Active vs. passive investing

What the 2024 historical data indicate

Ryan McWalter, CAIA
Senior Director, Investments

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A strong debate over the years: Updated research in an evolving environment

As a co-fiduciary and investment advisor, TruePlan helps retirement plan sponsors navigate one of the most important decisions they face: which investment options to offer employees. Each year, we revisit the active versus passive investing debate — an issue that continues to evolve — to ensure our guidance is grounded in both rigorous analysis and diverse perspectives. Nearly a year after our 2023 study (released in 2024), we've returned with fresh quantitative and qualitative insights to help clients and the broader industry make better informed decisions.

Quick recap of active and passive mutual funds

Actively managed mutual funds assess higher fees than passive index funds. Proponents of active management believe the fees are warranted by a fund manager's ability to provide better total or risk-adjusted returns, resulting in a potentially higher return profile and/or lower volatility.

In the decade following the 2008 financial crisis, investor surveys and industry flows indicated a preference for passively managed funds. For instance, a 2021 Gallup Investor Optimism Survey concluded that a majority of investors (71%) found passive investing to be superior to active investing.[1]

TruePlan strives to approach this debate objectively and provide transparent, understandable and research-based conclusions at the end of each calendar year. We combine the 2024 year-end data, presented on pages 6-11, with discussions we had with more than 60 asset management firms involved in active, passive and hybrid strategies throughout the year.

> *We are likely entering a notably different era of monetary policy (interest rates), which should impact capital markets and the conduciveness of active and passive management across asset categories and classes.*

[1] https://news.gallup.com/poll/354821/investors-passive-investing-path-wealth.aspx

Quantitative and qualitative considerations suggest that the decade following the 2008 financial crisis may have been a once-in-a-lifetime investment environment with the existence of a zero-interest rate policy and large-scale quantitative easing, which has now passed. This sentiment doesn't necessarily forecast a poor investment environment going forward, but it puts the 2009-2021 period into historical context.

TruePlan's 2024 analysis

Introduction

Our investment team covers the active versus passive debate for investments that are typically available to investors though their company-sponsored retirement plans, e.g., 401(k) plans for for-profit companies and 403(b) plans for not-for-profit companies. The research is done to capture the percentage of actively managed mutual funds that outperform their respective benchmarks, which are usually available in a passively managed mutual fund structure.

Methodology

TruePlan's approach is meaningful to retirement plan sponsors who are tasked with making more nuanced decisions regarding a diversified, multi-asset class or category lineup for their participants, often in consideration of employees with varying degrees of risk tolerance and time horizons.

Funds and share class included

TruePlan's process compares all actively managed mutual funds within a "peer group" (category) to the respective benchmark or index for that category over the trailing one-, three-, five-, 10- and 15-year periods, ending in December 2024. We capture one share class per fund, specifically the institutional share class and not those with sales commissions embedded into their expenses. The latter are not common in the retirement plan industry.

This approach contrasts with certain industry studies and commentary supporting the case for passively managed funds that highlight comparisons of large groups of equity funds to benchmarks that aren't an apples-to-apples comparison. For example, studies have compared large portions of the U.S. equity mutual fund universe to the S&P 500 Index rather than focusing on small cap funds versus small cap benchmarks, mid-cap funds versus to mid-cap benchmarks, etc.

Weighting methodology

Some active versus passive research studies weight the performance of actively managed mutual funds based on the funds' asset size to capture the industry's overall experience by assets. Our process doesn't weight the performance results by the funds' asset size; instead, we weight the funds' performance equally. As an example, the asset weighted approach leads to a $60 billion active large cap value fund's performance being 12 times more impactful to the research results than a $5 billion active large cap value fund.

We conclude that the equal weighted method is prudent for investment advisors who have the resources to search for, select and recommend both active and passive funds to their clients. The asset weighted approach doesn't capture investment advisors' research and sourcing processes, specifically those advising retirement plans. Therefore, it doesn't capture many investors' experiences.

TruePlan researches and recommends a variety of active and passively managed funds for clients. While we consider a fund's asset size in our process, we don't tilt our research and selection process to favor the industry's larger funds. We use a combination of total and risk-adjusted return measures and fee evaluation. Simply, if we believe a $5 billion large cap value fund is a better solution for a client from an overall investment and fiduciary perspective, we will recommend it over the $60 billion fund.

Analysis

Our analysis spans the following U.S. equity categories:

- large, mid and small cap value, blend and growth;
- public Real Estate Investment Trusts (REITs);
- international equity;
- emerging market equity;
- U.S. intermediate core and core plus bond;
- inflation protected bond; and
- U.S. high-yield bond.

