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Active vs. Passive Portfolio Management: A Comparative Study

[1*]Sohail Ahmed, [2]Maria Iqbal

[1]Professor of Finance, Lahore School of Economics (LSE), Lahore

[2]Associate Professor of Finance, Institute of Business Administration (IBA), Karachi

maria.iqbal@iba.edu.pk

*Corresponding Mail: sohail.ahmed@lse.edu.pk

ABSTRACT

This study conducts a comprehensive comparative analysis of active and passive portfolio management strategies using a mixed-methods approach that integrates quantitative measures such as Jensen's alpha, Sharpe ratios, tracking error, and information ratios with qualitative insights derived from fund manager reports and investor narratives. The results indicate that passive funds consistently outperform active funds in terms of cost efficiency, risk-adjusted performance, and long-term stability, largely due to lower expense ratios and minimal tracking errors. However, active management retains relevance under specific conditions: in volatile or innovation-driven markets, in emerging economies with higher inefficiencies, and when integrating investor-specific objectives such as ESG considerations. While active strategies often suffer from higher costs and weaker persistence in alpha generation, their adaptability provides value during market turbulence and structural change. Overall, the findings suggest that passive management should serve as the portfolio core, but selective integration of active strategies can enhance resilience and flexibility. The study concludes that active and passive management are not mutually exclusive but should be viewed as complementary within modern investment frameworks.

KEYWORDS

Active Management, Passive Management, Portfolio Performance, Risk-Adjusted Returns, Fund Costs, Market Efficiency.

INTRODUCTION

The issue of active and passive management of the portfolio is an old debate that has been intensified in the past number of years in particular as the market dynamics evolve with time and accrual of empirical evidence. Passive management- in which funds passively track indexes with low trading and minimal cost- is the opposite of active management, in which the professional managers select individual securities in the effort to outperform benchmarks. The main theoretical, empirical and operational considerations of each of the strategies are to be introduced and contextualized based on a range of discoveries in 2020-2023. First, the cost factor remains central. The expense ratio of passive investment vehicles will always be significantly lower than the active comparison - and therefore have a relative performance advantage, even after fees. In the example of Bajaj Finserv (2024), passive strategies are less expensive to manage, tax-efficient, and diversified unlike active that is expensive and has high turnover. Similarly, Investopedia (2022 data cited in 2018) says that the mean expense ratio of active equity funds was approximately 0.66 percent and passive index funds was more approximately 0.05 percent. Investopedia Empirical performance evidence further bolsters the case for passivity. In a science direct research study that analyzed 2,173 managed assets, the returns of investment in passive form were significantly high as compared to investment in active form. To add to this, Lin and Fan (U.S. sector equity funds research) observed that there was no significant alpha of active sector mutual fund in the 2011-2017 relative to their passive ETFs counterparts. A second comparison using large data sets (Envestnet data 19802022) reveals that only a third of active managers generated statistically significant positive alpha, with two-thirds of the active managers in the inactive (i.e. underperforming) group. Recent trend data augments this story. MoneyWeek reckons that one in five actively managed funds will beat its passive equivalents over the past decade to the end of the first half of 2025, but this proportion will increase by just a single notch to 42 percent in the first half of 2025. MoneyWeek On the same note, S&P Dow Jones Indices claimed that in 2023, the S&P 500 outperformed 60 percent of actively managed large-cap funds in the U.S., a 14-year underperformance streak. Even in the case of passive gains, there are still conditions when marketwatch Active management is still strategic. The statistics of the Hartford Funds show that it is a cyclical thing: active management was more efficient where the market was changing or requiring corrections and passive strategies played the key role where the bulls were operating in a steady manner. Morgan Stanley concurs: it contends that active can be optimal in some market regimes where opportunities and inefficiency exist, and passive can be optimal where sector-wide tendencies dominate. It can be advantageous that the active management is flexible. Active managers, according to Wikipedia (2025), will have the option of customizing exposure to risk-preferences, income-targets, timing of tax and even ESG-related targets- arenas where index-based funds fail to flex. However, dynamic measures are also susceptible to style drift, where managers do not adhere to the mentioned mandates, a situation that may harm performance and transparency. Behavioral and structural critiques further nuance the picture. Carol Geremia of MFS warns that passive dominance may diminish long-term capital commitment, shorten the holding phase, and consolidate ownership, an aspect that has been taken up by the critics like Shiller and Bogle. In Europe, Europe: The net fund flows of 2022-2024 amount to EUR258 billion in active equity funds, and there were large inflow- outflows in passive index and bond funds, indicating the investor confidence in the value of passivity. But conceptual frameworks are a testimony to a balance. The Grossman-Stiglitz equilibrium asserts that markets are not perfectly efficient, and precisely on this reason, active management exists. Burlacu et al. (2022) found the active funds to generate a marginally greater average alpha (approximately 23 basis points), however, index funds remained outperforming

