Active versus Passive Investing: An Empirical Study on The US and European Mutual Funds and ETFs

Desmond Pace, Jana Hili, Simon Grima

Contemporary Issues in Bank Financial Management

ISBN (International Standard Book Number.): 978-1-78635-000-8, eISBN (International Standard Book Number. Electronic version of Book): 978-1-78560-999-2

Publication date: 26 February 2016

Permissions

Abstract

Purpose

In the build-up of an investment decision, the existence of both active and passive investment vehicles triggers a puzzle for investors. Indeed the confrontation between active and index replication equity funds in terms of risk-adjusted performance and alpha generation has been a bone of contention since the inception of these investment structures. Accordingly, the objective of this chapter is to distinctly underscore whether an investor should be concerned in choosing between active and diverse passive investment structures.

Methodology/approach

The survivorship bias-free dataset consists of 776 equity funds which are domiciled either in America or Europe, and are likewise exposed to the equity markets of the same regions. In addition to geographical segmentation, equity funds are also categorised by structure and management type, specifically actively managed mutual funds, index mutual funds and passive exchange traded funds ('ETFs'). This classification leads to the analysis of monthly net asset values ('NAV') of 12 distinct equally weighted portfolios, with a time horizon ranging from January 2004 to December 2014. Accordingly, the risk-adjusted performance of the

Factor (1993) and Carhart Four-Factor (1997).

Findings

Solely examination of monthly NAVs for a 10-year horizon suggests that active management is equivalent to index replication in terms of risk-adjusted returns. This prompts investors to be neutral gross of fees, yet when considering all transaction costs it is a distinct story. The relatively heftier fees charged by active management, predominantly initial fees, appear to revoke any outperformance in excess of the market portfolio, ensuing in a Fool's Errand Hypothesis. Moreover, both active and index mutual funds' performance may indeed be lower if financial advisors or distributors of equity funds charge additional fees over and above the fund houses' expense ratios, putting the latter investment vehicles at a significant handicap vis-à-vis passive low-cost ETFs. This chapter urges investors to concentrate on expense ratios and other transaction costs rather than solely past returns, by accessing the cheapest available vehicle for each investment objective. Put simply, the general investor should retreat from portfolio management and instead access the market portfolio using low-cost index replication structures via an execution-only approach.

Originality/value

The battle among actively managed and index replication equity funds in terms of risk-adjusted performance and alpha generation has been a grey area since the inception of mutual funds. The interest in the subject constantly lightens up as fresh instruments infiltrate financial markets. Indeed the mutual fund puzzle (Gruber, 1996) together with the enhanced growth of ETFs has again rejuvenated the active versus passive debate, making it worth a detailed analysis especially for the benefit of investors who confront a dilemma in choosing between the two management styles.

Keywords

Active management
Passive management
Mutual funds
Exchange traded funds
Asset pricing models
Modern portfolio theory

Citation

Pace, D., Hili, J. and Grima, S. (2016), "Active versus Passive Investing: An Empirical Study on The US and European Mutual Funds and ETFs", Contemporary Issues in Bank Financial Management (Contemporary Studies in Economic and Financial Analysis, Vol. 97), Emerald Group Publishing Limited, Leeds, pp. 1-35. https://doi.org/10.1108/S1569-375920160000097006

Download as .RIS

Publisher: Emerald Group Publishing Limited