Nasdaq for Asset Owners

CIO Quarterly:

Active vs. Passive Management

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Foreword

Dear Reader,

By way of introduction, I am Drew Cronin, Head of Go-to-Market for Nasdaq Investment Intelligence. I joined Nasdaq via our acquisition of Solovis in 2020 and have spent 20 years working across sales, product development, marketing, and strategy to address the needs of asset owners and investment managers.

In my role I am responsible for GTM strategy and high-impact growth initiatives for Nasdaq eVestment™ and Nasdaq Solovis. To that end, I am thrilled to pick up the pen for this edition of the CIO Quarterly to share insights from our solutions.

This edition of the CIO Quarterly will focus on active vs. passive management, a hotly debated topic for asset owners—particularly amidst increased macro and market uncertainties. Across key public markets asset classes, the case can be made for both investing styles.

Allocators with a focus on capital preservation and low fees will point to the long-term positive performance of the market and the inability of active managers to consistently beat the market as strong justifications for passive investing. Investors focused on active management will suggest that manager selection is the key to beating the market and generating out-sized returns.

There's no right answer to the debate, and like many things, the truth is somewhere in the middle.

This report will explore the topic of active vs. passive management from various angles to help asset owners understand where each investment-style might fit best in their portfolio.

I hope you find the insights valuable and informative.

Kind regards,

Drew Cronin
Drew.Cronin@nasdaq.com
Head of Go-to-Market
Nasdaq Investment Intelligence

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Drew Cronin

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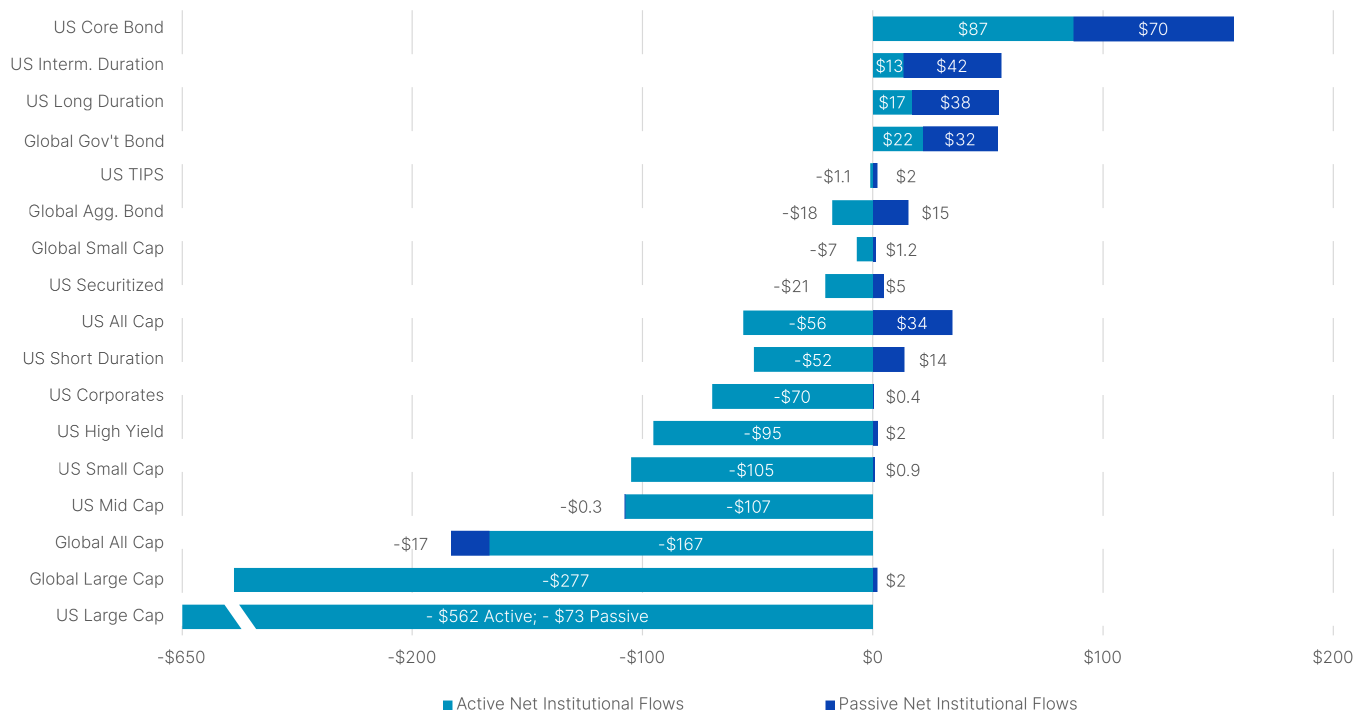
Asset Flows and Trends

