Strategic: Be active

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Why? Passive investing can provide cost-effective, broad market exposure in established markets. But active investing may be needed in volatile and uncertain periods, less developed markets, less liquid assets like small-cap stocks, or in thematic investing. In bonds, active management can help handle complexities like duration and credit risks.

Lea Beutter_Unsplash

Our view is that long-term investors need to strike the right balance between passive and active investment tools to achieve their long-term financial goals. But it can seem daunting to understand which type of approach may work best—and overly simplistic ideas like just focusing on costs may lead investors to miss out on returns and carry excess risk.

Over an eventful 2025, many global equity markets have delivered robust performance, especially after April volatility. Investors
who choose their own instruments in a globally diversified way have faced significant currency volatility, while low comovement between stocks and high return dispersion, especially after second-quarter earnings results, have increased the opportunities and risks for single-security investors.

Active investing may help even the most engaged investors in today's volatile environment, as part of a well-diversified portfolio and as a complement to stock picking. In equities, active managers can capitalize on high return dispersion and low intra-stock correlation, using strategies like long/short equity hedge funds to potentially enhance returns and reduce volatility.

In fixed income, active management can navigate complexities like duration and credit risks, particularly in markets with high volatility and wide performance differences. Active managers can adjust portfolios dynamically, taking advantage of opportunities in less liquid markets, managing risks more effectively than passive strategies, and having the agility to trade in markets where liquidity may be scarcer.

In alternatives, active strategies can provide diversification and resilience, in our view. Hedge funds, for instance, can adapt to macroeconomic shifts, using discretionary macro or equity-market neutral strategies to cushion portfolios in volatile markets. Active management's flexibility may allow investors to harness volatility, generating additional income or hedging against potential losses.

We believe a balanced approach combining active, passive, and single-security investing can enhance portfolio resilience over the long term. Investors should consider their risk appetite, investment horizon, and market efficiency when deciding the mix. For instance, passive investing may suit short-term trades in efficient markets, while active management can add value in less efficient or volatile markets. By blending these approaches, we believe investors can build a diversified, cost-effective portfolio that is well-prepared for future opportunities and resilient enough to endure likely volatility and uncertainty in the second half of the year.

While there is no one-size-fits-all approach, here are six key signposts that can guide investors in choosing between active or passive investment approaches:

Is broad investor risk appetite high or low? Generally, periods of high investor risk appetite arise from factors like robust economic growth, lower interest rates, easier financial conditions for companies (evidenced by lower credit spreads), and low expected or actual swings in market prices (low implied or realized volatility). In such circumstances, investors may prefer to capture positive broad-market movements through passive investing in, for example, equity indexes, and use selective active management to use volatility for hedging purposes. Conversely, investor risk-aversion, when accompanied by high market volatility and elevated uncertainty may favor active management, more judicious security selection, and using ways to harness volatility in order to generate additional portfolio income or hedge against potential losses.

How long is the intended investment period? Investors looking for a short-term trade in a particular part of the market (albeit one wider than a single stock, bond, or commodity) may consider passive investment for ease of buying and selling, relatively low costs, and for exposure that closely matches the performance of a specific industry, region, or index. Active management may be beneficial for investors with a long-term horizon, allowing them to capitalize on market dislocations and structural trends that may not be replicable purely through index investing. Blending active managers with passive and less market-directional approaches (such as equity long/short or equity market neutral hedge funds) can provide diversification benefits, enhancing portfolio resilience against style-investing shifts or wider market downturns.

How efficient is the market? Active management is often preferred in less liquid assets or markets, such as small-caps or emerging markets. In particular, active managers have more flexibility on what securities to trade when market liquidity is low and when to trade securities—whereas passive instruments may have to follow changes in their benchmark closely (even if this is less advantageous to performance in low-liquidity markets) to avoid deviating too far from the reference index. In technical terms, passive approaches try to minimize tracking error as a primary concern.

Active manager outperformance may be more persistent in less efficient markets. For example, a 2024 article from Wilmington Trust found that between December 1999 and December 2023, a majority of emerging market fund managers outperformed on a 12-month rolling basis for 75% of the time versus the MSCI EM Index and 65% of the time for US small-cap managers versus the Russell 1000. However, this figure falls to 38% for US large-cap managers, given the greater efficiency of this market.

Market liquidity is just one form of market efficiency. Others include the availability of investment research on a particular company—which tends to rise the more analysts cover it —and the share of professional, institutional investors in a market.

How closely (together) are returns moving in a particular market? Active management tends to perform better in environments where returns between instruments with an asset class move in different directions rather than in tandem (low intra-stock correlation) and where the return differences between the “winners” and “losers” are greatest (high return dispersion). When the return difference between stocks within an index like the S&P 500 increases, active managers can capitalize on these conditions through strategies like long/short equity hedge funds, potentially reducing volatility and enhancing returns.

Is the cost versus potential outperformance outlook favorable? While passive investing can offer cost-effective exposure to broad markets, active investing can potentially generate alpha (returns in excess of broad market movements), especially in markets with high dispersion and volatility. Investors should weigh the cost of active strategies against the potential for outperformance, particularly in niche or emerging sectors. Reviewing an active strategy’s tracking error versus a passive strategy as well as the overlap in portfolios is a good starting point to gauge the outperformance potential.

How does investor type affect market movements? Market segmentation and behavioral patterns can create inefficiencies that active managers exploit. Segmentation arises from institutional constraints, while behavioral biases like overconfidence and conservatism can lead to market momentum. Active managers can take advantage of these inefficiencies, especially in less efficient markets like corporate credit and emerging market debt, where information asymmetries exist. The law of active investing suggests that outperformance depends on skill and breadth, with skill being harder to acquire but crucial for success. Expanding investment mandates and focusing on diverse instruments can enhance active management's effectiveness.

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Appendix

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