We chose these categories because they are commonly available in participant-directed defined contribution retirement plans, such as 401(k) and 403(b) plans.

We conclude that there are certain asset categories or classes where a high percentage of active managers outperform passive management, even when accounting for certain biases that come with performance comparisons over varying timeframes — most notably, survivorship bias. It is important to note that the actively managed mutual fund data carries survivorship bias. Survivorship bias is “A type of sample selection bias that occurs when a data set only considers ‘surviving’ or existing observations and fails to consider observations that ceased to exist.”[2]

This can create overly optimistic ex-post return performance by removing the performance of funds that failed, closed or liquidated. Therefore, it is reasonable to presume that a complete universe of actively managed funds, including both active and closed funds, would show a larger percentage of funds underperforming their benchmarks, especially over longer time periods. For example, a fund may close due to underperformance or low asset levels, with low asset levels driven by subpar performance.

In consideration of survivorship bias, the data still support the case for active management in certain asset classes or categories. When considering the market volatility in recent years and the more limited impact of survivorship bias, this is particularly notable. The shorter time periods have a much larger number of managers to sample and evaluate — in what many believe was a challenging and telling environment for active management due to elevated inflation and interest rate volatility.

The data utilized in this report are driven by Ycharts Inc., and respective benchmark and actively managed mutual fund returns (net of fees).

Asset classes and categories conducive to active management with a high percentage of active managers outperforming passive management:

- large cap value;
- small caps (value, blend and growth);
- international equity;
- public REITs; and
- U.S. intermediate core and core plus bond.

Asset classes and categories where a low percentage of active managers outperforming passive management:

- large cap blend;
- large cap growth;
- mid-caps (value, blend and growth);
- emerging market equity;
- inflation protected bond; and
- U.S. high-yield bond.

[2] Corporate Finance Institute. Survivorship Bias. https://corporatefinanceinstitute.com/resources/capital-markets/survivorship-bias/

Results and recommendations

Based on the 2023 and 2024 research results, TruePlan recommends that retirement plan sponsors continue to offer a combination of active and passively managed mutual funds in their retirement plan menus. This can help balance the pursuit of favorable long-term total and risk-adjusted returns with controlling fees.

Final thoughts

As market dynamics continue to change over time, active managers will have more environments and opportunities to prove their value. Therefore, the active versus passive management debate should continue and be encouraged, as new conclusions may arise. This is especially the case in fluid and evolving environments with varying investment perspectives and approaches.

Category data (charts) provided on pages 6-11 are based on total net returns for the funds and noted indexes.

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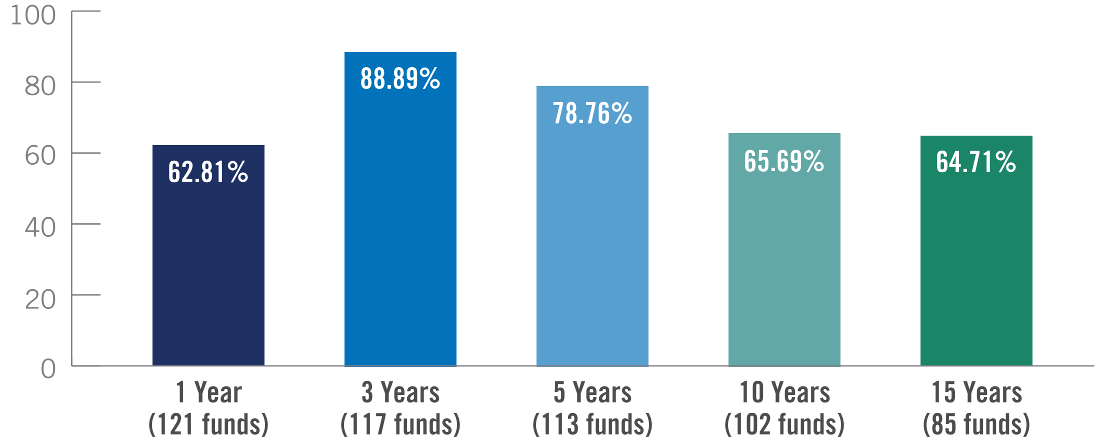
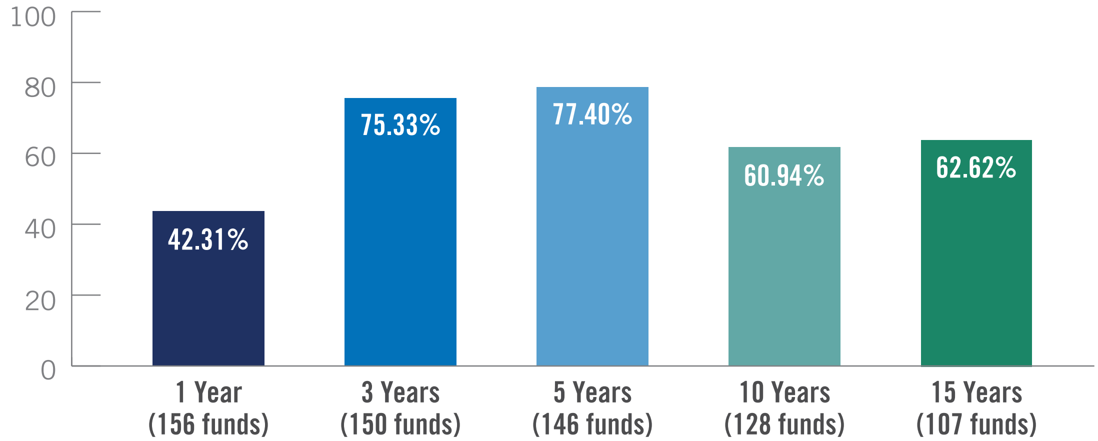
contact@trueplanadvisors.com