Utilizing data from [Nasdaq eVestment™ Analytics](), this section provides insights on equity and fixed incomes strategies seeing some of the largest inflows and outflows of institutional capital over the trailing three years. For allocators, the data provides insights on which strategies their peers are allocating capital to (or withdrawing capital from) and whether they have favored active or passive management styles.

Net Institutional Asset Flows

Net Institutional Flows: 3-Years through Q4'23 in US$ bn

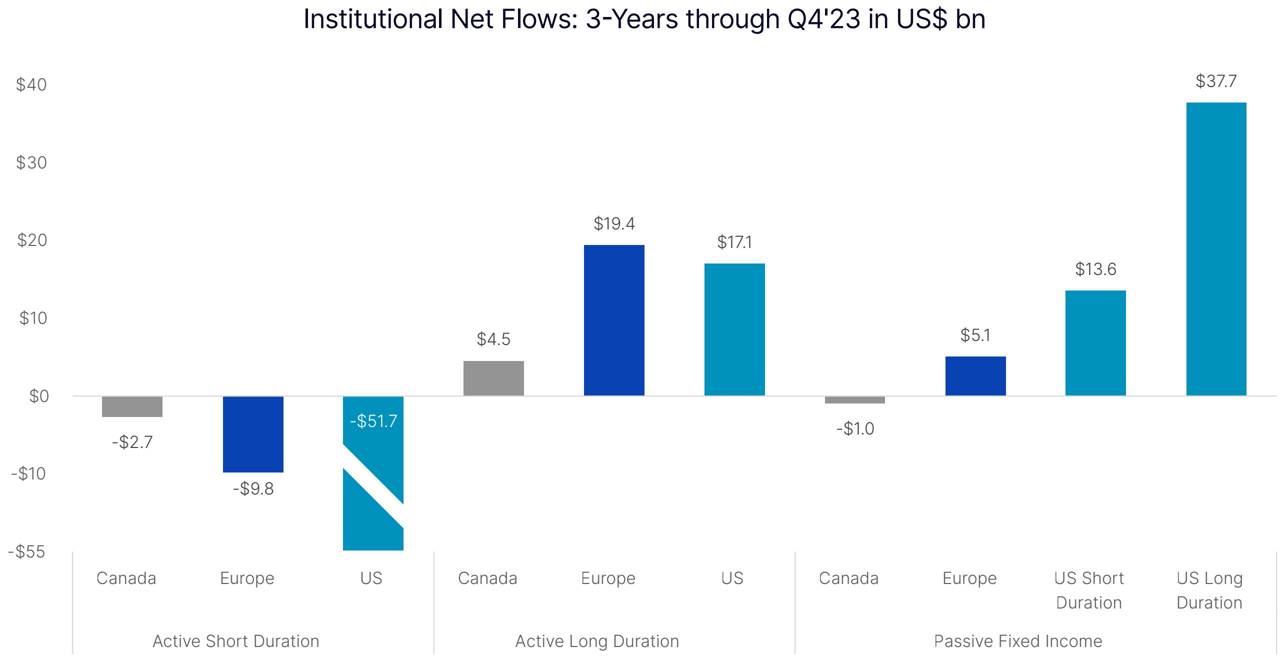


Source: Nasdaq eVestment Analytics

Over the trailing 3-year period through Q4 2023, fixed income generally experienced greater net inflows than their equity counterparts from institutional allocators, across both active and passive strategies. These inflows come on the back of higher yields which have made the asset class attractive again for investors. Overall, actively managed **US core bond** saw the greatest net inflows with $87 billion. Passively managed **US core bond** saw $70 billion in net inflows over the same period. The significant net capital inflows to **US core bond, US intermediate duration** and **US long duration,** top three in terms of aggregate net inflows, suggests institutional investors are rebalancing toward these strategies after relative underperformance beginning in 2022.

