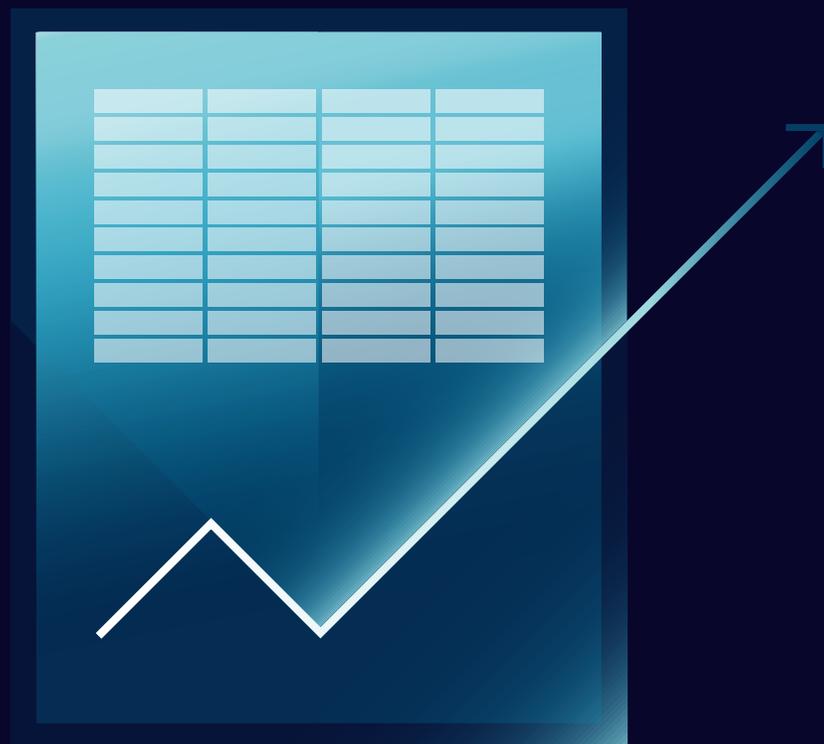


Understanding

Indexes



In the financial world, there's a term, "index", that often pops up, leaving many people curious about its meaning and significance. In this primer, we'll dive into the concept of indexes, demystifying their purpose and shedding light on why they're essential when interpreting financial markets. Whether you're new to investing or looking to expand your financial knowledge, understanding indexes is necessary, given their role in managing financial assets.

What Is an Index?

An index can be thought of as a basket of securities. It provides a snapshot of how that group of securities is faring collectively, offering insights into overall market trends and performance. Just as an individual might use a scale to measure their weight, investors rely on indexes to measure the health and direction of various sectors, asset classes, and markets.

Indexes Come in Many Shapes and Sizes

Indexes come in various forms, catering to different needs and interests. Some of the most common types include:



Broad-Based Market Indexes: A broad-based market index is a comprehensive benchmark that captures the performance of a wide array of stocks or securities representing various sectors and industries within different markets. It can serve as a barometer for evaluating the overall health and direction of the stock market.



Sector-Specific Indexes: A sector-specific index is a specialized benchmark that focuses on tracking the performance of companies within a specific industry or sector. Unlike broad-based market indexes, which encompass a wide range of sectors, sector-specific indexes provide more targeted insights into the performance of a particular industry.



International Indexes: International indexes, also known as global indexes, are benchmarks that track the performance of markets worldwide. They serve as benchmarks for evaluating the performance of global investments and comparing them to specific market segments or indices in different regions.



Fixed Income Indexes: Fixed income indexes are benchmarks that measure the performance of investments in fixed income securities, such as bonds. By looking at fixed income indexes, investors can get insights into the overall trends in the bond market, including changes in interest rates, credit quality, or investor sentiment.

