ETF Insights

April 2024

Active vs Passive Investing: Examining Performance

There has been a longstanding debate regarding active versus passive investments. Active investors believe that through sufficient research and skill, they can identify price anomalies and earn excess risk-adjusted returns by selecting individual stocks and timing the market. On the other hand, passive investors adhere to the efficient market hypothesis, which suggests that security values are already fairly reflected in prices, and obtaining consistent excess risk-adjusted returns is challenging. Passive investors believe in the benefits of diversification and choose to capture the long-term market return by holding a broad market basket.

To evaluate the performance of active investments, the average returns of equity mutual funds over the past 10 years are compared with their respective market benchmarks in different regions. The average return of funds in the Morningstar EAA OE Category is used as a proxy for active return and compared with the (net) total return index data from Bloomberg. The following key observations can offer valuable insights into the performance of active and passive investments.

Excess Return: Morningstar Average Fund Return vs. Market Benchmarks (2014-2023)

Markets	Benchmarks	Excess return (Average Fund Returns – Passive Index Return) (%)									
		2014	2015	2016	2017	2018	2019	2020	2021	2022	2023
US	S&P 500	-2.67	-2.15	-2.09	-1.10	-2.43	-2.06	-0.19	-2.60	-1.45	-1.39
Eurozone	MSCI EMU	-1.32	0.70	-1.89	-1.28	-1.25	-1.32	-0.32	-0.61	-1.24	-2.31
Hong Kong	Hang Seng	-2.22	-1.36	-3.67	-0.04	-3.56	0.04	13.88	0.53	-3.72	-2.68
Japan	NIKKEI 225	-0.37	-0.72	-3.14	2.20	-6.78	-1.95	-8.04	6.00	1.28	-2.73
China	MSCI China	-3.34	3.87	-4.28	-7.82	-1.68	3.19	12.71	7.02	-3.83	-5.14
China A-shares	CSI 300	-18.12*	6.33	2.14	7.73	0.73	1.55	11.27	0.08	-2.91	-4.98
India	Nifty 50	10.13	6.05	-0.98	5.31	-7.54	-5.19	0.55	4.37	-6.93	3.08
Brazil*	Ibovespa	-2.61	-0.06	-14.39	1.22	0.10	1.21	1.73	0.38	-6.62	-7.05
Korea	KOSPI 200	0.07*	7.30*	-10.79	-2.33	3.19	-6.69	-0.85	6.02	-2.49	-5.73
Taiwan*	TWSE	-3.87	3.13	-6.04	-0.54	-6.30	-0.72	-3.40	5.80	-6.87	11.36

Passive investing outperformed   Active investing outperformed

Source: Bloomberg (Net Total Return Index), Morningstar EAA OE Category (US Large-Cap Blend Equity, Eurozone Large-Cap Equity, Hong Kong Equity, Japan Large-Cap Equity, China Equity, China Equity - A Shares, India Equity, Brazil Equity, Korea Equity, Taiwan Large-Cap Equity) returns in USD
* Bloomberg, Gross Total Return as proxy due to data availability for Brazil, Taiwan, selected years for China A-shares, and Korea.

#1 Active investing underperformed in developed markets, particularly in the US

Over the past 10 years, it is evident that US large-cap equities, using Morningstar US Large Cap Blend Equities as a proxy, have consistently underperformed the S&P500 Index. This observation is further supported by the data from the S&P Index Versus Active Scorecard (SPIVA), which indicates that 87.42% of all large-cap US funds have failed to outperform the S&P 500 for the same period.

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Similarly, Eurozone large-cap funds have consistently trailed behind benchmark returns, except in 2015. This trend is also observed in other developed markets like Hong Kong and Japan, where active funds have fallen short of their benchmark indices 70% of the time. These findings highlight the frequent underperformance of actively managed funds against their respective market indices in developed markets.

#2 Active investing showed more value added in emerging markets

The performance of emerging markets tells a different story, as active funds have generally demonstrated their value-added capabilities to varying degrees. Specifically, China A shares and India equities have exhibited strong performance relative to their respective indices. Indian active funds have outperformed in 6 out of 10 years, while China A-shares active funds, on average, have surpassed the CSI 300 Index in 7 out of 10 years. Conversely, funds that include China shares listed overseas have only outperformed the MSCI China Index in 4 years. In Brazil, the active performance's outperformance is 50/50.

#3 Active investing lagged behind the index during periods of market volatility

During periods of market volatility, active funds tend to underperform, especially during downward market trends. Fund managers face challenges in accurately timing their investments amidst unforeseen geopolitical events, financial crises, and pandemic outbreaks. This phenomenon was particularly evident in 2018 when global equity indexes recorded negative returns, and the average performance of active funds in most markets was worse than their respective market indices. Similarly, in 2022, despite significant declines in market indices, average active funds continued to lag behind the overall market returns.

Our observations explained

Why did active funds perform worse in developed markets? In markets like the US and Europe, large-cap equities are extensively traded and researched, making it difficult to identify significant price anomalies. This means that exceptional skills are required to discover anomalies, which may be challenging for active fund managers. As a result, **active funds in developed markets tend to underperform most of the time.**

On the other hand, **emerging markets theoretically offer more opportunities for active fund managers**. These markets often have information barriers, fewer market participants, and more trading restrictions, which can lead to inefficiencies. For example, in the case of emerging markets like China, there are additional trading restrictions and entry barriers in the A-shares market. These provide active fund managers with the potential to profit from market inefficiencies and take advantage of the less efficient nature of these markets compared to global equities.

Conclusion

Active investing relies on the stock picking of fund managers to differentiate between a stock's value and its market price; however, predicting long-term market movements proves challenging. On the other hand, passive investing relies on the stock market's efficiency to price stocks at fair value. Generally, passive investing in developed markets is regarded as more effective than active investing.

Ultimately, the choice between active and passive investing depends on an investor's individual preferences, risk tolerance, and investment goals. Some investors may prefer the potential for higher returns and the opportunity to outperform the market that active investing offers, while others may opt for the simplicity and lower costs associated with passive investing.

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