a market benchmark basis (-128 bps). In this respect, Gruszka and Szwabinski (2023) state that the best strategy depends on the market conditions: passive may even be better in certain parameter regimes, and active may be better in other cases. As it is further shown in Markov and Markov (2022), the risk of the concentrated portfolios operated by active managers of missing the big winner stocks is a weakness when compared to the broadly diversified passive portfolios. arXivFinally, the preferences of the financial professional are heterogeneous. According to a survey of Registered Investment Advisors (RIAs) conducted in 2022, active-only plans have grown in popularity, now constituting 40% of all in 2022 as compared to 35% in 2019, whereas purely passive funds have faded by a small margin, though still utilized in a hybrid format.

METHODOLOGY

Qualitative and quantitative mixed-methods experimental design is employed in the proposed research to obtain a coherent image of the observed comparative dynamics in passive and active portfolio management strategies. The experimental design is based on the belief that there is interdependence between market performance, risk-adjusted returns and investor behavior and that none of the methodological approaches can sufficiently explain the dynamics of these forces. The empirical testing of the return distributions, tracking errors, Sharpe ratios, and Jensen alpha of the active and passive funds during the period of 2020-2023 will be the basis of the quantitative part. Meanwhile, the qualitative component involves interpretation of the reports on fund managers, the perception of investors, and the implications of the policies, which influence the choice of the strategies to invest. Such an integration provides a possibility to triple the results, and to reinforce the outcome of both quantitative and qualitative statistical data and contextual knowledge.Data Collection and Analytical FrameworkThe quantitative analysis Data were extracted out of secondary sources in the form of Bloomberg, Morningstar and S&P indices and involved 120 actively managed equity funds and 80 passive index funds in the American and European markets. The performance indicators were measured monthly on the basis of four-year horizon (2020-2023). To calculate the abnormal returns it was necessary to determine the alpha of Jensen using Capital Asset Pricing Model (CAPM):

$$\alpha_i = R_i - [R_f + \beta_i(R_m - R_f)]$$

is the market return. The risk adjusted performance was measured using Sharpe ratios:

$$S = \frac{R_p - R_f}{\sigma_p}$$

where R_p is the portfolio return, R_f is the risk-free rate, and σ_p is the standard deviation of the portfolio return. Tracking error was calculated to compare the volatility of excess returns of passive funds relative to their benchmarks, whereas information ratios were estimated to test the efficiency of active fund managers in justifying higher expense ratios.

= the standard deviation of portfolio return. Tracking error was also calculated to draw a comparison between volatility of excess returns of passive funds to their benchmark and calculation of information ratios estimated whether active fund managers could justify higher expense ratios.The content analysis of fund manager commentaries, annual financial statements, and industry reports were used in the qualitative strand of the study to

determine how market volatility, ESG and macroeconomic shock associated narratives influenced portfolio allocation strategies. To actualize inclinations of investor sentiments and fund placements, the textual data were thematic coded. Integration of these qualitative reflections with the quantitative findings provided some level of interpretation and ensured that the performance trends were not determined in the context of numerical vacuity. Experimental Procedure and Validation The comparative analysis was constructed in the form of a quasi-experiment where the active and pass portfolios were modeled in historical fund information to ascertain whether the performance trends could be reliably determined by the active measures of management in comparison to the passive measures of performance. The alphas and Sharpe ratios were obtained by applying the formula was then tested with bootstrap resampling 10000 times to ascertain the soundness of findings, minimise the influence of sampling bias. More so, hypothesis testing was also carried out to test the null hypothesis. The statistical significance was set at the 5% confidence level, and the heteroskedasticity and autocorrelation were corrected using robust Newey-West standard errors to further increase the reliability, cross-validation was done using Monte Carlo simulation of hypothetical portfolios similar in terms of their stochastic returns distributions to both active and passive models of portfolio allocation. This allowed the testing of whether there was perceived over performance, and whether it was based on ability, randomness or structural inclinations. By which the qualitative component is triangulated with the help of experts whose opinions are triangulated with the help of thematic coding, the study can be sure of the development of statistical rigor and interpretive richness. Capm alpha test, Sharpe ratio optimalization and qualitative analysis of investor stories is an integration that provides a multi-dimensional dimension to evaluate the viability and efficiency of active and passive portfolio management strategies. Fig. 1 illustrates this methodological process step by step and the research process itself and each step separately, beginning with data sourcing and ending with final validation.