EXAMPLE SECTOR INDEX Technology Index



- Cybersecurity Providers
- Software Providers
- Networking & Telecomm Companies
- Hardware Manufacturers
- Internet Services & E-commerce
- Semiconductor Manufacturers

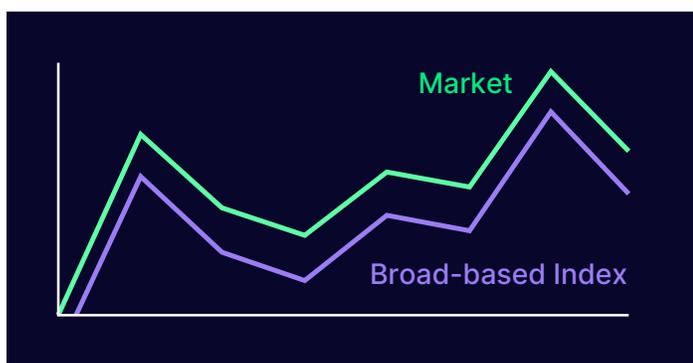
EXAMPLE BROAD-BASED MARKET INDEX Stock Market Index



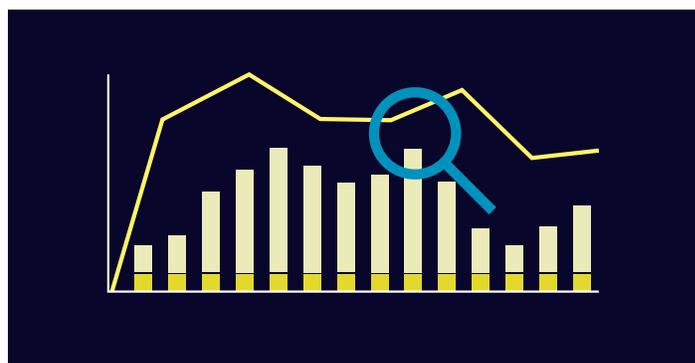
- Banks
- Automotive Manufacturers
- Clothing Brands
- Supermarket Chains
- Healthcare Companies
- Pharmaceutical Companies

The Role of Indexes

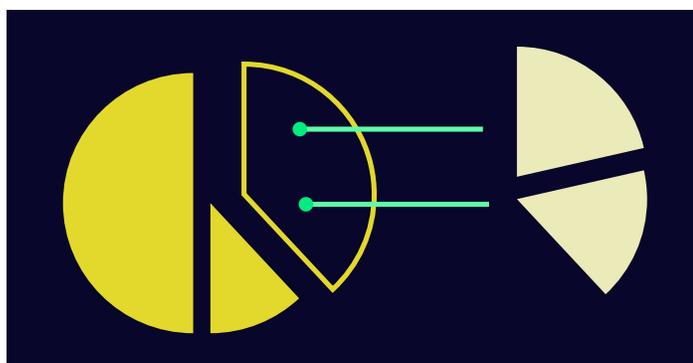
Indexes serve multiple purposes. **Firstly, they act as benchmarks that investors can use to compare the performance of their investments.** For example, by tracking the movement of a broad-based index that measures most or all of a particular market, investors can evaluate how their portfolios are performing relative to the broad market. This information can drive investment decisions and assess the effectiveness of investment strategies.



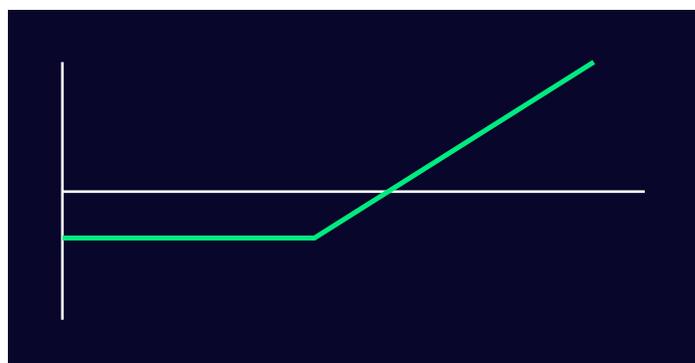
Secondly, indexes can provide a more detailed overview of market trends and overall market sentiment. By analyzing the performance of a narrower index such as an industry, sector or thematic index, investors can gain valuable insights into the overall health of that particular slice of the market. These insights enable investors to make informed decisions by identifying potential opportunities and risks within specific market segments.



Indexes are used as a basis for **constructing investment strategies.** Investors can choose to replicate the composition and weightings of an index through index funds or exchange-traded funds (ETFs), allowing them to gain exposure to a broad market or sector without investing in each individual security.



Indexes are used as the underlying reference for **index options.** Index options allow investors to gain exposure to the performance of a specific market or sector without directly owning the underlying securities. These options contracts give investors the right, but not the obligation, to buy (call option) or sell (put option) an index at a predetermined price within a specified time period. Learn more about indexes and their role in options trading [here](#).



