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Growing Together With Integrity And Respect



Independent Thinking: The Best of Both Worlds: Why Combining Active and Passive Strategies Can Improve Portfolio Outcomes

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The Best of Both Worlds: Why Combining Active and Passive Strategies Can Improve Portfolio Outcomes

Executive Summary

The debate between active and passive investing is often portrayed as a binary choice. In reality, the strongest portfolios combine elements of both approaches to optimise outcomes.

Passive strategies offer cost-efficiency, broad market exposure, and reliability—particularly in highly efficient markets. Active strategies, meanwhile, provide flexibility, downside protection, and access to specialist or emerging opportunities often overlooked by traditional indices.

This paper explores how blending active and passive strategies can deliver:

- Better diversification across regions, sectors, and styles
- Dynamic risk management and resilience in changing markets
- Access to forward-looking investment themes
- Enhanced long-term outcomes with only modest increases in cost

Rather than asking whether active or passive is better, advisers and investors should focus on aligning strategy with client goals, risk tolerance, and time horizon.

The future of investing lies not in choosing sides, but in integrating the best of both worlds.

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Introduction

The Investment Association appears to have begun reporting on tracker (index) funds in January 2016. Approximately £102.7 billion—around 11% of the £900.3 billion under management—was held in tracker funds. By January 2025, that figure had risen to £388.7 billion, representing 25% of assets under management. The proportion held in passive strategies is even higher in the US, now exceeding 50%.

At face value, this suggests that around 75% of UK fund assets remain in actively managed strategies. Yet advocates of passive investing dominate much of the prevailing discourse on the “correct” way to invest. Sources such as SPIVA (S&P Indices Versus Active) are frequently cited to support the view that consistently beating the benchmark through active management is extremely difficult—if not impossible.

This polarisation has led to an increasingly binary debate in which disagreeing with one side is considered fundamentally wrong. Yet the UK market still prefers active management—at least regarding asset allocation.

This white paper does not aim to declare a winner in the active vs passive debate. Instead, it seeks to explore the strengths and limitations of each approach and demonstrate how combining both can lead to more resilient and potentially enhanced portfolio outcomes.

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Understanding Active and Passive Approaches

When constructing an investment portfolio, one of investors' fundamental decisions is whether to adopt an active or passive investment approach—or, indeed, to combine the two. Each approach has distinct characteristics, advantages, and limitations.

Passive Funds in a Nutshell

Passive investing is rooted in tracking a specific market index, such as the S&P 500 or FTSE 100. These funds aim to replicate the index's performance by holding all (or a representative sample) of its constituent stocks in the same proportions.

This approach is especially popular in markets like the US, where equity markets are widely regarded as highly efficient. In such environments, all publicly available information is quickly reflected in share prices, making consistently outperforming the index through active stock selection increasingly difficult.

Because passive funds are rules-based and require minimal day-to-day intervention, they are typically very cost-effective. Fees are low, and performance closely mirrors that of the benchmark. If the S&P 500 rises by 10%, investors in a passive fund tracking the index can expect a near-identical return (minus a small fee). Conversely, if the market falls by 10%, the fund will also mirror that decline.

In essence, passive investing offers predictability, broad market exposure, and low cost—but it does not aim to outperform.

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Understanding Active and Passive Approaches

Active Funds in a Nutshell

Active investing, by contrast, relies on the expertise and judgement of fund managers to select investments they believe will outperform the broader market or a specific benchmark. Using the S&P 500 as an example, an active manager might invest in just 50 stocks from the index—those they believe are undervalued, have stronger growth potential, or are better positioned in the current economic climate.

This hands-on approach typically comes at a higher cost. Active funds charge more due to the research, analysis, and active decision-making involved. However, the potential payoff is also greater. If a manager successfully identifies opportunities and outperforms the market over time, the additional return can more than compensate for the higher fees.

Of course, not all active managers consistently outperform, and identifying those who can deliver long-term value is challenging. But active management remains a key part of the investment toolkit for many investors, particularly those seeking downside protection, tactical flexibility, or differentiated strategies.

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Deep Dive into Passive

The term "passive investing" is often associated with straightforward index tracking, but the landscape is far more diverse than it first appears. From structural differences to evolving investment styles, passive strategies have developed significantly over the past decade, broadening the range of options available to investors.

Structure: Mutual Funds vs. ETFs

While many investors still think of index investing in terms of mutual funds, Exchange-Traded Funds (ETFs) have become an increasingly popular vehicle, especially in the US—and are gaining traction in the UK.

Key differences:

- ETFs can be traded throughout the day, just like individual stocks, offering flexibility for more active investors.
- Full daily transparency is a hallmark of ETFs, with all holdings disclosed regularly.

Neither mutual funds nor ETFs are inherently better; they offer different routes to implement passive strategies based on investor preference, trading style, and transparency needs.

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Deep Dive into Passive

Investment Style: From Pure Passive to Smart Beta

The traditional image of passive investing involves tracking a broad market index precisely—but this has evolved:

- **Pure passive:** replicate an index with no adjustments.
- **Smart beta:** apply rules-based filters, tilting portfolios towards factors like value, momentum, or low volatility.
- **Systematic strategies:** blend passive and quantitative active approaches.