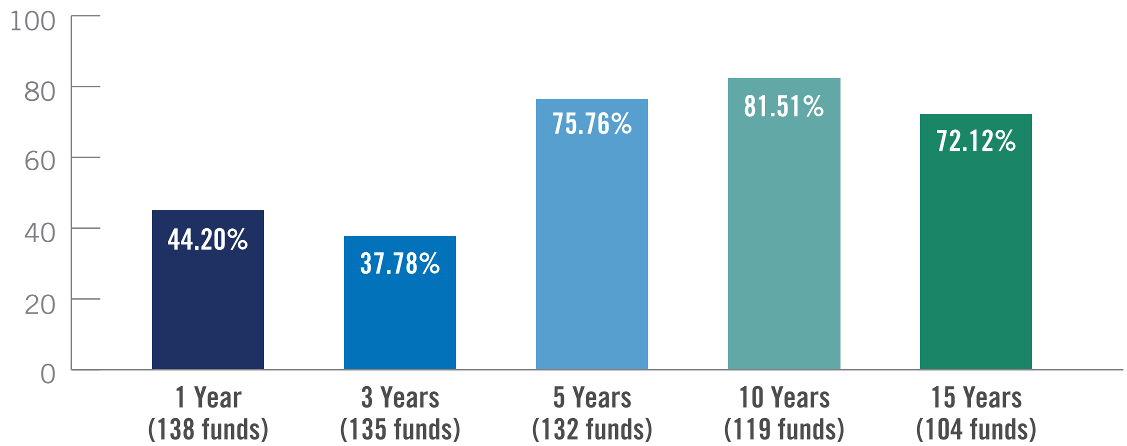
Small Cap Value Category (Percentage of funds that outperform the Russell 2000 Value Index)



Small Cap Blend Category (Percentage of funds that outperform the Russell 2000 Index)



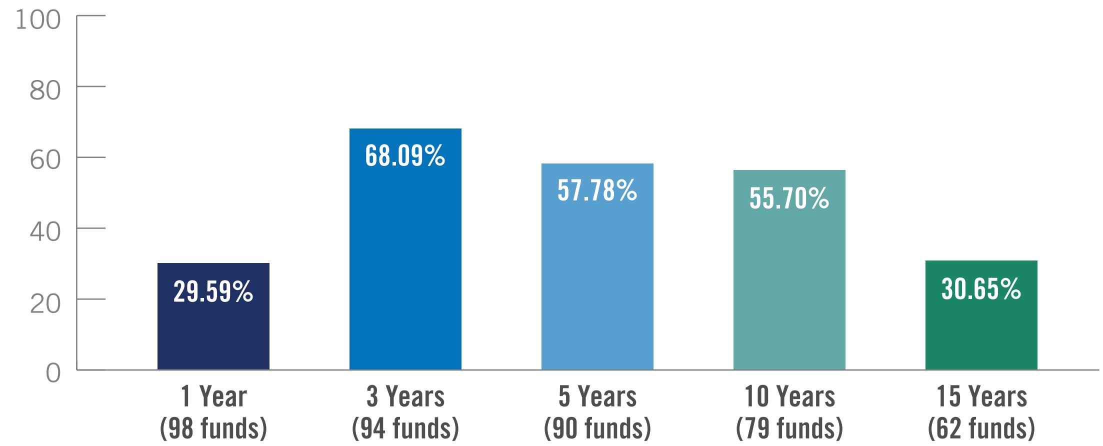
Small Cap Growth Category (Percentage of funds that outperform the Russell 2000 Growth Index)