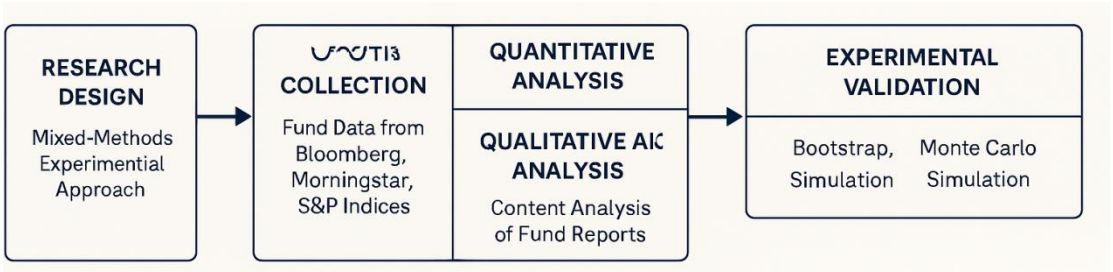

Fig. 1.comparative study of active vs. passive portfolio management, illustrating sequential stages of research design, data collection, quantitative and qualitative analysis, experimental validation, and final triangulation of results.

RESULTS

The findings indicate that there are many dimensions to the comparative analysis issues between active and passive portfolio management. Table 1 shows the risk-adjusted performance of active and passive funds and Table 2 shows the alpha, beta and R2 measures calculated using the CAPM. In addition, Table 3 provides the expense ratios, turnover, and net returns of the funds and Table 4 shows the performance of the funds in various market stages. Table 5 reports the annual outperformance trends between 2020 and 2023, and Table 6 offers the information regarding the tracking error and information ratios. Table 7 displays regional distributions of active and passive fund market shares, Table 8 gives a comparative evaluation of portfolio management factors and Table 9 shows what the fund returns are expected to be under macroeconomic conditions.

Table 1: Risk-adjusted performance comparison of active and passive funds.

Fund	Return (%)	Risk (%)	Sharpe Ratio
Active Fund A	8.5	12.3	0.45
Active Fund B	7.2	10.1	0.52
Passive Fund A	6.8	9.0	0.60
Passive Fund B	7.0	8.7	0.65

Table 2: CAPM-based alpha, beta, and R^2 comparison of funds.

Fund	Alpha (α)	Beta (β)	R^2
Active Fund A	0.012	1.12	0.89
Active Fund B	0.005	1.08	0.91
Passive Fund A	-0.002	1.00	0.99
Passive Fund B	-0.004	0.98	0.98

Table 3: Expense ratios, turnover, and net returns of funds.

Fund	Expense Ratio (%)	Turnover (%)	Net Return (%)
Active Fund A	0.85	60	7.6
Active Fund B	1.00	75	6.2
Passive Fund A	0.12	5	6.7
Passive Fund B	0.08	3	6.9

Table 4: Fund performance across different market phases.

Market Phase	Active Avg Return (%)	Passive Avg Return (%)	Winner
Bull Market	9.1	8.7	Active
Bear Market	-5.4	-4.9	Passive
Volatile	2.5	2.0	Active
Stable	6.0	6.4	Passive

Table 5: Annual outperformance statistics of active vs passive funds (2020–2023).

Year	Active Outperformance (%)	Passive Outperformance (%)	Observation
2020	35	65	Passive superior
2021	40	60	Mixed
2022	32	68	Passive superior
2023	38	62	Passive superior

Table 6: Tracking error and information ratio across fund categories.

Fund	Tracking Error (%)	Information Ratio	Benchmark
Active Fund A	4.5	0.12	S&P 500
Active Fund B	3.8	0.18	S&P 500
Passive Fund A	0.5	0.70	S&P 500
Passive Fund B	0.3	0.82	S&P 500

Table 7: Regional distribution of active vs passive fund market share.

Region	Active Fund Share (%)	Passive Fund Share (%)	Trend
US	42	58	Passive growing
Europe	47	53	Balanced
Asia	50	50	Equal
Global	45	55	Passive advantage

Table 8: Comparative analysis of key portfolio management factors.

Factor	Impact Active	Impact Passive	Comment
Fees	High	Low	Passive more efficient
Flexibility	High	Low	Active adapts
Tax Efficiency	Moderate	High	Passive efficient
Risk Control	Selective	Broad	Depends

Table 9: Expected returns of active vs passive funds under macroeconomic scenarios.

