Why Not Both? Blending Active and Passive Management

Derek Beiter | Senior Investment Analyst
Last Updated: February 05, 2025

Reframing the Active-Passive Debate

There is much debate on whether active investment managers can consistently outperform passive benchmark indexes, often framed as “active versus passive.” When framed this way, the word “versus” implies there is stark opposition between the two concepts or that perhaps they are irreconcilable. Our view is different, as we believe it can be beneficial to use active and passive management together in portfolios.

Active managers choose stocks, bonds, or other securities based on their research and outlook, often attempting to outperform a benchmark index. Meanwhile, passive managers attempt to replicate the performance of a benchmark index, often with lower costs and less portfolio turnover. While focused on index-like exposure, passive investing may reduce key-person risk and style drift, which may occur when active managers venture away from the exposure the investor wanted.

LPL Research created a framework that allows our Active-Passive portfolios to tilt toward active management in the asset classes where our research suggests it may have greater potential for outperformance. Weighted-average expenses for the overall portfolio may be controlled by paying for active management only where we believe it is likely to succeed. The "Best of Both Worlds" table summarizes how a blended Active-Passive portfolio may combine the benefits of active and passive management.

Best of Both Worlds?

Active Management	Passive Management	Blended Active-Passive Portfolios
Potential to outperform (or underperform) an index	Expected to perform in-line with index, minus fees	Use active management where outperformance may be more likely
Typically higher cost	Typically lower cost	Relatively low weighted average expenses for the overall portfolio
Potential for the exposure or investment style to drift	Obtains the desired portfolio exposure	Limits potential style drift to the active portion of the portfolio
Portfolio turnover varies with the manager's approach	Lower turnover may result in less taxable events	Can lean toward passive management or lower turnover managers

Generally higher key person risk	Generally less key person risk	Limits key person risk to the active portion of the portfolio

Source: LPL Research 02/05/25

Framework Methods

Our study of active management began with a quantitative (hard data) analysis of historical risks and returns. We grouped actively managed mutual funds into asset classes based on the benchmarks listed in their prospectus documents. The study included over 4,200 stock funds and over 1,700 bond funds, using up to 20 years of historical data. The criteria used to assess active management included 10 different measures across four categories:

- Average over- or under-performance (excess return) of funds compared to their benchmark indexes. Conceptually, this is similar to investing $1 in each fund within a certain asset class. To deem active management favorable on this measure, we generally wanted positive excess returns.
- Percentage of funds that outperformed their benchmark indexes. This can be thought of as the probability of picking a fund that outperformed if an investor randomly picked one fund within a certain asset class. We generally wanted over 50% of the active funds to outperform, measured over various three-year periods within the last 20 years.
- Risk-adjusted performance, as measured by information ratio. A fund's information ratio is its excess return divided by its tracking error, which measures volatility relative to the benchmark index. When the information ratios were higher, we generally had a more favorable opinion of active management.
- The excess returns of top-performing funds (top 25% versus benchmark) and the excess returns of bottom-performing funds (bottom 25% versus

benchmark). This measured the size of the reward for choosing funds wisely and the penalty if fund selection is ineffective. We generally wanted this ratio to be above one.

Importantly, we evaluated the actual costs of passive management, because it is not free and varies across funds and across asset classes. We also considered that, in some asset classes, it may be more difficult for passive managers to closely replicate the returns of the benchmark index. Finally, we considered softer "qualitative" criteria that may impact the success of active management, such as benchmark concentrations or unique risks that are hard to quantify.

Framework Output

Applying our framework, asset classes were placed into one of three buckets: Favors Active, Favors Passive, or Favors a Balanced Active-Passive Approach. We relied heavily on our quantitative (hard data) analysis when making these placements. In a select few cases where the quantitative data did not capture unique risks or challenges, we made a qualitative adjustment to the asset class placement. For example, we took a more favorable view of active management within emerging market (EM) equity than would be indicated purely by the hard data. In EM, where geopolitical risks may be frequent and severe, we believe active management may often be preferable to passive investments forced to invest in certain countries or sectors due to benchmark construction.

Asset Class Placements

Favorability	Asset Class
Favors Active	Small cap Equity Intermediate High-Quality Bonds (Core & Core-Plus) Corporate Bonds (Investment-Grade)

	Foreign & Global Bonds Emerging Market Equity Emerging Market Debt High Yield Municipal Bonds
Favors Balanced Active-Passive Approach	Large cap Value Equity Developed International Equity (Large Foreign) High Yield Corporate Bonds Long-Term Municipal Bonds
Favors Passive	Large cap Growth Equity Mid-cap Equity Government Bonds Short-Term Municipal Bonds Intermediate-Term Municipal Bonds

Source: LPL Research 02/05/25

While data analysis, rather than preconceptions, guided our asset class placements, it is interesting to consider common traits among the asset classes in the Favors Active bucket. Many of the asset classes that have been favorable to active management have a wide range of securities in their investable universe, which may allow active managers a broader opportunity set. In small cap, for example, there are more companies available for active managers to scour for opportunities, as compared to mid-cap and large cap. Core- and core-plus and foreign and global bond funds may benefit from the many varied decisions active managers are able to make, such as which sectors and maturities to emphasize, in addition to security selection. In contrast, the decisions available to government bond managers are somewhat limited, as one government bond may differ from another only in its maturity date, which may limit the potential for differentiated returns.

Key Points

We find benefits to blending active and passive management. By emphasizing active management in asset classes where it may be more likely to succeed, portfolio expenses may be reduced while retaining performance potential. Our quantitative analysis over the last 20 years suggests that active management has often been successful within small cap equities, core- and core-plus bonds, and foreign and global bonds, all of which are grouped in the Favors Active bucket. In some asset classes, such as large cap value equities and developed international equities, active management delivered occasional or modest benefits that may be roughly in balance with the benefits of passive management. In large cap growth equities, mid-cap equities, and government bonds, even the best active managers often struggle to outperform passively managed investments. While they are placed in the Favors Passive bucket, there may still be instances when certain active managers are appropriate for Active-Passive portfolios. Our rigorous framework for evaluating active management is one of many inputs LPL Research considers when managing its Active-Passive portfolios. We believe the LPL Research Tactical Active-Passive model portfolios may allow investors to benefit from active management and low-cost passive investing while adhering to LPL Research's rigorous asset allocation, investment manager research, portfolio construction, and risk management principles.

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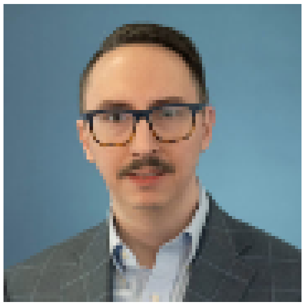

Derek Beiter

Derek Beiter conducts investment research of third-party investment managers. He is also a member of the Strategic Model Portfolio Committee and Chair of the Optimum Model Portfolio Committee.