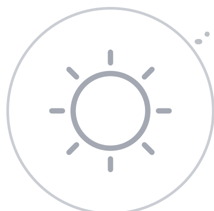
Can Switching to Index Funds Reduce Risk?

Know the realities to help align investments to your goals

Everyone knows that investing involves risk. But "risk" is difficult to pin down, even though we encounter various measures of risk every day and make decisions based on our perception of that risk. When the weather report predicts a 50% chance of rain, you likely weigh the risk of getting wet and decide if you want to carry an umbrella.

When selecting mutual funds, **risk may be a consideration** in choosing between active and index funds.

A recent survey of mutual fund buyers found that **more than half think active funds carry more risk** than passive index funds.[1]



Given this belief, some have **mistakenly assumed** that holding **index funds can dramatically reduce risk,** especially during uncertain market environments.

But in fact, switching from actively managed funds to index investments is **not likely to be an effective plan** to manage the overall risk of an investment portfolio.

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Index funds cannot avoid market volatility

Index funds seek to track a benchmark index. Because of this approach, index funds tend to have returns very close to the benchmark index minus fees, and index funds with the same benchmark tend to show very similar performance to each other. In contrast, active funds may return more or less than their benchmark indexes (after fees) and may differ from each other in performance.

Recent research showed that one in five mutual fund buyers believed that stock index funds can protect them from market ups and downs.[1] However, index funds cannot eliminate market volatility – in fact, they are fully exposed to market volatility, by design. The average U.S. large-cap index fund, for example, moves with the market itself, experiencing big swings in one-year performance numbers. Since 1996, the average annual swing in one-year performance has been 17%, and the maximum annual change, from -41% in Feb. 2009 to 52% in Feb. 2010, has been nearly 93%.

INDEX FUNDS, BY DESIGN, EXPERIENCE VOLATILITY SIMILAR TO THE MARKET THEY TRACK

Average One-Year Return for U.S. Large-Cap Equity Index Funds

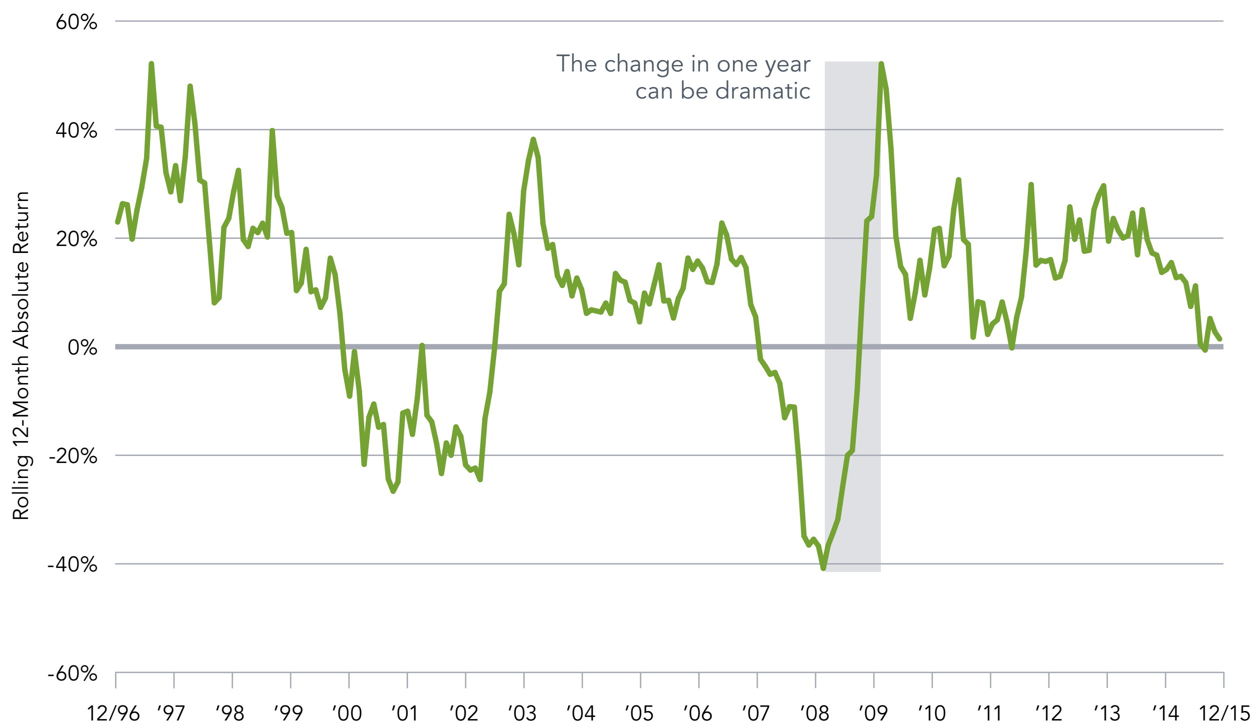


Chart shows equal-weighted averages of rolling one-year returns for all index mutual funds in the Morningstar database listing the S&P 500 as the fund's primary benchmark, including closed and merged funds. It does not represent actual or future performance of any individual investment option. Source: Morningstar Direct. Past performance is no guarantee of future results. It is not possible to invest directly in an index. Index performance is not meant to represent that of any Fidelity mutual fund.