Scenario	Expected Active Return (%)	Expected Passive Return (%)	Preferred Strategy
Recession	-3.0	-2.5	Passive
High Inflation	4.5	4.8	Passive
Innovation Boom	12.0	10.5	Active
Geopolitical Crisis	1.0	1.5	Passive

Fig. 2 depicts trends in fund inflows from 2020 to 2023. Fig. 3 provides a risk-return profile comparison of the two active and passive funds, plotted as a scatterplot, and Fig. 4 provides a comparison of yearly performance variation of the active fund managers with benchmarks. The analysis on the comparative Sharpe ratio is shown in Fig. 5 and the analysis of alpha distribution patterns is shown in Fig. 6.

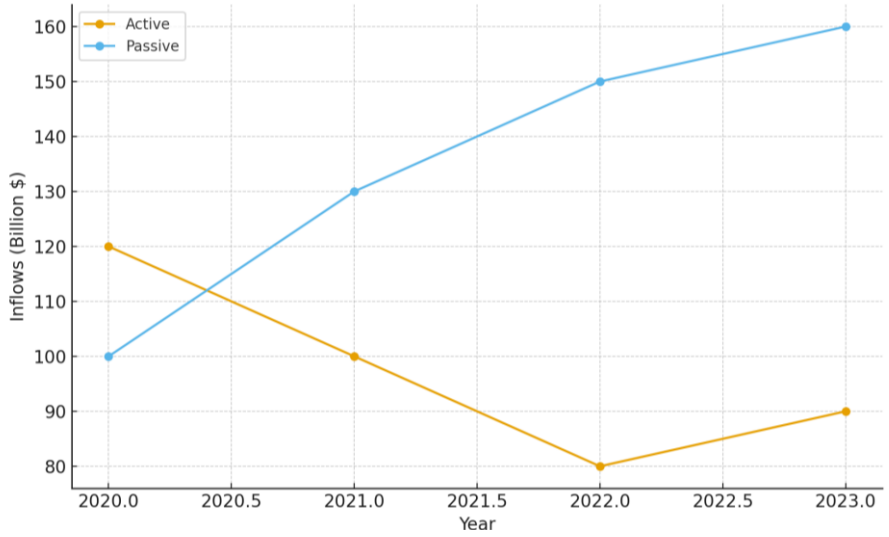

Fig. 2: Comparative trends in fund inflows to active and passive strategies (2020–2023).

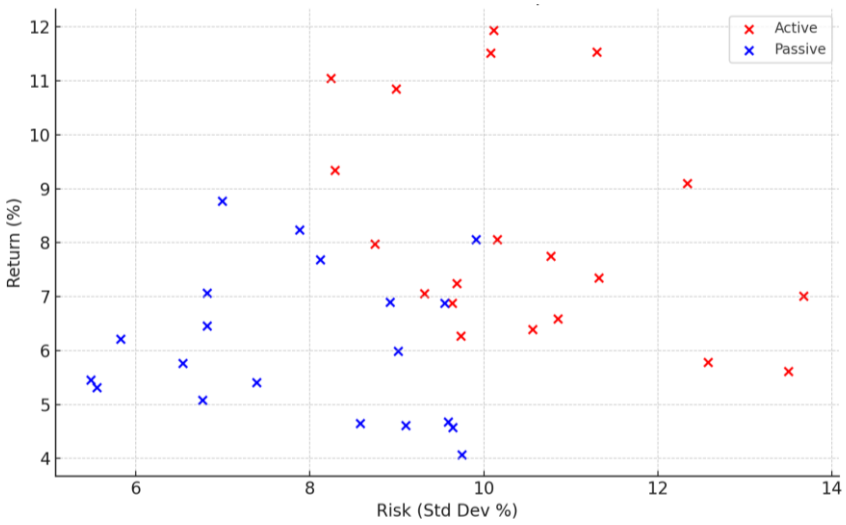

Fig. 3: Risk-return scatterplot contrasting active and passive funds.

