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Active vs Passive Investing: What Really Matters? A Plain-English Explanation

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Introduction

In months 4 and 5, we explored the basics of investing and what investment funds actually are.

This time, we move on to one of the biggest debates in the investment world:

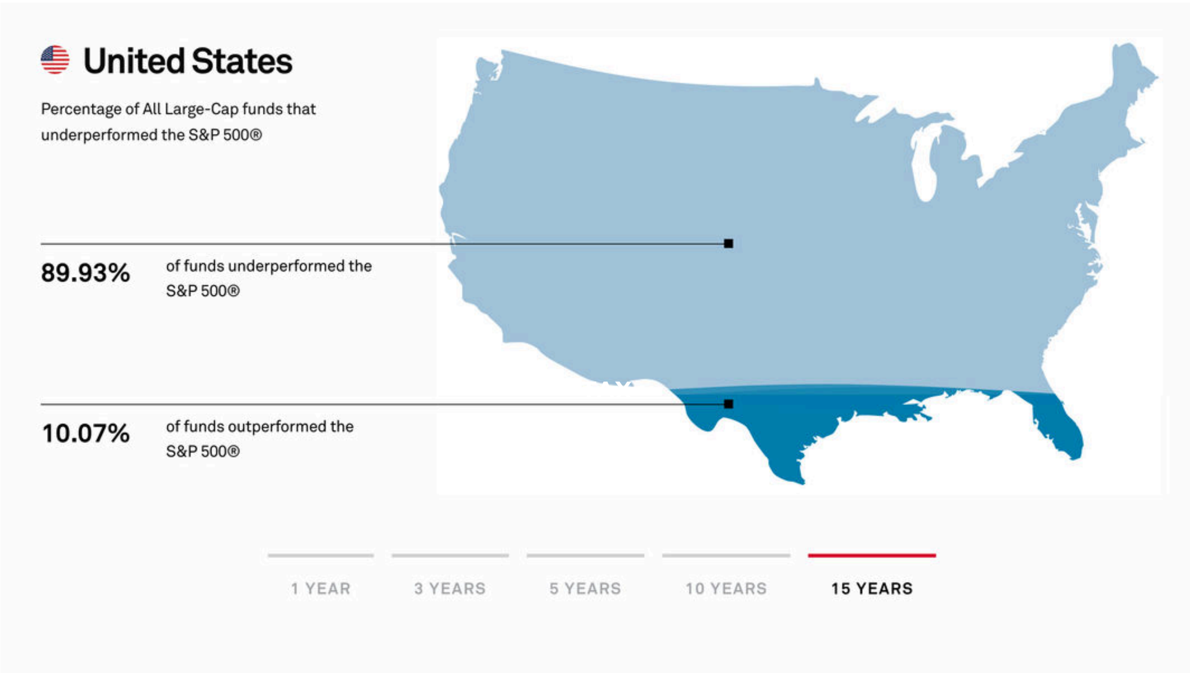
"Should I choose active funds or passive funds?"

Over the last 15 years, passive investing has grown enormously in popularity. Following the Global Financial Crisis, a prolonged period of low interest rates, low inflation and strong market returns helped passive strategies gain significant momentum.

At the same time, passive fund providers have been highly effective at communicating a simple message:

Why pay more when most active managers fail to beat the market?

Much of this argument is supported by research such as the SPIVA reports, which compare active managers against market indices.



However, before we can answer whether active or passive investing is better, we first need to understand what these terms actually mean.

More importantly, we need to recognise that this debate is often far more nuanced than it first appears.

The key message throughout this article is simple:

The most important factor is not whether a fund is active or passive. It is whether the investment strategy helps you achieve your goals and whether you can stick with it over the long term.

What Is Passive Investing?

In simple terms, passive investing involves tracking a market index.

Rather than attempting to outperform the market, the objective is simply to deliver the market's return, less costs.

Common examples include tracking:

- The FTSE 100
- The FTSE All Share
- The S&P 500
- Global stock market indices

A passive investment typically has the following characteristics:

- Tracks an index
- No manager selects individual investments
- Lower costs
- Broad diversification
- Transparent construction

Benefits of Passive Investing

Lower Costs

Costs are one of the few factors investors can control.

Because passive funds do not require teams of analysts or fund managers making investment decisions, charges are often lower.

Simplicity

Passive investing is relatively easy to understand.

You know what market you are investing in and how the fund is expected to behave.

Transparency

Investors can generally see exactly which index they are tracking and understand what they own.

Potential Drawbacks

Passive investing is not perfect.

Potential limitations include:

- It can never outperform the index it tracks.
- It becomes increasingly concentrated in whatever is performing best.
- It follows markets down as well as up.

For example, if a market returns 5% in a year, a passive fund will typically deliver slightly less than 5% after costs.

What Is Active Investing?

This is where things become more interesting.

Many people assume active investing simply means a fund manager attempting to beat an index by selecting individual investments.

Whilst that is true, active investing covers a much broader range of approaches.

In reality, anything that seeks to improve upon a pure index-tracking strategy involves some degree of active decision-making.

