index.
UCITS	The European Union framework for funds sold to the public. Most European ETFs follow it.

Accumulating and distributing	Two versions of a fund. Accumulating funds reinvest dividends; distributing funds pay them out.

Key takeaways

1. An index fund copies an index. An ETF is a fund that trades on an exchange like a stock. Most ETFs are index funds.
2. One share of an S&P 500 ETF gives you a small slice of about 500 companies.
3. Fees compound. Over 30 years, a 1% fee can leave you with about a quarter less compared with a 0.03% fee.
4. Most active funds have done worse than their index after fees, which is why index funds have become so popular.
5. Compare ETFs by index, cost, size, spread and tracking, and be very careful with leveraged and inverse ETFs.

Test yourself

Circle one answer for each question. The answer key with explanations is on the next page. You can also take this quiz online at markettalks.info and see your score instantly.

1. What does an index fund try to do?

- A Copy the performance of an index
- B Beat the index every year
- C Avoid all falls in the market
- D Pick only the best stocks

2. How is an ETF different from a mutual fund?

- A An ETF cannot hold stocks
- B An ETF only trades once a week
- C A mutual fund always has lower fees
- D An ETF trades on an exchange all day at changing prices

3. What was the first US-listed ETF?

A QQQ, in 1999
B SPY, in January 1993
C VOO, in 2010
D IVV, in 1985

4. An ETF has an expense ratio of 0.03%. How much does it cost a year on $10,000?

A $0.30
B $3
C $30
D $300

5. In 2025, what share of active large-cap US stock funds did worse than the S&P 500, according to SPIVA?

A About 21%
B About 50%
C About 79%
D 100%

6. Why are leveraged ETFs risky to hold for a long time?

A They cannot be sold
B They pay no dividends
C They only trade after hours
D They reset every day, so long-term results can differ a lot from the expected multiple

7. What does an accumulating UCITS ETF do with dividends?

A Reinvests them inside the fund
B Pays them to you in cash
C Gives them to the provider
D Holds them for one year and then pays them out

8. Two ETFs track the same index and charge the same fee. Which point is most useful in choosing between them?

A. The colour of the logo
B. Which one fell most last week
C. The size of the fund and its spread
D. The number of letters in the ticker

Answer key

1 A

Copy the performance of an index

An index fund holds the stocks in an index, in the same weights, so that its return follows the index.

2 D

An ETF trades on an exchange all day at changing prices

ETF shares trade on an exchange like a stock. Mutual fund orders are filled once a day at the net asset value.

3 B

SPY, in January 1993

State Street launched the SPDR S&P 500 ETF Trust, ticker SPY, in January 1993.

4 B

$3

0.03% of $10,000 is $3 a year.

5 C

About 79%

S&P Dow Jones Indices found that 79% of active large-cap US funds underperformed the S&P 500 in 2025.

6 D

They reset every day, so long-term results can differ a lot from the expected multiple

Leveraged and inverse ETFs aim for a multiple of the daily move. Because they reset each day, their results over longer periods can be very different from what people expect.

7 A

Reinvests them inside the fund

An accumulating fund keeps dividends inside the fund and reinvests them. A distributing fund pays them out.

8 C

The size of the fund and its spread

Larger, heavily traded ETFs usually have tighter spreads and are less likely to close.

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