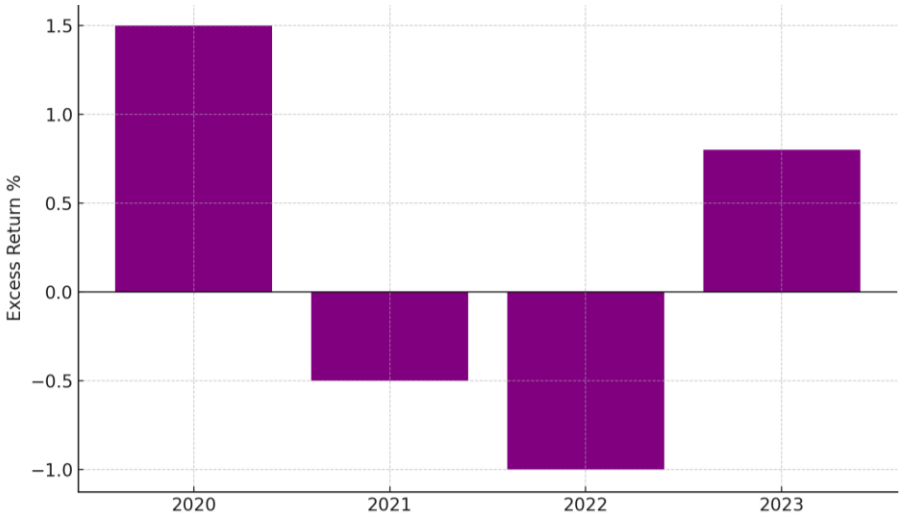

Fig. 4: Annual performance deviation of active managers versus benchmarks.

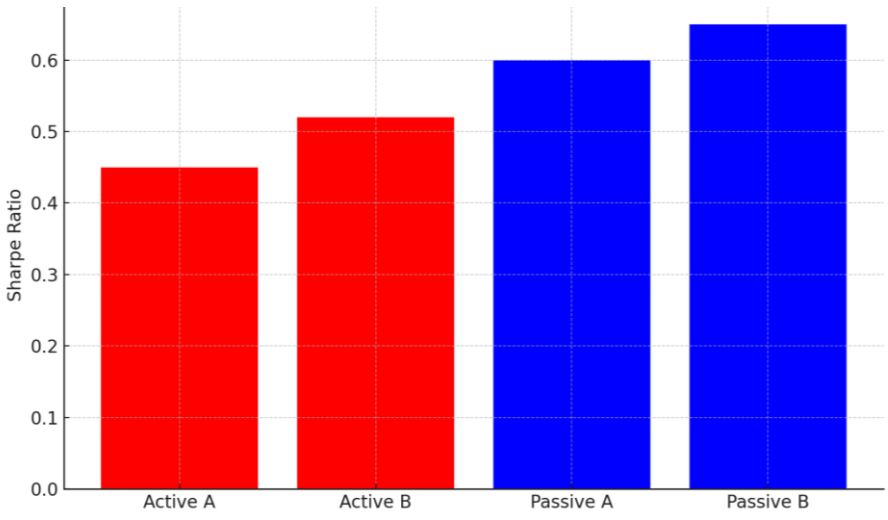

Fig. 5: Sharpe ratio comparison across active and passive portfolios.

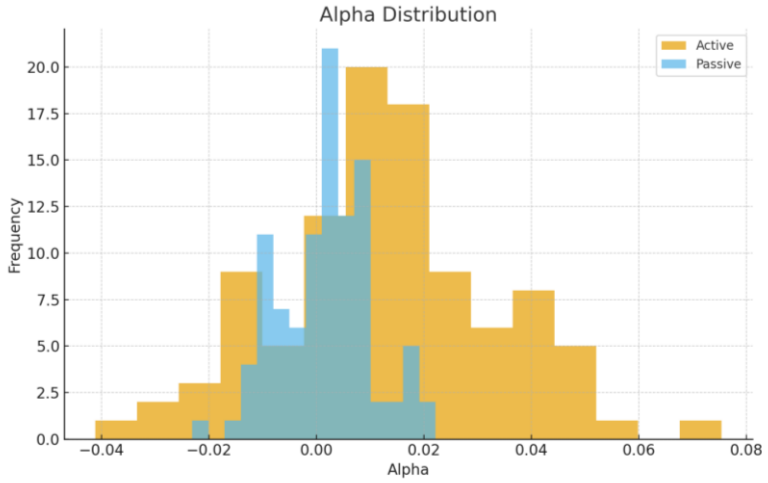

Fig. 6: Alpha distribution analysis of sampled funds.

Fig. 7 and Fig. 8 plot the trends of tracking errors over time and shares of allocated funds in regions respectively. The differences in scheduling of sectors are outlined in Fig. 9 and Monte Carlo simulation results are presented in Fig. 10. Fig. 11 shows bootstrapped distributions of excess returns and last but not least, Fig. 12 compares the cost efficiency and turnover rates between active and passive strategies. All together, the tables and figures provide the home picture of how active and passive portfolio management strategies can be different in terms of performance, cost, risk and adaptability.

