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Beyond the False Dichotomy of Active versus Passive

By Apurva Schwartz

If you have even a passing familiarity with financial media, you may well believe that the debate around active versus passive management has long been settled. There seems little tolerance for any argument that active managers outperform over any reasonable time period. We think this is an unbalanced conversation that creates a false dichotomy between active and passive.

Most articles on active management start the same way. First there's the summary of the data in the latest active-passive performance scorecard from SPIVA or Morningstar—which are invariably one-sided. Then there's the discussion of the high cost of active management, especially compared with index funds. The more academically minded authors also will reference "The Arithmetic of Active Management" (Sharpe 1991) and its "proof" that active management is doomed to underperform. But all this hardly seems like a balanced or analytically honest fight.

And it's not just index fund advocates who use this lead-in. Oddly enough, even those seeking to make the case for active management feel that they need to present the negative case first.

We at the Active Managers Council believe this introduction to active management needs a rethink. Not only is it a strange way to present the value of an active approach to investing, it perpetuates mistruths about active management's theoretical performance, actual performance, and cost–benefit to investors. Yet this is the way that many in the industry—including many financial advisors—present active management to their clients.

Let's examine each of the elements of the classic introduction and how they should be reframed to provide a more accurate picture of active management.

IN THEORY: ACTIVE AND PASSIVE IN BALANCE

Sharpe's arithmetic of active management has become a touchpoint for conversations about investing.

Its simplicity is part of its appeal. Sharpe makes only two assertions. The first is that the average active manager will earn the same return as the average passive manager before costs. The second is that, because the costs of active management are higher than the costs of passive management, the average active manager will earn less than the average passive manager after costs.

Warren (2020; 2021) says "Sharpe's logic is seductive" and turns a critical eye on Sharpe's proposition. But Warren concludes that Sharpe does not present the best theoretical model of the relationship between active and passive.

That's because, taken to its logical conclusion, Sharpe's proposition would result in a world where all investors are passive investors. What rational person would want to be an active investor if it meant earning a lower return?

If the market became 100-percent passive, no one would be doing research on companies. As a result, no one would know whether a stock's price was too high or too low relative to the prospects for the underlying company, which means that stock prices would be disconnected from real-world value. And trading activity wouldn't help matters, because buys and sells would be driven only by cash flows and not by an opinion on a stock. All in all, a completely passive market would be an unpredictable market.

[This framing] creates a false dichotomy between active and passive.

But a 100-percent passive market also would be an unsustainable market. It wouldn't be long before some investors would realize that market inefficiency creates an opportunity for profit, and investors would begin investing actively, buying undervalued investments and shorting overvalued ones.

Observing the better-than-average returns from an active approach, other investors would begin shifting assets into actively managed funds. Ultimately, the increase in active management—and the investment research needed to support it—would start to bring market prices back into line with fundamental values.

The shift into active management would continue until the superior

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returns from investing actively are completely offset by the higher research and trading costs an active approach entails. At this point, active and passive management would be in balance, each with a reasonably stable share of the investment pool.

This balancing point is often called the Grossman–Stiglitz equilibrium, after Sanford J. Grossman and Nobel Prize winner Joseph Stiglitz, who set forth the theoretical framework for it in Grossman and Stiglitz (1980).

Active management is not doomed to underperform, as Sharpe suggests. Instead, in the Grossman and Stiglitz model, which is supported by empirical evidence, active and passive are in balance.

"The research findings seem to accord more with a Grossman and Stiglitz equilibrium than Sharpe's proposition," notes Warren. Berk and van Binsbergen (2015; 2016) look at active U.S. equity funds and find that the average fund earns $3 million above the index return after fees—nice, but not significantly different from the zero return predicted by Grossman and Stiglitz. Leippold and Rueegg (2020) expand the analysis to all the equity and fixed income funds in the Morningstar database and get similar results overall, though their findings vary by fund category.

Note that these researchers are calculating total dollars of outperformance rather than the average outperformance per fund. In other words, they are using a dollar-weighted approach rather than an equal-weighted approach. As a result, results of these research papers can't be compared with the headline statistics from the SPIVA report and the Morningstar Active–Passive Barometer. More on this theme to follow.

To summarize, active management is not doomed to underperform, as Sharpe suggests. Instead, in the Grossman and Stiglitz model, which is supported by empirical evidence, active and passive are in balance.

IN PRACTICE: ACTIVE MANAGERS DO OUTPERFORM

That's the theory. The second critique of active management is that it doesn't outperform in practice, but that criticism is overly broad and arguably unfounded.