All active equity strategies shown above saw net outflows over the trailing three years with **US large cap** (-$562 billion) and **global large cap** ($-277 billion) seeing the greatest redemptions. Passive **US all cap** was the only equity strategy to see notable net inflows ($34 billion), with **passive global large cap, global small cap,** and **US small cap** also registering minor net inflows. That said, active **US all cap** saw net outflows of $56 billion implying that **US all cap** as a whole saw net outflows over the trailing 3-year period.

Fixed Income in Focus



Source: Nasdaq eVestment Analytics

Diving in more deeply to the net asset flow data for fixed income, the data yields some additional findings. **US long duration** saw net inflows across both active and passive strategies while **US short duration** saw a divergence: passive US short duration saw $13.6 billion of net inflows while active US short duration experienced $51.7 billion of net outflows.

In Europe and Canada, institutional investors pushed more capital into active **long duration** strategies while pulling capital from active **short duration** strategies. Both regions also experienced net inflows into passive strategies although not to the same magnitude as active strategies, suggesting that investors believe manager selection is important in the space.

Consultant Insights

Consultants are some of the best sources for analysis on active versus passive investing – specifically with a focus on where in an investment portfolio an allocator should be leveraging each.

In this 2024 analysis, **NEPC** used data from [Nasdaq eVestment] to conduct two tests on active management: a dispersion test across the trailing 10-year period and median manager outperformance of the benchmark, net of fees, over a rolling 3-year basis.

Below are the results of the NEPC analysis of actively managed equity strategies:

US Equities

	Large Value	Large Core	Large Growth	Mid Value	Mid Core	Mid Growth	Small Value	Small Core	Small Growth
Test 1 (Dispersion)	Fail	Fail	Pass	Pass	Pass	Pass	Pass	Pass	Pass
Test 2 (Rolling Outperformance)	Pass	Fail	Fail	Fail	Fail	Fail	Pass	Pass	Pass
Efficient Passive Option	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes

Based on the analysis of Nasdaq eVestment data, for US equities, actively managed **small cap** strategies were the only ones to pass both of NEPC's quantitative tests. The lack of rolling outperformance over the benchmark (Test 2) across two of the three large cap sub-strategies could be a contributing factor to the significant net outflows from institutional investors seen by US large cap equity strategies in the *Asset Flows and Trends* section of this report.

Ex-US Equities

	Global Equity	ACWI ex US	EAFE Large Cap	EAFE Small Cap	EM Large Cap	EM Small Cap	China A Shares
Test 1 (Dispersion)	Pass	Pass	Fail	Fail	Fail	Pass	Pass
Test 2 (Rolling Outperformance)	Pass	Pass	Pass	Pass	Pass	Pass	Pass
Efficient Passive Option	Yes	Yes	Yes	Yes	Yes	Yes	Yes

The analysis on ex-US equities highlights a more diverse set of strategies where allocators can find out-performance via active management. **EAFE large cap, EAFE small cap,** and **EM large cap** failed the dispersion test while passing the benchmark outperformance test, suggesting that the active managers in the space are delivering similar levels of outperformance.

The NEPC analysis was sourced from [Nasdaq eVestment Market Lens], which features a deep and regularly updated repository of consultant insights and research. These documents help asset owners stay informed on key industry topics and provide a range of perspectives that can complement the insights and advice they receive from their own consultants.

Q&A with an OCIO

Susan Webb is Founder, CEO and Chief Investment Officer at Appomattox, a New York based outsourced chief investment officer (OCIO) which specializes in building and managing global multi-asset portfolios. Appomattox constructs portfolios integrating a variety of active management investment styles including private capital and alternatives strategies. In this Q&A Susan shares her insights on active vs. passive management and where allocators can find opportunities across both investment styles in 2024.

When does choosing active over passive management make sense for an allocator?

The decision between active and passive management should be tailored to each portfolio's needs and will vary depending on the strategy, asset class, and sector focus of a prospective investment. Active management often shines in environments where there is less liquidity and transparency in the underlying securities, such as with foreign bonds and small-cap equities, where market inefficiencies can be exploited due to factors like bid-offer spreads and liquidity concerns.