How are Indexes Created?

All indexes use a systematic, rules-based approach to construct their basket of securities.



1. Objective and Purpose

The first step in creating an index is to define its objective and purpose. This involves determining the specific market segment or asset class that the index will represent.



2. Methodology Design

Once the objective is established, a methodology is designed. The methodology outlines the rules and criteria for selecting and weighting securities within the index. This includes factors such as market capitalization, sector allocation, liquidity requirements, and rebalancing frequency.



3. Universe Selection

The next step involves selecting the universe of securities that will be considered for inclusion in the index. This could be a specific stock exchange, a particular region, or a specific sector of the market.



4. Eligibility Criteria

Within the chosen universe, eligibility criteria are defined to determine which securities are eligible for inclusion in the index. These criteria may include factors like market capitalization, trading volume, financial stability, and listing status.



5. Weighting Methodology

Indexes use different methods to assign weights to the selected securities. Common weightings include market capitalization-weighted, equal-weighted, or factor-based weightings. The weighting methodology determines how much influence each security has on the overall index performance.



6. Regular Review and Rebalancing

Indexes undergo periodic reviews to ensure they remain representative of the intended market segment. This involves reassessing the eligibility criteria, evaluating the constituent securities' performance, and making necessary adjustments to maintain the index's integrity.



7. Calculation and Dissemination

The index values are calculated based on the methodology, using real-time or end-of-day pricing data. These values are then disseminated to market participants through various channels, including financial news outlets, market data vendors, and online platforms.



8. Monitoring and Governance

Index providers have dedicated teams responsible for monitoring the index's performance, adhering to the methodology, and addressing any potential issues or concerns that may arise. Robust governance procedures ensure the accuracy and reliability of the index.

How to Invest in Indexes

Once an index is created, it cannot be invested in directly. However, there are different ways investors can access what the index is tracking through products that mirror the index's overall goals. Here are some common methods for investing in indexes:

Exchange-Traded Funds (ETFs)

An ETF (Exchange-Traded Fund) is a type of investment fund that trades on stock exchanges, just like individual stocks. It is designed to track the performance of a specific index, sector, commodity, or asset class. Similar to mutual funds, an ETF offers investors a diversified portfolio of securities. However, unlike mutual funds, ETFs can be bought and sold throughout the trading day at market prices.

Index Mutual Funds

A mutual fund is an investment vehicle that pools money from multiple investors to invest in a diversified portfolio of securities. The goal of a mutual fund is to generate returns for its investors based on the performance of the securities it holds. These securities can include stocks, bonds, or other assets, and can be created to track the performance of an index.

Index Options

Options provide investors with the right, but not the obligation, to buy or sell an asset at a predetermined price within a specified timeframe. Index options enable investors to trade on the expected movement in the underlying securities. For more about options, see our primer [here](#).

Direct Indexing

Another method for investing via indexes is through direct indexing. Direct indexing allows investors to create a customized portfolio that closely mirrors the composition of a specific index. With direct indexing, investors can directly own the individual securities that make up the index, tailoring the portfolio to align with their specific investment objectives.

Investments vs. Vehicles

Differentiating between “investment” and “vehicle” is important in investing. First, investors decide on the type of asset they want to invest in, like stocks, bonds, or currency, or they choose a specific theme, such as Artificial intelligence (AI), fintech, or electric vehicles. Once their investment objective is clear, they select the appropriate vehicle. This can be a direct investment in a specific stock or a “wrapper” that combines multiple assets into one security.

Choosing an investment is similar to selecting a car. First, you decide on the broad category or type of investment, just like choosing a car type such as caravan, truck, or SUV. Then, you narrow down your choices by selecting the specific investment within that category, similar to choosing a specific car model. This approach helps ensure that your investment decisions align with your goals and preferences, just as selecting the right car meets your transportation needs.

Investment / Type of Vehicle



Investment Vehicle / Car Model



Conclusion

Indexes are an important component of today's financial markets. They give investors a sense of how well a market is doing in isolation and allow for comparison between a fund that is benchmarked against it, as well as between differing indexes. Understanding what is in a particular index can offer an investor a better sense of what they may own and whether the holdings may help meet their goals.

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