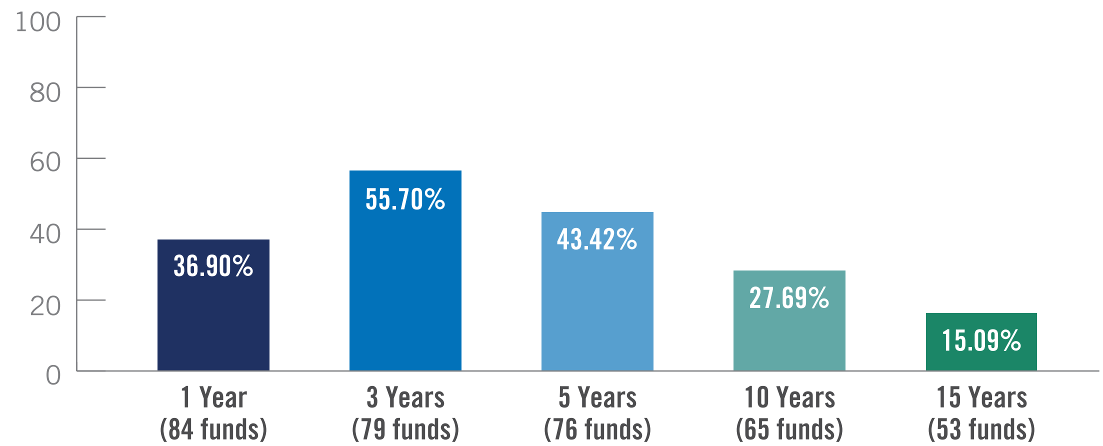
Data are through December 2024 | Source: TruePlan and Ycharts (net of fees).

Past performance is not a guarantee of future returns.

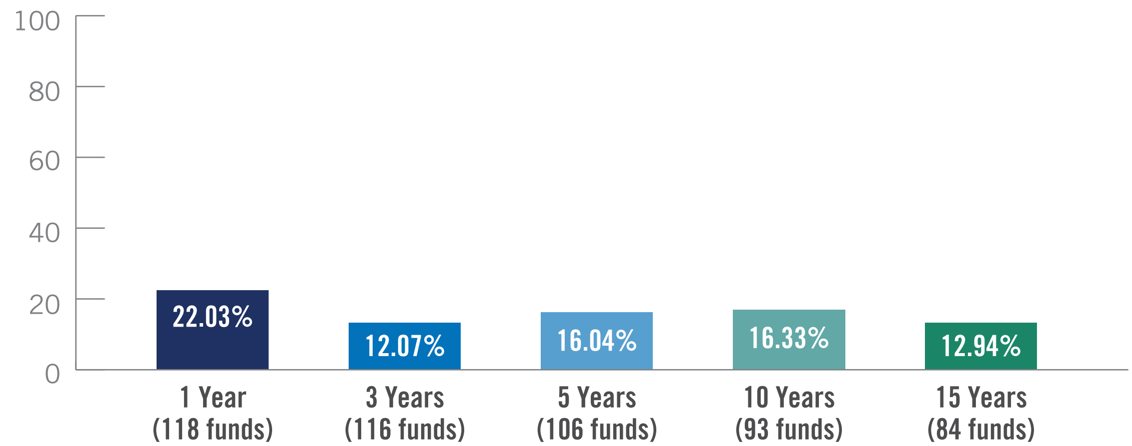
Mid Cap Value Category (Percentage of funds that outperform the Russell Mid Cap Value Index)



Mid Cap Blend Category (Percentage of funds that outperform the Russell Mid Cap Index)



Mid Cap Growth Category (Percentage of funds that outperform the Russell Mid Cap Growth Index)



Data are through December 2024 | Source: TruePlan and Ycharts (net of fees).