This creates a spectrum rather than a simple active versus passive choice.

Passive Plus or Strategic Allocation

Some strategies use passive building blocks but make active decisions around:

- Asset allocation
- Geography
- Sector exposure
- Risk management

These approaches are often referred to as:

- Passive Plus
- Strategic Asset Allocation
- Active Passive

The objective is to maintain relatively low costs while attempting to improve diversification and long-term outcomes.

Traditional Active Management

At the other end of the spectrum are traditional active managers.

These managers make deliberate investment decisions based on research, valuation analysis and market views.

As a result, their portfolios often look significantly different from the index.

Benefits of Active Investing

Potential for Outperformance

Some active managers have historically delivered returns above the market over long periods.

Flexibility

Active managers can adapt portfolios when opportunities or risks emerge.

Useful in Less Efficient Markets

Active management can sometimes be particularly valuable in areas such as:

- Smaller companies
- Emerging markets
- Specialist sectors
- Sustainable investments

Potential Drawbacks

There are also disadvantages:

- Higher charges
- No guarantee of success
- Some managers underperform after fees

Importantly, all fund performance figures are normally shown after fees have already been deducted.

The Evidence: Why the Debate Never Ends

The reason this debate continues is that both sides have valid arguments.

Supporters of passive investing point to:

- Lower costs
- Simplicity
- The difficulty of consistently beating markets

Supporters of active investing point to:

- Market inefficiencies
- Risk management
- Flexibility
- Specialist expertise

The reality is that there is no universal winner.

Some active funds outperform.

Some active funds underperform.

Some passive strategies perform exceptionally well.

Others experience long periods of weaker returns.

Different market environments favour different approaches.

This is why research remains important.

Interestingly, many investors who describe themselves as passive investors actually own strategies that incorporate some degree of active decision-making.

The labels themselves are often less important than understanding what sits underneath them.

Why This Is Not a Binary Decision

At Manning Gee Investments, we believe low-cost investing is important.

However, that does not mean there is only one solution.

Our investment approach recognises that different clients have different objectives, preferences and circumstances.

Rather than forcing clients into a single philosophy, we believe in offering appropriate choices.

This creates a spectrum of solutions:

Pure Passive

The lowest-cost option.

Designed to track markets with minimal intervention.

Passive Plus

Uses passive investments but incorporates strategic asset allocation decisions.

Blended Strategies

Combines active and passive approaches.

Designed to balance cost efficiency with opportunities for active management to add value.

Sustainable Strategies

Often require additional analysis and decision-making because sustainability objectives may not always align perfectly with traditional market indices.

Retirement planning can also introduce additional considerations.

A strategy designed to grow wealth during accumulation may not be the same strategy best suited to generating sustainable income in retirement.

This is why we believe the discussion should not be about choosing sides.

It should be about selecting the most appropriate solution for the objective being pursued.

Costs Matter — But Behaviour Matters More

One of the biggest reasons passive investing has become popular is cost.

That makes sense.

If two investments deliver the same return, the lower-cost option will leave more money in your pocket.

However, there is a danger in becoming obsessed with costs alone.

The reality is that the biggest threat to long-term investment success is often not fees. It is behaviour.

Consider two investors.

Investor A

Chooses a very low-cost passive portfolio.

Everything goes well until markets fall by 20%.

The headlines become frightening.

They sell their investments and move to cash.

Unfortunately, they miss much of the recovery.

Investor B

Uses a slightly more expensive portfolio.

When markets fall, they remain invested.

They understand the purpose of their investment strategy.

They stay focused on their long-term goals.

When markets recover, they participate fully in that recovery.

Despite paying slightly higher costs, Investor B may achieve a significantly better outcome.

This is why financial planning matters.