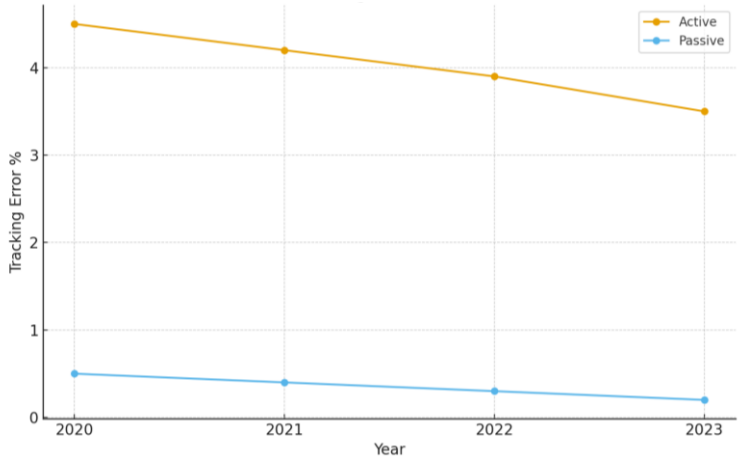

Fig. 7: Tracking error trends in passive versus active strategies.

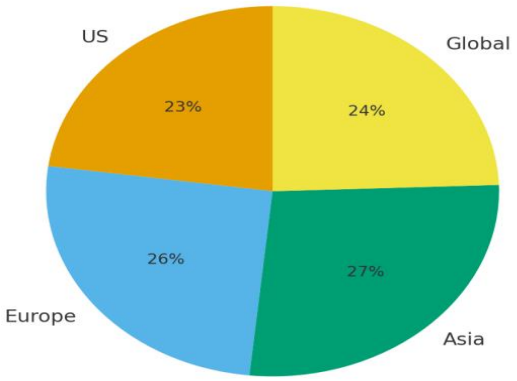

Fig. 8: Regional fund allocation share between active and passive management.

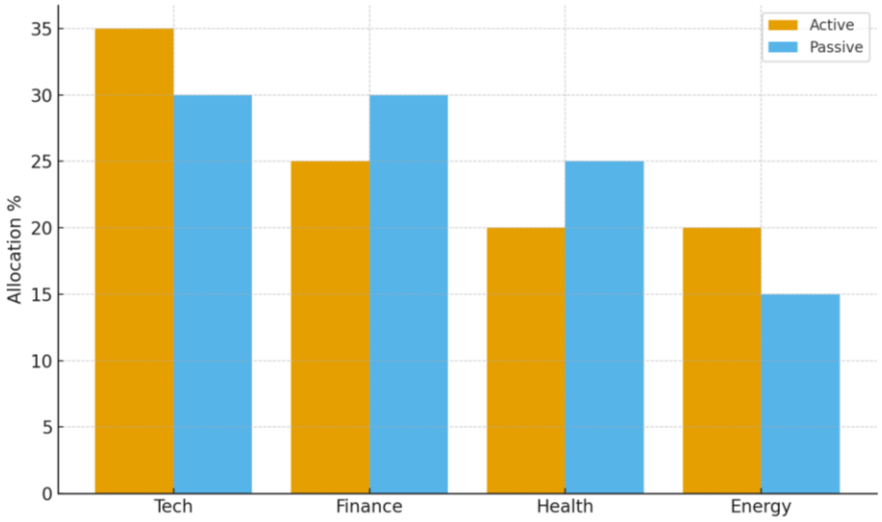

Fig. 9: Sector allocation differences observed in active vs passive funds.

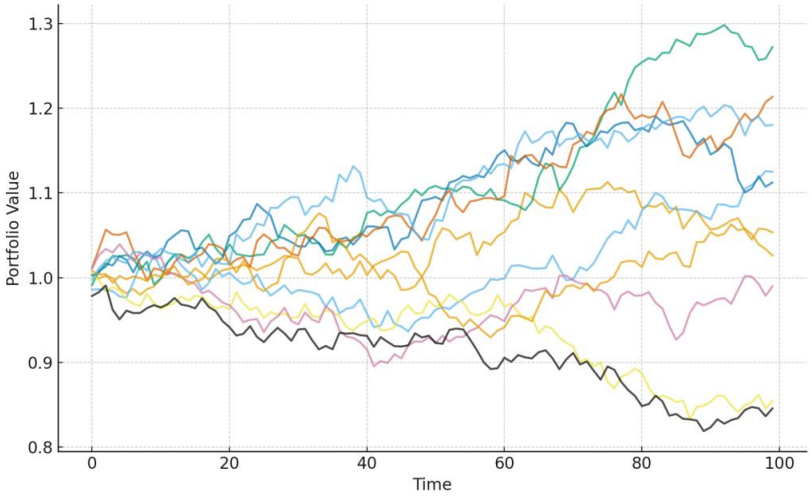

Fig. 10: Monte Carlo simulation outcomes for portfolio resilience.