Index funds don't cushion bear markets

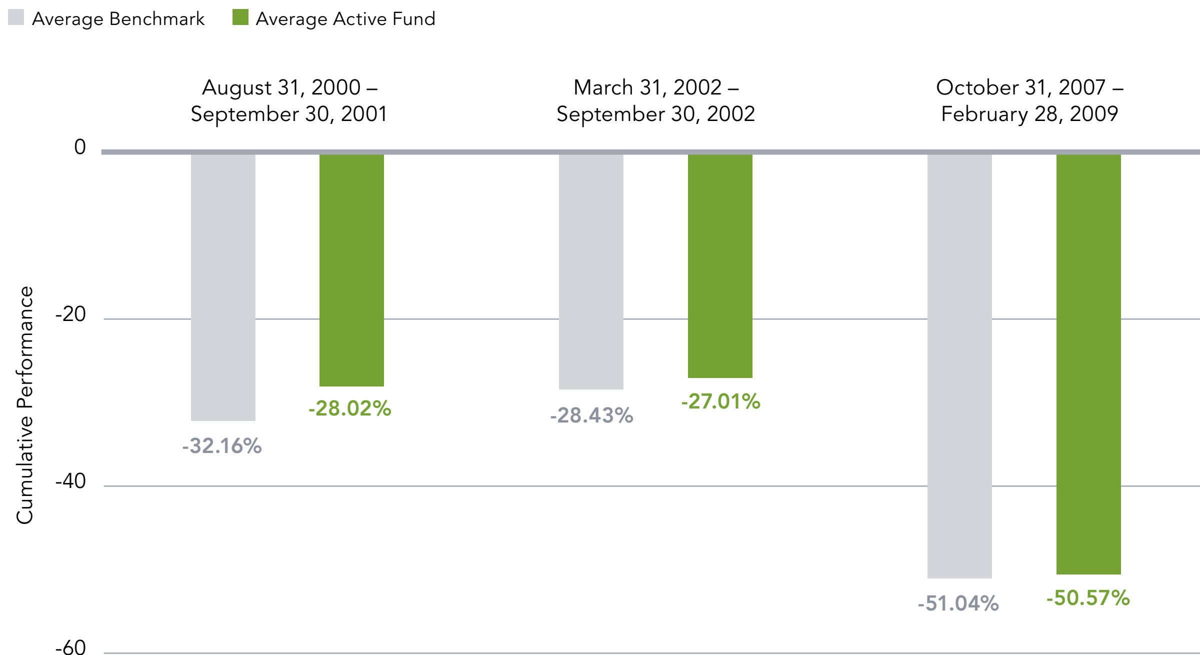
For many, risk and volatility only matter when movement is in one direction: down. Avoiding major losses can be an important part of preserving assets. Index funds are designed to track market returns even when the market is going down, while active funds can attempt to outperform the market. Even so, eight out of nine survey respondents didn't believe that active equity funds have performed better than index funds in bear markets.

However, the actual data tell a different story. In each of the three most recent bear markets for U.S. large-cap equity, active funds outperformed their benchmark indexes on average and after fees, while index funds underperformed on average after fees. Average active outperformance ranged from 0.5% during the global financial crisis to more than 4% during the early dot-com bust.* Active funds may be able to select securities that outperform a bear market, or may reduce exposure to a market before a sell-off.

Of course, not all active funds exactly matched the average, while index funds tended to be relatively consistent across funds. However, owners of an actively managed fund that they believe will outperform over time might want to talk to their advisor before switching to index funds, particularly if they are considering a change in their portfolio simply because they are concerned about future bear markets.

ACTIVE U.S. LARGE-CAP MUTUAL FUNDS BEAT THEIR BENCHMARKS DURING RECENT BEAR MARKETS, WHILE INDEX FUNDS CLOSELY TRACKED THEIR BENCHMARKS (BEFORE FEES)

Average Period Return for Active U.S. Large-Cap Mutual Funds and Benchmarks



Bear market: a period of 20% or greater loss in the S&P 500 that follows a gain of 10% or more from the previous low. Table reports average cumulative performance for all U.S. large-cap equity funds in the Morningstar database, from August 31, 2000, to September 30, 2001; March 31, 2002, to September 30, 2002; and October 31, 2007, to February 28, 2009. Fund performance is an equal-weighted average based on monthly returns, using all U.S. large-cap equity (including value, growth, and blend) mutual funds. It includes funds that did not exist for the full period. Each fund was compared to the primary prospectus benchmark. Source: Morningstar Direct. Past performance is no guarantee of future results.

*Analysis measures returns for each period from the beginning of the bear market to the end.

Aligning your investment approach to your goals

Understanding your own perceptions around risk is an important part of building a wealth management plan. Index funds can provide low-cost exposure to various markets with performance that stays close to the benchmark, but they can't eliminate market volatility or potential losses. Switching from active funds to index investments may not reduce risk in the ways some may expect. Talk to your advisor about the role that actively managed funds (for potential outperformance and a wider range of exposures) and index funds (for low-cost market tracking) can play in an overall portfolio strategy.

Working with your financial advisor may help lower the possibility of making emotionally driven financial decisions, especially during periods of market volatility. By considering your financial goals, investment time horizon, and tolerance for risk, your advisor can tailor an investment plan designed to help manage portfolio risk.

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[1] Fidelity Active/Passive Quantitative Study, 2016, which surveyed 3,483 Fidelity customers who are mutual fund buyers.

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