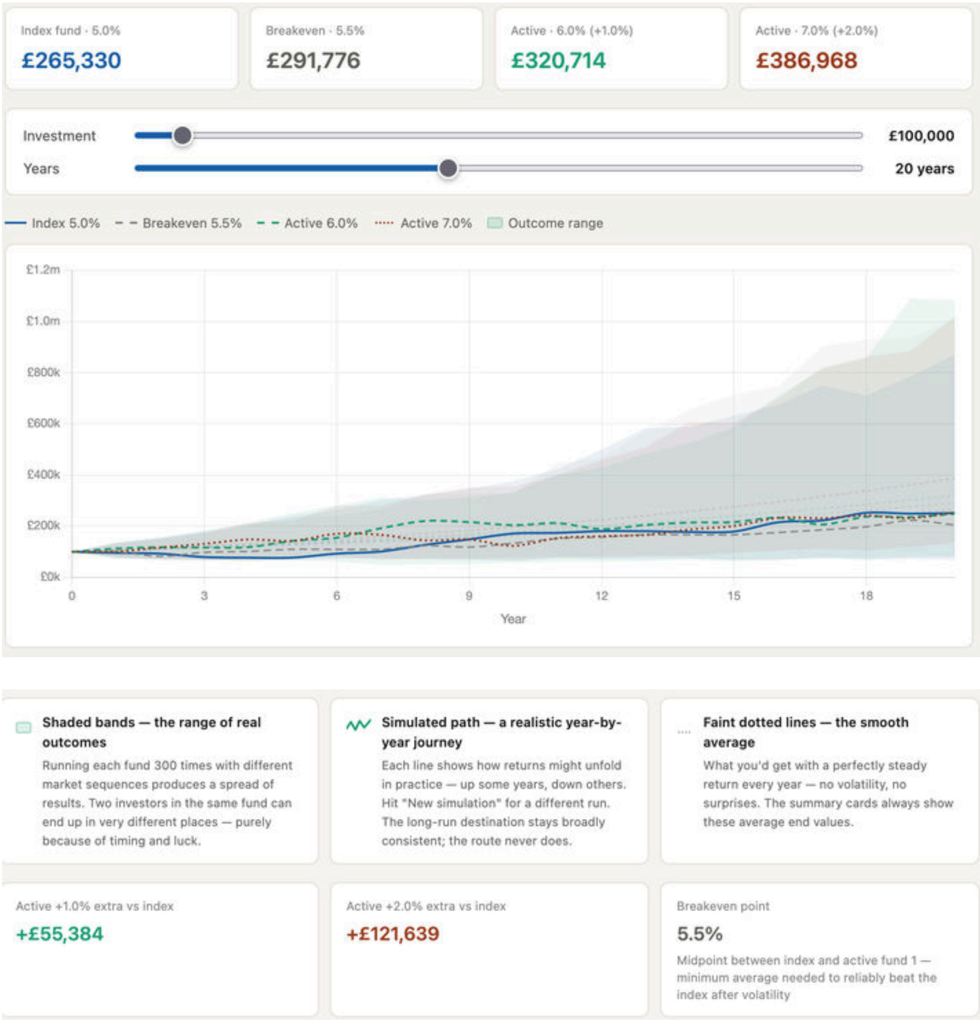
Successful investing is rarely about finding the perfect fund.

It is usually about creating a plan that gives you the confidence to stay invested when markets become uncomfortable.

A good investment strategy that you abandon is often worse than a reasonable strategy that you stick with for decades.

What Really Matters?

One of the challenges with the active versus passive debate is that investors often focus on the wrong question.



The purpose of this chart is not to prove that active investing is better than passive investing.

Instead, it demonstrates the power of compounding.

Even a relatively small improvement in returns can create a significant difference over long periods of time.

Of course, achieving those higher returns is not guaranteed.

Some active managers will outperform.

Some will underperform.

Some passive-plus approaches may add value.

Others may not.

The lesson is not that one approach is always superior.

The lesson is that long-term outcomes are driven by a combination of factors:

Having Clear Goals

What is the money for?

Appropriate Risk

Taking enough risk, but not too much.

Diversification

Avoiding excessive concentration.

Cost Awareness

Keeping charges sensible.

Consistency

Staying invested.

Behaviour

Making fewer emotional decisions.

Time

Allowing compounding to work.

The most successful investors are often those who spend less time worrying about labels and more time focusing on a consistent long-term strategy.

Final Thought: Focus on the Plan, Not the Label

The active versus passive debate will probably continue for many years.

Supporters of passive investing will point to lower costs and simplicity.

Supporters of active investing will point to flexibility, risk management and the potential for outperformance.

Both arguments have merit.

The reality is that successful investing is rarely determined by a single decision.

It is the combination of:

- Having clear goals
- Taking an appropriate level of risk
- Diversifying effectively
- Keeping costs sensible
- Staying disciplined during difficult periods

At Manning Gee Investments, we believe investments should support your financial plan, not drive it.

Whether active, passive or a blend of both, the most important investment decision is having a strategy that matches your goals and one you can stick with through the ups and downs of investing.

Because ultimately, successful investing is not about choosing a side.

It is about creating a plan that helps you grow, protect and eventually pass on wealth with confidence.

Frequently Asked Questions

Is active investing better than passive investing?

Neither is automatically better.

Passive investing focuses on tracking a market index at a low cost, whilst active investing seeks to outperform the market through investment decisions.

Both approaches have strengths and weaknesses. The most suitable option depends on your goals, risk tolerance and investment timeframe.

Why has passive investing become so popular?

Passive investing has grown significantly because of its low costs, simplicity and strong performance during a period when many active managers struggled to consistently outperform major stock market indices.

However, past performance does not guarantee future results, and different market conditions may favour different approaches.

Can active fund managers consistently beat the market?

Some active managers have outperformed over long periods.

The challenge is identifying those managers in advance and understanding whether the additional costs are justified.

This is why research, diversification and ongoing review remain important.

Should I choose active funds or passive funds for retirement?

There is no single answer.

Many retirement portfolios use a blend of active and passive investments.

The most important consideration is whether the strategy matches your retirement objectives, income needs, risk tolerance and capacity for loss.

What matters more: investment costs or behaviour?

Both matter, but behaviour often has the greatest impact on long-term outcomes.

A low-cost investment strategy can still produce poor results if an investor repeatedly buys and sells at the wrong time.

Having a clear plan and staying invested during periods of uncertainty is often more important than trying to save a small amount in fees.

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