Index Trackers explained

How to keep in step with the market

Tracker funds are a cheap and popular way to invest in the markets and there are now many such funds available to the private investor. But what are they and why are they so popular?

Tracker funds attempt to mimic the performance of a section of the share market: most commonly an index. They are easy to understand and carry lower fees than managed funds as they require less active management. If they work as they should they won't outperform the index, but crucially they won't significantly underperform it either; a reassurance that appeals to a lot of individual investors.

Tracker funds follow an index by employing one of the following three techniques:

Full replication trackers

A full replication tracker fund holds every share in the index in proportion to its percentage weighting in the index. So if a company has a market value that is 5% of the FTSE 100 index, a full replication tracker that followed the FTSE 100 would invest 5% of the fund in that company's shares.

Stratified sampling trackers

A stratified sampling tracker fund holds the biggest shares in the index plus leading shares from each sector that reflect the performance of the whole of that sector. It is therefore similar to the index in terms of sector spread but holds fewer shares than the index. So if the Pharmaceutical sector represented 10% of the FTSE All-Share index across seven shares, the fund manager of a tracker that followed the FTSE All-Share might simulate that 10% weighting by investing in only four Pharmaceutical shares but at a greater weighting than their index weights.

Synthetics based trackers

In a synthetics based tracker the index is tracked through the use of derivatives. The fund manager will use futures and/or options to mimic the performance of an index.

Tracking Error

An index tracker aims to keep in line with an index rather than outperform it. It is more likely to underperform the index because of 'tracking error' although there are some techniques used to improve performance, such as pre-empting changes due to entry or exit from the benchmark index. Tracking error occurs where there is a difference between the performance of the fund and the performance of the index or where high charges impact the fund's return. Tracking error will typically be greater for trackers that use stratified sampling or synthetics than for those based on full replication. Within each category, the size of the historical tracking error is a reflection of the fund's success at tracking the index.

Exchange Traded Funds

Exchange Traded Funds (ETFs) are baskets of securities that can also be used to track an index or market sector. They are listed and traded on share exchanges continuously throughout normal trading hours unlike OEIC or Unit Trust index tracker funds which are only traded once a day.

Choosing an Index Tracker

Index trackers are available from a number of fund houses including Legal & General, HSBC and Barclays iShares; but before you select a fund house you need to decide which index you want to track. For example, if you want to track the UK market you could choose a tracker that follows the FTSE 100 (an index of the 100 most highly capitalised UK companies), the FTSE 250 (the next 250 largest companies after the FTSE 100) or the FTSE All-Share (the aggregation of the FTSE 100, FTSE 250 and FTSE Small Cap Indices). If you already have a number of investments in the UK you may prefer to diversify your portfolio by investing in a tracker that follows a foreign market or a particular sector.

You should also compare the charges of similar funds. Most trackers do not apply an initial charge, or where they do it will only be a small fee. Tracking error is also important; compare the tracking error over multiple periods not just a 5 year window.

Do remember that index trackers are designed to follow the performance of a benchmark index so if the index is rising, the value of the tracker fund will rise too. But if the index is falling, the fund value will also fall; the fund manager will not try to switch investments in the hope of arresting the fall.

At a glance

Index trackers rise and fall with the benchmark index.

Typically underperform index due to 'tracking error'.

Lower fees due to less active management.

Widely available for both UK and foreign markets.

How to buy

To buy an index tracker fund or an ETF visit share.com/freepickers