Summary
• Active funds are run by managers or management teams that research, make investment decisions, and try to outperform the markets, while passive funds invest in a basket of stocks which replicate the performance of a market.
• Because of their hands-off style, passive funds come with far lower fees than their active counterparts.
• Over 10 years, only one in four active funds has succeeded in surviving and outperforming (net-of-fees) comparable passive funds.
• It's possible to be 'active' with passive funds – index-tracking ETFs can be bought and sold on the stock exchange.
• Some argue that a combination of active and passive funds is the most successful approach to take for pensions.

Active vs passive – what works for pensions?

Sandra Haurant debates the merits of active and passive investment strategies for pension schemes

When it comes to active and passive investment, it's a question of style. With active investment, a manager will pick and choose assets to put in the fund, aiming to create a mix that will produce higher-than-market returns. Passive investment, on the other hand, involves investing in a set collection of securities in an index. The fund rides out all those inevitable index fluctuations, in the expectation that the highs will, over time, outstrip the lows.

The push for passive

"There are numerous benefits of using passive funds like exchange traded funds (ETFs)," says Invesco fund manager, multi-asset strategies UK team, David Aujla. "First and foremost, they offer a cost-effective way of accessing 'market-beta.'"

After all, while active management teams need time and resources to research, plan, buy and sell assets at the right moment, passive funds simply sit tight. Put simply, says Morningstar senior analyst, Kenneth Lamont, with passive: "You don't have a manager to pay; you are in effect crowdsourcing or harnessing the power of the market."

Beyond the fee factor

Fees are a major factor, but they are not the only point in favour for passive investment strategies. "Diversification and liquidity are two other important considerations," says Aujla. "Passive funds offer investors an efficient way to diversify portfolio risk and exposures without having to select individual stocks or bonds."

There are, he argues, ETFs of all manner of varieties, offering international, regional, industry-specific and niche exposure, all able to provide investors with "access to sectors where it may be more difficult, costly and time-consuming to buy and sell individual securities".

When it comes to liquidity, while mutual funds often favoured by pensions are only priced once a day, often investors can buy and sell passive funds through ETFs anytime during trading hours. You can be quite active with passive, in other words.

"Another reason to go for passive is transparency," says Lamont. In its simplest form, a passive index-tracker investing in the FTSE 100 will contain no surprises, only FTSE 100 shares. It does what it says on the tin; and even with more complex funds, it's generally straightforward to lift the lid and find out just what is inside.

Highs and lows

But surely an active manager, making decisions based on research carried out by a crack team, will do better than a passive fund that just sits and waits? In fact, while certain actively managed funds can (and do) beat the markets, the majority don't.

Morningstar publishes a report designed to analyse the performance of comparable passive and active funds. In 2023 it was based on 8,338 unique funds with around $18 trillion in assets – roughly 55 per cent of the US fund market. The latest report showed that less than half (47 per cent) of active strategies had delivered higher net-of-fees returns than their average passive counterpart. And according to Morningstar, fewer than one in four active strategies survived and beat their average passive counterpart over the 10 years leading to December 2023.

Actively seeking returns

The stats show that most active funds don't beat the markets, but it is technically possible for them to do so; on the other hand, by definition, a passive fund tracking a certain index can only do as well as that index.

"While consistent outperformance over time may not always be guaranteed, an experienced and successful active fund manager could potentially reward investors with better returns than 'the market,'" Aujla says. "This can be in the form of superior returns in rising markets or perhaps more importantly, lower losses in falling markets. The inability of passive funds to outperform, is a key point in favour of active funds."

What's more, says Aujla: "In time, passive funds like ETFs can be tainted with construction biases, such as a high concentration risk in a limited number of securities. A great example today is the high concentration of US equity ETFs towards mega-cap tech giants."

Known as the Magnificent Seven, those tech giants (Apple, Amazon, Alphabet, Meta Platforms, Microsoft, Nvidia and Tesla) dominate the markets, creating issues for managers. "Today, the S&P 500 Index is the most concentrated it's been since the early 1950s and taking a passive approach exposes investors to a few high-flying securities," says Russell Investments head of strategic client solutions, David Rae. "The market dominance of the Magnificent Seven is very reminiscent of the late 1990s. Microsoft and Cisco dominated in the US and in the UK phone technology companies made up more than 20 per cent of the FTSE 100 index in 1999.

"As recent experience shows, the dominance of a small number of stocks can be a difficult environment for active managers to outperform the index. Should the Magnificent Seven dominance fade and cross-sectional volatility increase, the opportunity to successfully exploit active management should return."

Indeed, says Aujla, while exposure to high-flyers has worked well in the recent past, the future may look different. "More actively managed portfolios can help reduce concentration risks as they are not bound to hold the same holdings in the same proportion as the underlying index. Spreading risk in other attractively-priced areas of the market is therefore an option."

A question of assets

"One of the key appeals of active management is that, unlike passive investing, it recognises the innate inefficiency and irrationality of markets and their participants," Aujla adds. Niche areas such as small and mid-cap (SMID) equities are a good example. While major players attract the attention of the majority of analysts, SMID tend to be under the radar. As Lamont puts it: "There are far fewer eyeballs on these companies, so there is potentially more to be gained *[from an active approach]*."

Cycles and sectors

While passive funds are obliged to follow markets down into troughs as well as up when there are peaks, a skillful active manager, in theory at least, might steer a fund around the worst falls. And frequently, those times of volatility are when active managers do better. "We saw this happen, for example, in the wake of the dot-com bubble burst. Technology stocks plunged by 40 per cent in 2000, while healthcare stocks went up by 30 per cent. What followed, proved to be a generally good period for active management," says Aujla.

Best of both worlds?

For defined contribution (DC) schemes, lower fees are likely to remain a primary objective, ensuring returns are not stripped out by costs, making passive funds a natural choice for the near future. But according to Aujla: "Investors are starting to consider higher cost products if they add value. Our head of consultant relations points to increased interest in multi-factor equity and global equities strategies, and some discussions around active strategies for emerging market exposure, all of which have done well of late."

Meanwhile, increasingly ESG-centric strategies could lead to a more active approach, says Rae. "More bespoke solutions that better reflect the pension fund objectives, provide for enhanced levels of stewardship and more comprehensively capture environmental, social and governance (ESG) risks are growing in importance," he says. "Traditional passive strategies replicating an industry benchmark are less effective in this arena."

"As recent experience shows, the dominance of a small number of stocks can be a difficult environment for active managers to outperform the index"

For Rae, the question is not so much passive or active, but finding ways with both. "A solution to the challenges of active management is to build a portfolio that is diversified across managers. This gains exposure to multiple investment processes across different decision-makers and embeds the collective wisdom of various investment specialists," he says. "Combining this approach to alpha generation with lower risk strategies and passive strategies results in a smoother investment journey for pension funds."

The active versus passive debate, then, will continue to rumble on; the long-term figures will go on demonstrating the power of passive, and individual managed funds will provide the exception to the rule.

Written by Sandra Haurant, a freelance journalist