Eagle Strategies LLC

Investment

PLANNING ESSENTIALS

# Active or Passive: Which Investment Approach is Better?

**It's a question that investors often ask: What's the difference between "active" and "passive" investment management, and which one is right for me? The first part of the question is relatively easy to answer.**

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| ***Active managers*** *seek to outperform a specific benchmark index (like the S&P 500® or the Russell 1000) by overweighting and underweighting the stocks that make up the index; or in some cases holding stocks not even included in the benchmark.* | *A* ***passive approach,*** *on the other hand, seeks to exactly replicate a specific benchmark index. It owns all the stocks that make up the index in the exact same proportions as the index.* |

Not surprisingly, passive mutual funds (index funds) and ETFs typically deliver performance that closely matches their benchmark — lagging by a small amount due to fees. But because they require little in the way of manager oversight, these funds are generally able to charge lower fees than active managers do. And, in effect, passive managers replicate the relatively static holdings of a benchmark index, as they tend to buy and sell securities less often than active managers, who buy and sell shares in an effort to generate excess return. This generally means that passive funds will be more tax-efficient—producing fewer long- and short-term taxable gains.

Conversely, by trying to identify stocks they feel are overvalued or undervalued (based on certain quantitative and qualitative measures), active managers offer investors the potential for significant outperformance—something that passive managers simply can't deliver.


## THERE'S NO CUT-AND-DRY WINNER

There are compelling arguments to be made on both sides of the active vs. passive debate. Although 57% of active strategies outperformed their average passive counterpart over the 12 months through June 2023, this surge did little to adjust long-term against passive strategies. Over an extended 10-year period, Morningstar data shows that only one out of every four active strategies outperformed their passive counterpart.[1]

Yet, while much has been written in recent years about the comparative superior returns achieved through passive investing using index funds and ETFs (compared with active fund managers), that doesn't tell the whole story.

The ability of active managers to beat their benchmark varies widely depending on which asset class you're watching. It's true that few active managers are able to outperform in the more widely traded asset classes, such as Large Cap Growth, Large Cap Core, and Mid Cap, where markets are highly efficient and there's little in the way of unknown information. But in other asset classes like Emerging Markets, High Yield Bonds, Real Estate, and Alternative Investments (where there's less transparency and insights may not be as readily accessible), active managers have achieved a far greater degree of consistent success.

According to Morningstar's most recent fund fee analysis, however, the asset-weighted average expense ratio for active funds in 2022 was 0.59%, while the asset-weighted average expense ratio for passive funds was 0.12%.[2] Over an extended period, that half of a percent annual difference can have a measurable effect on your portfolio's total value.

## CONSIDER A BLENDED APPROACH

It seems as though a logical approach to the active/passive debate would be to rely heavily on passive management but to then selectively employ active managers in market areas where there's a strong potential to add value on a risk-adjusted basis.

Passive investment strategies using index funds or ETFs offer an ideal way to gain broad market exposure —both inexpensively and in a tax-efficient manner. Active strategies can then help deliver potential excess returns and provide greater diversification across certain market areas, which in turn may provide more overall portfolio stability, depending on your particular goals.

You may also want to consider altering your active/passive investment mix to reflect the prevailing market conditions. When markets are relatively stable and generally moving in lockstep, passive strategies will often be the preferable choice. But during periods where the economy is weakening and markets become more volatile, active management may be able to offer both outperformance and reduced risk (since they have the ability to periodically move in and out of cash, whereas passive strategies typically must remain fully invested).

Which strategy is right for you: active, passive, or a combination of the two? It's a decision that will vary from investor to investor—depending on your particular goals, priorities, and personal preferences.

[1] Morningstar's Active/Passive Barometer, March 2023.
[2] Morningstar 2022 Fund Fee Survey, August 2023.

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