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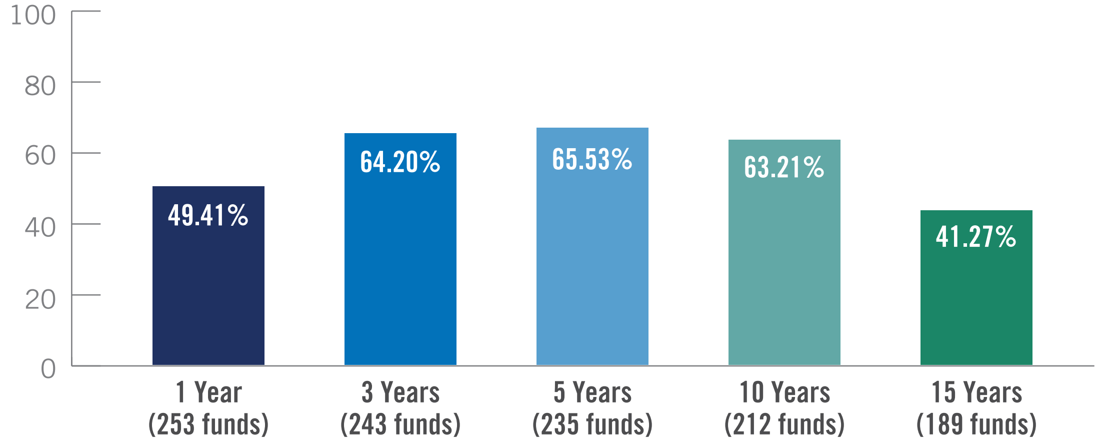
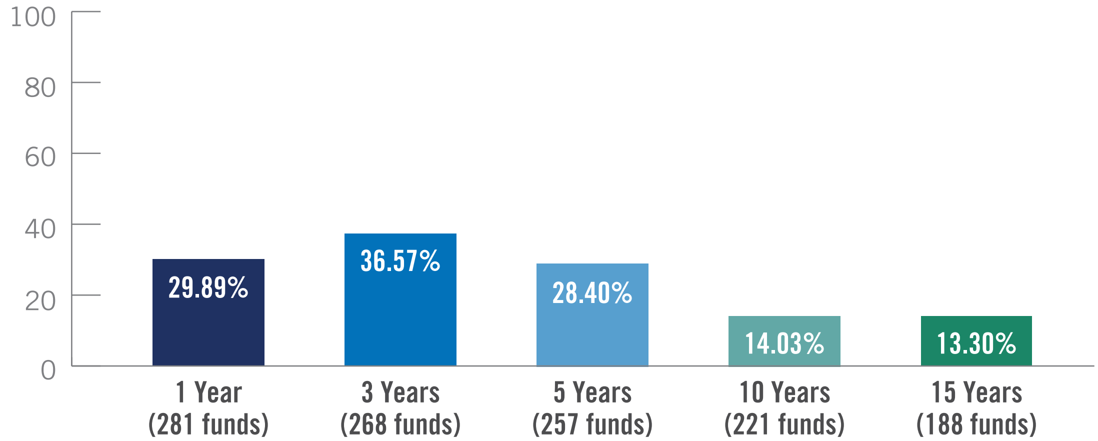
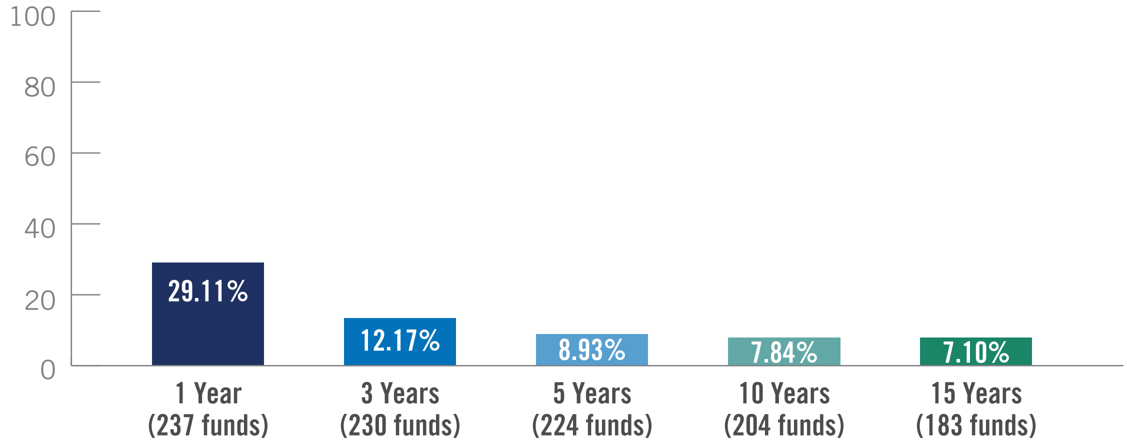
Large Cap Value Category (Percentage of funds that outperform the Russell 1000 Value Index)



Large Cap Blend Category (Percentage of funds that outperform the Russell 1000 Index)



Large Cap Growth Category (Percentage of funds that outperform the Russell 1000 Growth Index)



Data are through December 2024 | Source: TruePlan and Ycharts (net of fees).