Conversely, passive management might be more effective in large-cap equities, where it is challenging to outperform the market, and in scenarios where transparency and liquidity are high. That said, if we have identified a manager who excels at long/short equity investing for a particular niche, for instance, and if the client is willing to sacrifice the liquidity premium, we will typically favor those managers. In general, for underlying investments that are complex, less liquid, or within specific sectors where a knowledge edge can be leveraged, active management typically offers greater advantages, in our view.

Are the fees associated with active management justified?

The justification for active management fees hinges on the manager's ability to generate alpha, net of costs. Fees can vary significantly across funds, making it essential to consider whether a particular active manager can add value that exceeds their fees. Allocators need to scrutinize each manager's capabilities and track record to assess whether they are likely to provide sufficient value for their fees—even for a given manager, that can vary depending on the market environment and monetary conditions.

How should allocators approach benchmarking for active and passive strategies?

Benchmarking needs to be approached very differently for active and passive strategies due to their distinct objectives and performance metrics.

For active strategies, where the goal may be superior risk-adjusted returns, it is crucial to contextualize performance against an appropriate index and consider the specific role of the allocation in achieving market objectives. In contrast, passive strategies—which aim to replicate broad market performance—are best compared against general market indexes.

Evaluating active managers may require comparing their performance to more specific or nuanced benchmarks, acknowledging the distinct goals and market dynamics they aim to exploit. When we consider a portfolio-level benchmark, we will factor in the composition of active/passive management in our allocations and may use blended benchmarks if it seems appropriate.

What strategies might benefit from active management in 2024?

Looking ahead at the next 12-18 months, European equities present a particularly promising opportunity for active management given the potential for significant performance dispersion within the sector. Active managers with a keen understanding of value can be particularly beneficial in situations like these. We are also looking to explore opportunities with tech VC firms—we anticipate significant growth in the sector in the coming months beyond the largest index-leading companies and will look to skilled VCs to capture that. In addition, we are planning to increase exposure to credit, where targeted strategies focusing on specific sectors or asset types, like CLOs, energy, or distressed industrials, can uncover substantial value.

In what scenarios is passive management the preferable option?

Passive management is ideally suited for investors seeking broad market exposure, especially in contexts where the dispersion of returns across the market is minimal. This approach ensures efficient replication of market performance, both on the long and short sides, by closely tracking a specified index or benchmark, making it a better choice for investors prioritizing cost-efficiency and market representation.

Research: Active Management Benchmark Outperformance

Leveraging data from the Nasdaq eVestment platform, this section is a retrospective analysis of active equity and fixed income managers' returns compared to their benchmarks over the past 10 years. The chart indicates the proportion of actively managed products in various regional asset classes which have outperformed their benchmarks in each calendar year since 2014. Benchmarks are selected at the more granular strategy level then aggregated into regional asset class groupings.