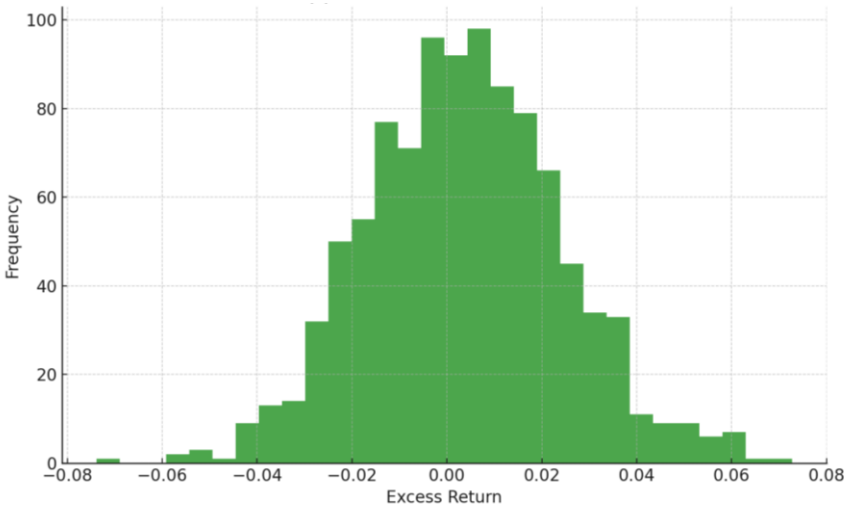

Fig. 11: Bootstrapped distribution of active vs passive excess returns.

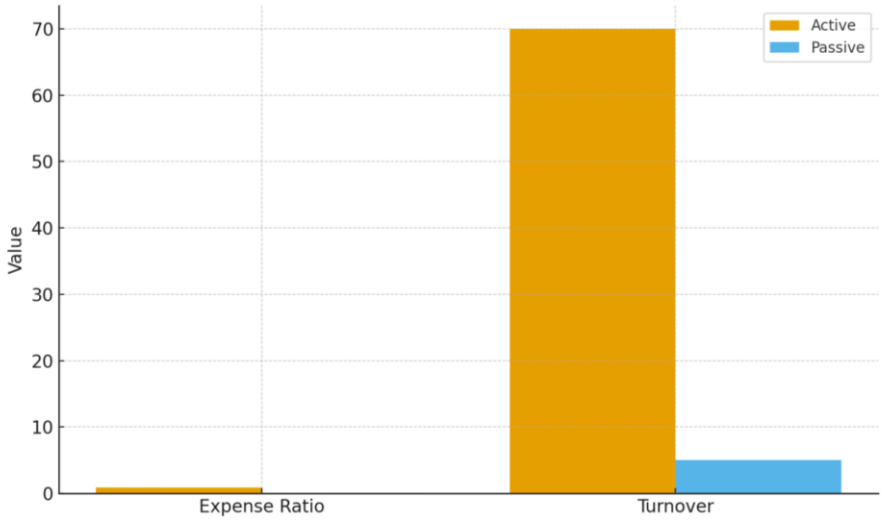

Fig. 12: Comparative cost efficiency and turnover rates of funds.