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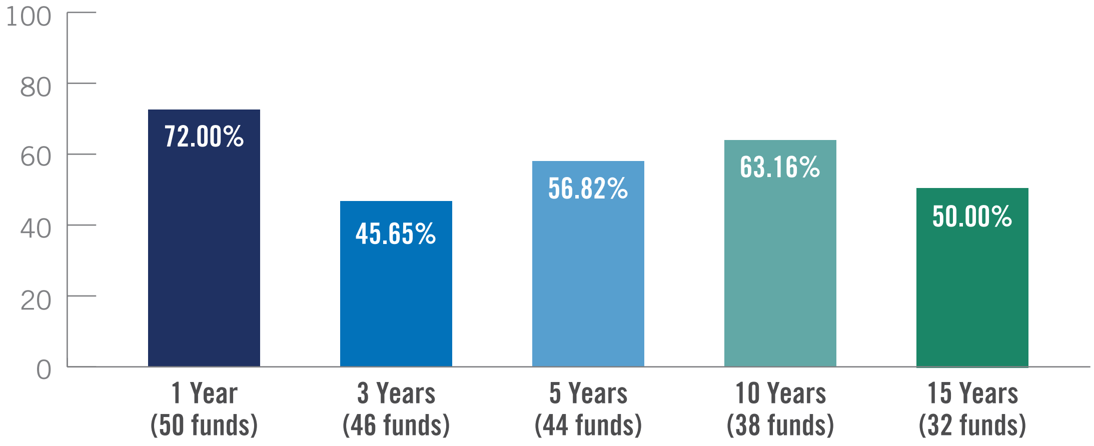
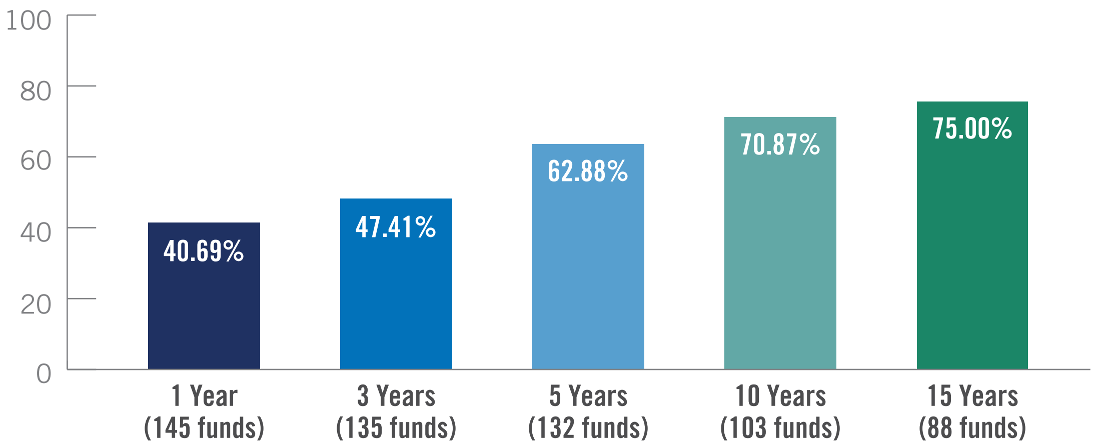
Real Estate Investment Trusts – Funds investing in publicly traded real estate securities (Percentage of funds that outperform the Vanguard Real Estate Index, VGSNX*)