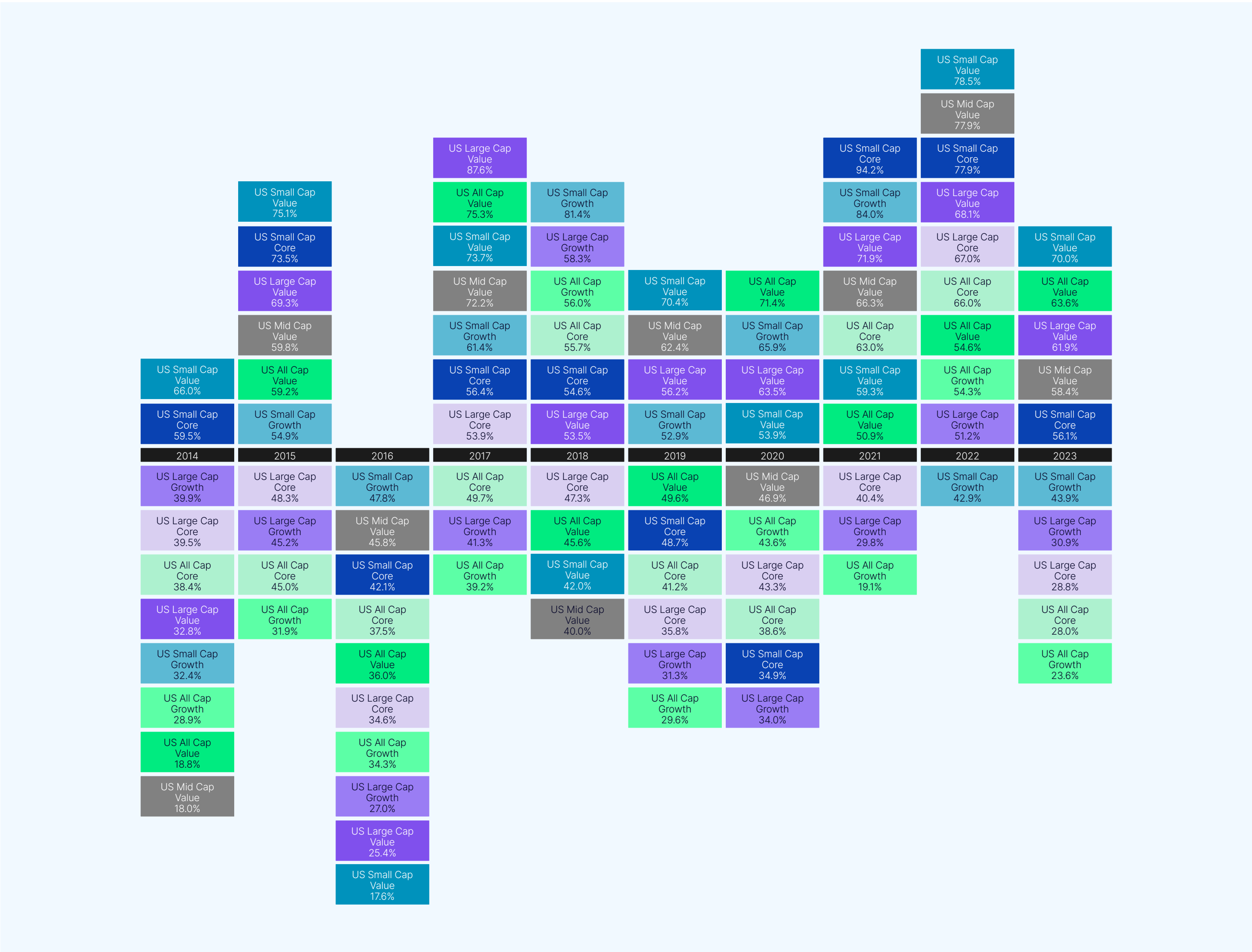
Regional Asset Classes

Source: Nasdaq eVestment Analytics

Benchmark outperformance across active equities was hard to come by in 2023. At a high level, emerging markets and international equity strategies did best with 63.3% and 54.7% of managers beating their benchmarks during the year. Emerging markets equity outperformance was widespread across market capitalization segments and investment styles, whereas ACWI ex-U.S. managers accounted for the bulk of international equity outperformance. EAFE managers did not beat their benchmarks as frequently.

The majority of active fixed income strategies outperformed their benchmarks in 2023. For many fixed income universes, managers took credit risk in excess of their benchmarks and were compensated for it. More than 50% of aggregate, core plus, and corporate bond managers investing globally and in U.S. markets showed positive excess returns. Fewer high yield and bank loan managers to beat their benchmarks – among U.S. HY, U.S. bank loan, global HY, and global bank loan managers that outperformed for the 7-year period ending in 2022, 50% or less outperformed again in 2023.

US Equity



Source: Nasdaq eVestment Analytics

Outperformance by active US equity managers was bifurcated along investment strategy lines in 2023. For US large cap value managers, any inclusion of Magnificent Seven stocks (Alphabet, Amazon, Apple, Meta, Microsoft, Nvidia, and Tesla) in their portfolio helped achieve benchmark-beating returns. US large cap growth managers had the opposite problem in which underweighting or exclusion of these companies from their portfolios drove underperformance.

Understand performance across your multi-asset class portfolio

Performance analysis isn't just a quarterly retrospective of your portfolio holdings. It should be a regular workflow that facilitates a clear understanding of what contributed to your performance results and whether the investment risks taken were commiserate with the returns generated.

Nasdaq Solovis empowers asset owners with full portfolio visibility to conduct this level of analysis.

Watch the masterclass here

Get in touch

Reach out to learn more about how Nasdaq Solovis drives instant insights across your entire multi-asset class portfolio so you can create context fast to drive decision-making.

Contact Us