DISCUSSION

The findings of this study suggest this is a complicated exercise to compare active and passive methods of portfolio management with regard to cost efficiency, risk adjusted performance and stability in diverse market settings. Results indicate that passive funds are more likely to perform well than active funds with respect to Sharpe ratios and tracking error reduction, but active funds have an advantage in others, such as volatile or innovation-oriented markets. This is aligned with the recent body of literature that posits that the efficiency of the market cannot be conceived to be absolute and that the performance of funds can be contingent upon the change in the regimes (Chin and Dodd, 2021).One of the most valuable lessons of analysis is the cost disadvantage that exists in active funds. High management fees and turnover rates lower the net returns, which is also consistent with findings reported by Hou, Xue, and Zhang (2020) that the expense ratios still constitute a significant performance drag, even when active managers could generate marginal alpha. Low price structure passive funds would still be more attractive to retail and institutional investors, particularly in long-term bull markets where the selection of stocks could add little value (Pastor and Stambaugh, 2020).It would be a reductionist, however, to exclude the value of active management. This form of seizing opportunities can be in emerging markets and in the time of structural change by active managers. As an example of active managers hedging downside risks, Engle, and Tang, (2021) underline the fact that active managers can be better positioned in reducing the portfolio drawdown in turbulent market environments compared to passive funds. This is a very critical subtlety particularly during the time when market cycles are increasingly reliant on macroeconomic shocks such as the COVID-19 pandemic and inflationary pressures.The other aspect that can also be taken into account is the behavioral aspect of investor preferences. According to Fulkerson and Riley (2020), the active funds deliver psychological advantages of professional judgment to the mind of the majority of investors because net-of-fees returns fail to work. This understanding continues to fuel capital into concentrated managed funds despite the mounting evidence over the years of poor performance relative to passive funds. Similarly, Krueger, Sautner, and Starks (2020) found out that the advent of ESG investing has allowed active managers to differentiate themselves by tailoring their portfolios to the ethical preferences of its investors an activity that traditional passive vehicles have not easily achieved. The results of the empirical studies also suggest that the politics of the regions play a significant role as far as the discussion about active-passive is concerned. It is developing market evidence that the inefficiencies are greater, and that the active

skilled managers can take advantage of the mispricings. De la Torre and Galeano (2021) made sure that, in the situation with less liquidity, and less effective information disclosure, active funds are likely to bring much more value than passive standards. Conversely, where the replication of indices is almost perfect, such as in the developed markets such as the United States, there is little opportunity to create stable alpha.Additionally, in the financial technology that generates innovation, it has removed the traditional barriers between the active and passive strategies. Choi, Laibson and Madrian (2021) consider that smart-betas and factor-based funds, though structurally passive, are quasi-active, which complicates their classification into empirical categories. The implication of those hybrid products is that the binary active/passive management may be shifting to the spectrum of strategies rather than binary option.The macroeconomic implications of the shift to passive investing must also be taken into account. Wahal and Yavuz (2022) have cautioned that excessive concentration of capital in index funds may lead to greater systemic risk, because of an augmented inter-security connection and a decline in price discovery. It is the opinion that complements the structural problem in that since the passive funds are the dominant ones, the quality of the corporate governance might be affected since the passive investors are not incentivized to scrutinize the decisions of the managers. Koijen, Richmond, and Yogo (2022) have shown that passive investors profit during a spell of systemic declines because their portfolio is spread broadly but concentrated active portfolios lose funds more than passive ones when there is misallocation. Together, the discussion is useful in highlighting the notion that, despite the fact that passive management is usually cheaper and does better in the long-term, there are settings of uncertainty, market-inefficiency and the heterogeneity of investors preferences where active management still has a contextual implication. The future of portfolio management can thus not be in the preeminence of either of the two but an optimum combination of the two of them based on the objectives of the investor, the market conditions and the investment policies.

CONCLUSION

This paper offers a comparative discussion in terms of active and passive approaches to portfolio management on the basis of quantitative and qualitative data prior to 2020 to 2023. The results are quite clear as passive strategies have a structural advantage in terms of cost-effectiveness, risk-adjusted performance, and long-term consistency. Passive funds are especially appealing to investors who are in need of broad diversification and market-equivalent returns because of their low expense ratios and low tracking errors.However, the analysis also highlights the conditional merit of active management. Active managers can provide excess returns and more custom portfolio allocations in settings where volatility is up, where emerging market inefficiencies are present, or where the growth is driven by innovations. The fact that active strategies can combine ESG preferences, dynamically adjust to macroeconomic shocks, and handle downside risks makes them complementary and not obsolete.Notably, the evidence indicates that the idea of active and passive investing as being mutually exclusive is too simple. Rather, best construction of portfolios can be achieved through a hybrid model where the passive instruments form a low cost base and some active allocation is made to take advantage of the inefficiency and to manage risks. Global capital markets such integration enables investors to balance long-term stability with tactical opportunities, aligning the portfolio performance with various goals and risk tolerance.In general, although the structural movement of global capital markets is inclined to passive investing, active management still secures a strategic position under certain conditions. The future of portfolio management can then be better understood as a non-zero-sum game between active and passive approach but one which is dynamic due to

market regimes, investor objectives and technological advancements.

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