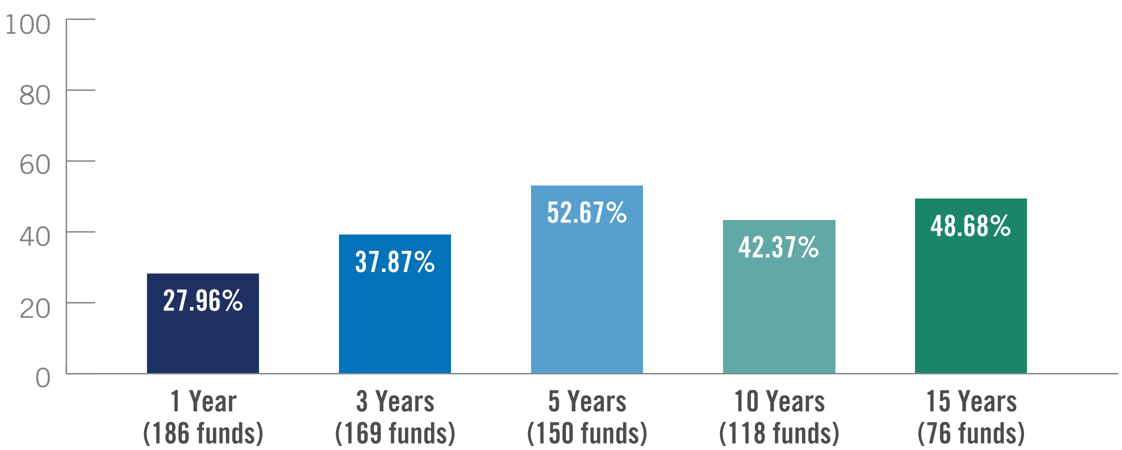


*Vanguard's Real Estate Index Fund was used due to a lack of a 15-year track record for relevant REIT indices.

International Equity (Foreign Large Blend) Category (Percentage of funds that outperform the MSCI ACWI Ex-USA Index)



Emerging Market Equity Category (Percentage of funds that outperform the MSCI Emerging Market Index)



Data are through December 2024 | Source: TruePlan and Ycharts (net of fees).

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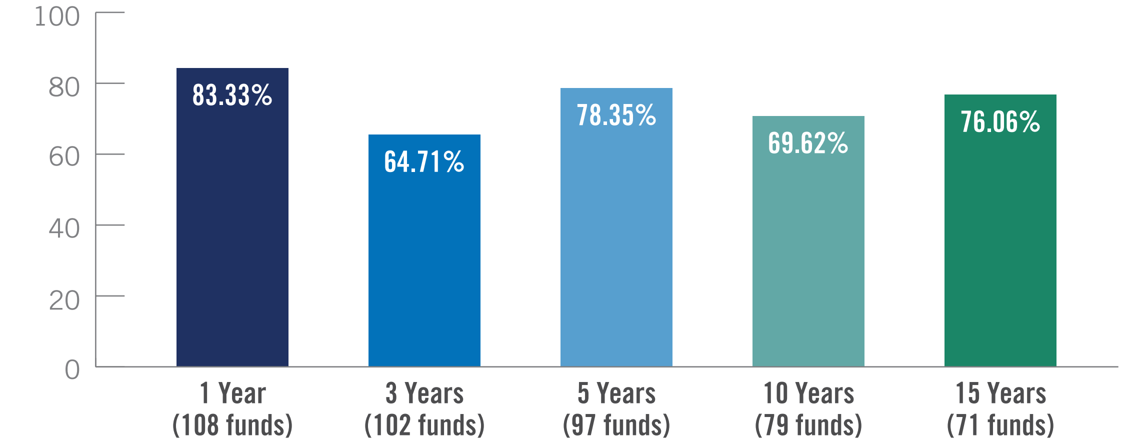
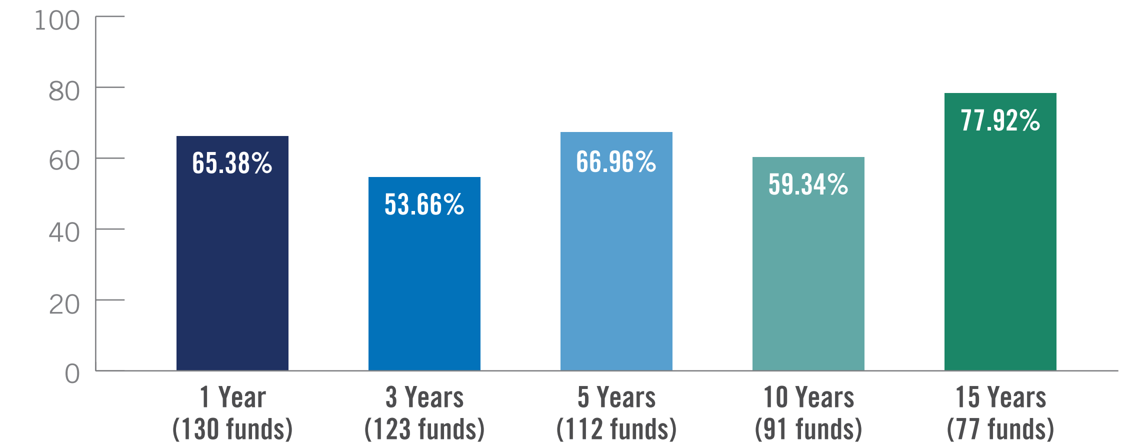
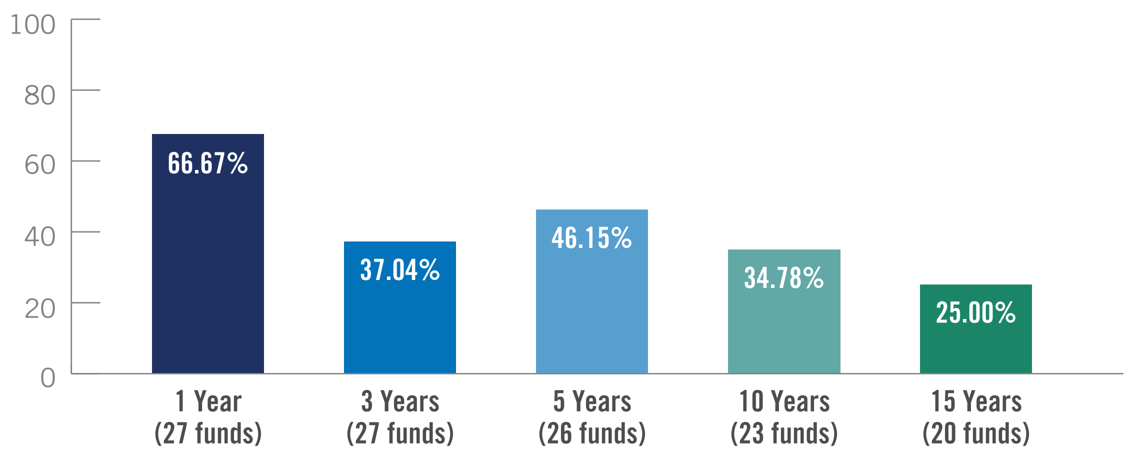
Intermediate Core Bond Category (Percentage of funds that outperform the Bloomberg US Aggregate Bond Index)