Of course, even Sharpe's proposition does not preclude individual active managers from outperforming. Sharpe is saying that, on average, the gross return of active management will equal the market return, but that average return combines the returns of some managers who outperform and some who underperform.

And, yes, individual managers do outperform—a fact that industry practitioners are well aware of, and one that has attracted the attention of a considerable body of academic research. Cremers et al. (2019) surveys that literature. They conclude that the research shows that "active managers have a variety of skills and, in many cases, tend to make value-added decisions" and that "many funds do appear to create value for investors even after accounting for fees."

The authors note that numerous studies find that active managers add value through stock selection, both on a fund-by-fund basis and at an aggregate industry level. This stock-picking ability is most pronounced for stocks with high idiosyncratic volatility, for stock selection within industries, and for the largest positions in a portfolio. The source of this selection ability varies. Some managers can predict earnings, some correctly judge post-merger performance, and others trade in advance of trends.

Cremers et al. also find that the weight of the evidence supports the hypothesis that investors are able to identify outperforming managers in advance, not just with the benefit of hindsight. For example, several studies confirm that investment advisors effectively manage the talent on their portfolio management teams, efficiently allocating capital among managers in a way that enhances returns.

Perhaps even more importantly, investors at large can use public information to suss out manager skill. Investment approach is a particularly important predictor. The research suggests that funds with a differentiated approach—those with low exposure to common factors, high active share, or a high level of concentration—are more likely to add value for their investors. Low turnover, effective trading, a willingness to hold unpopular stocks, and a disciplined approach also have been associated with better results. Superior research abilities also appear to be key, meaning that managers have access to additional information, both qualitative and quantitative. Other viable predictors of outperformance include portfolio manager background (socioeconomic and educational) and fund ownership (by portfolio managers or directors).

Cremers et al. caution that managers' ability to create value varies with market conditions, citing research finding that active managers do better when trading volumes are higher and the economy weaker. The dispersion of returns appears to be a critical factor, with active management performing better when there is greater variation in returns within a market.

The authors observe that the competitive environment also matters. Not surprisingly, active managers tend to do better in markets that are less efficient, such as

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the emerging markets. They also are more likely to outperform when they invest in asset classes or use styles where they have fewer competitors, though there's a caveat: The presence of index-fund competition actually can help active manager performance by providing competition that leads to lower fee levels.

For example, fixed income has been an area where active management has been generally successful, according to Choi et al. (2021). They find that the average active bond fund outperforms index-based equivalents.

In brief, many individual active managers outperform, and investors are not throwing darts in the dark when it comes to manager selection; there are many data points that investors can use to predict skill. Active managers in general also can outperform, particularly in certain asset classes or when market conditions are favorable.

A CRITICAL READING OF THE SCORECARDS

But what about the active-passive scorecards? For many investors, the biannual SPIVA report[1] and Morningstar Active/Passive Barometer[2] are the definitive takes on the performance of active management relative to passive.

The methodology of these reports has not gotten much attention, yet a close examination suggests that, although helpful, these reports should be interpreted carefully.

Most notably, the headline statistics of these reports are computed on an equal-weighted basis, meaning that every fund has the same impact, regardless of size. But it turns out that investors are actually good at picking managers, so that dollar-weighted returns (which SPIVA and Morningstar provide) are almost always higher than the equal-weighted returns. For example, in the year-end 2023 SPIVA report, more than 85 percent of the observations for U.S. equity funds were higher on a dollar-weighted basis than on an equal-weighted basis. Put another way, funds with worse performance tend to be smaller.

More technically, the scorecards penalize bundled fee structures, meaning that fees paid for advice (such as 12b-1 fees) are deducted from fund assets rather than charged separately. These bundled structures are more likely to be used in older funds (which are more likely to be actively managed) than in newer funds (which are more likely to be index-based). Fee structures are increasingly unbundled for all funds, so this is less of an issue in newer scorecard reports; however, the scorecards still present an overly negative assessment of active manager skill, especially in older reports.

Funds still can generate excellent long-term performance even if they don't outperform in every period. In fact, even the best active managers will underperform in some periods. Morningstar does not publish a persistence scorecard.

The scorecards' approach to funds that are no longer in existence—which is commonly referred to as the adjustment for survivorship bias—also has received criticism. Though it may seem like a technicality, the treatment of survivorship bias has an outsized impact on results. SPIVA and Morningstar use an approach that, given the turnover in fund offerings, almost guarantees poor results for active management. By contrast, an analysis from fund manager T. Rowe Price uses a different approach to survivorship and finds that active fund performance is quite competitive with index fund performance. For those interested, an analysis from the Active Managers Council, titled "Rethinking Survivorship Bias in Active-Passive Comparisons," explains the impact of this methodological choice in detail.[3]

SPIVA's "persistence" scorecards also are problematic. These annual reports look at fund performance in consecutive one-, three-, and five-year periods, and they invariably find that only a small proportion of funds outperform period after period.

Notably, Morningstar's Jeffrey Ptak has called performance persistence a "red herring."[4] His reasoning: Funds still can generate excellent long-term performance even if they don't outperform in every period. In fact, even the best active managers will underperform in some periods. Morningstar does not publish a persistence scorecard.

Overall, although the scorecards can provide some insight on trends, especially in shorter periods, their methodology leads them to an overly negative assessment of active manager skill. In other words, they should not be the last word.

EVALUATING COST-BENEFIT

The third core criticism of active management is that it charges higher fees than index fund management. Essentially, this critique assumes that active and passive managers are offering exactly the same service, with only a difference in price. But there is evidence that, in many cases, active managers are providing additional benefits that support higher fees.

In this vein, Cremers et al. note that active managers add value by anticipating changes in market direction or volatility. By contrast, index funds must remain fully invested at all times. For multi-asset portfolios, these market-timing skills are particularly important. Note that successful market timing may result in lower risk rather than higher

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performance—a benefit that would not be captured in a simple scorecard analysis.

Active managers also can provide access to asset classes where indexing is difficult. Most obviously, investments in private equity or venture capital are necessarily actively managed, given the difficulty of creating indexes in these areas. Choi et al. stress that most fixed income investing involves active management—even in ostensibly indexed portfolios. Fixed income indexes can contain a very large number of issues, many of which are difficult to buy and sell. Therefore, fixed income indexes are difficult to replicate exactly, so that index funds in this asset class tend to make substitutions based on the manager's research and analysis.

As has often been pointed out, all else being equal, lower-cost investments always will outperform higher-cost investments.

Another area where active management is essential is in sustainable investing. Identifying environmental and social factors that may have a material impact on corporate performance involves judgment, as does assessing how those factors are affecting a particular company. Although the sponsors of sustainability indexes also perform this analysis, active managers have greater ability to tailor the approach to align with investor values and are more likely to provide transparency into the decision-making process.

On a cautionary note, investors thinking about hiring an active manager need to consider a hidden cost—that of researching the selection of the manager. In many instances, this cost may be fairly low. For instance, an investor working with a financial advisor can tap into the advisor's expertise, but a participant in a defined contribution plan can know that the investment options have been vetted by the fiduciaries overseeing the plan. But for some investors, the costs of researching managers may be high, if only in a psychic sense.

Of course, investors need to be conscious of all the costs involved in an investment and weigh the costs versus the benefits. As has often been pointed out, all else being equal, lower-cost investments always will outperform higher-cost investments. But a careful assessment of costs and benefits might lead to the use of active management for some components of a portfolio and index funds in other components.

A NEW INTRODUCTION TO ACTIVE MANAGEMENT

So, here's a better introduction to active management:

- Active and passive investing are both important. The markets need both, and investors need both. In theory, the two are in equilibrium—a theory that is supported by empirical evidence.
- Active managers do outperform in fact. Individual managers often outperform, and considerable evidence shows that investors can—and do—identify outperforming managers in advance. Active managers in general also can outperform, particularly in certain asset classes or when market conditions are right.
- Active management generally does cost more but often because it provides greater benefit. Investors should carefully consider both cost and benefit but often may find that combining active and passive in a portfolio is optimal.

In sum, active management is an important component of a complete financial plan, and the industry needs to introduce it in an appropriately positive way.

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ENDNOTES

1. See https://www.spglobal.com/spdji/en/research-insights/spiva/.
2. See https://mscomm.morningstar.com/activepassive/.
3. See https://www.investmentadviser.org/wp-content/uploads/2021/12/WP_Rethinking_Survivorship_v2.pdf?t=61ba488b2f944.
4. J. Ptak, "Quit Chasing Unicorns: Consistent Fund Performance Is Overrated," Morningstar (December 18, 2018), https://www.morningstar.com/funds/quit-chasing-unicorns-consistent-fund-performance-is-overrated.

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