Intermediate Core Plus Bond Category (Percentage of funds that outperform the Bloomberg US Universal Index)



Inflation Protected Bond Category (Percentage of funds that outperform the Bloomberg US TIPS Index)



Data are through December 2024 | Source: TruePlan and Ycharts (net of fees).

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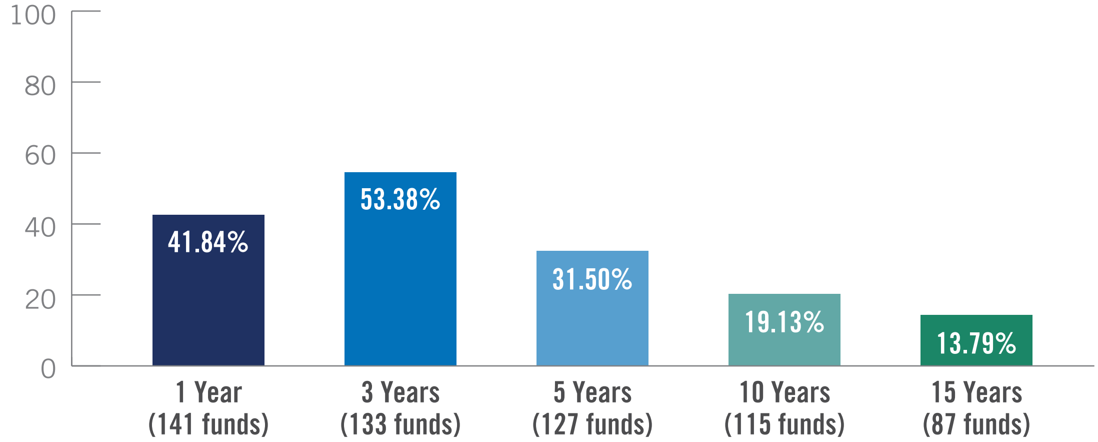
High Yield Bond Category (Percentage of funds that outperform the Bloomberg US HY Corporate Index)



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Benefit and Retirement Advisors

trueplanadvisors.com

One Empire Drive, Rensselaer, NY 12144
800.388.1963 *fax* 518.431.7601

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