Hybrid passive strategies reflect growing demand for low-cost, rules-based investing with strategic insights.

Low Costs and Relative Efficiency

One of the strongest arguments for passive investing is cost efficiency:

- Plain-vanilla index trackers often have fees under 0.10%.
- Even smart beta strategies typically remain much cheaper than active funds.
- Modest fees can significantly impact long-term outcomes when compounded over decades.

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Deep Dive into Passive

Alignment with Long-Term Market Trends

Passive strategies are designed to move in tandem with the market and are therefore well-suited to investors with a long-term perspective.

- In efficient markets, like the S&P 500, trying to beat the market often results in underperformance after fees, so simply riding the market wave can be a smart move.
- Introducing active elements to passive strategies can alter the return profile, potentially enhancing performance or providing better downside protection, albeit with added complexity.

Efficiency of the Underlying Market Matters

Traditional market-cap-weighted indices work best in highly efficient, well-researched markets.

- For areas like large-cap US equities, passive funds can provide exposure with minimal tracking error.
- However, in less efficient or more nuanced markets—such as emerging markets, small caps, or sector-specific strategies—there may be a greater opportunity to add value through active management or more customised passive structures.

This has led to a rise in thematic ETFs, factor strategies, and customised index blends, which give investors more choices at a lower cost than traditional active funds.

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Deep Dive into Passive

Do You Still Need to Do Research?

A common misconception is that passive investing requires no research.

While it's true that a pure index tracker demands little due diligence beyond cost and tracking error, the broader world of passive investing now involves important decisions:

- Which index?
- Which vehicle (mutual fund or ETF)?
- What level of factor exposure is acceptable?
- How do these products behave in different market environments?

In short, passive investing isn't always "set and forget." As the options grow more sophisticated, so does the need for thoughtful selection and periodic review.

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Deep Dive into Active Investing

While passive investing attracts significant attention, it's essential not to overlook the continued dominance of active management in the UK. As of early 2025, approximately 75% of UK fund assets remain in actively managed strategies. On the surface, this seems at odds with data showing that many active funds underperform their benchmarks. So why does active investing still hold such a strong foothold?

The answer lies in nuance and selectivity.

Not all active funds deliver outperformance, and some investors may miss out on returns by backing underperforming managers. However, this doesn't mean active management should be dismissed. Well-researched and well-managed active strategies can outperform the market over the long term, offering value that a simple index tracker may not provide.

As with many aspects of investing, the quality of the outcome is tied to the quality of the research behind the decision.

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Deep Dive into Active Investing

A Real-World Example: Woodford

One of the more well-known active fund failures in recent years was the Woodford Equity Income Fund. We chose not to recommend this fund in our portfolios for two key reasons:

1. Performance: The fund had consistently underperformed over the preceding five years.
2. Governance: There were significant concerns around transparency and risk oversight, particularly the replication of similar holdings across smaller structures, reducing diversification and increasing concentration risk.

This decision was validated over time. But it's also worth noting that no approach is immune to error, even with robust due diligence. Active investing involves judgment, and judgment occasionally leads to imperfect outcomes.

The key takeaway? Active strategies require careful, ongoing research—but when done well, they provide genuine opportunities to add value beyond what an index alone can deliver.

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Deep Dive into Active Investing

Three Reasons to Consider Active Strategies

Exploiting Market Inefficiencies

Markets such as the US large-cap space are highly efficient, making it difficult for active managers to add value. But not all markets operate this way.

- Emerging markets, small-cap stocks, and niche sectors often have lower analyst coverage and less transparent pricing, which provides opportunities for skilled managers to uncover mispriced assets.
- Many of today's mega-cap names—Amazon, Meta, Nvidia—began as under-the-radar companies. Active managers with strong research processes were able to identify them early.

This search for inefficiencies is the core of active investing: finding value where others aren't looking.

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Deep Dive into Active Investing

Three Reasons to Consider Active Strategies

Downside Protection and Tactical Flexibility

Active funds can adjust their positioning based on market conditions—an option unavailable to passive funds.

- A global active fund, for example, may choose to reduce exposure to the US if valuations look stretched, or increase allocations to sectors with better risk-reward dynamics.
- Some active strategies are designed to limit losses in down markets, using tools such as cash buffers, hedging, or defensive sector tilts—tools not available to passive trackers.

This flexibility can lead to lower volatility and improved resilience, especially during market stress.

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Deep Dive into Active Investing

Three Reasons to Consider Active Strategies

Targeted Exposure to Sectors and Themes

Active management allows investors to pursue particular investment themes—areas that might be underrepresented or absent in a traditional index.

- Think frontier markets, pure sustainability mandates, technology disruptors, or post-COVID healthcare innovation.
- Many indices are market-cap weighted and inherently backwards-looking, meaning that newer or more innovative companies may have minimal representation.

Active strategies can capture these forward-looking opportunities more effectively than a static index.

Final Thoughts

Active investing isn't about believing managers always beat the market. It's about recognising that active strategies can complement passive exposure, enhancing return potential, reducing downside risk, and providing tailored access to unique investment themes when applied selectively and with rigour.

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Combining Strategies

When and How?

The starting point for any portfolio construction should always be the desired outcome.

If low cost is the primary objective, pure passive exposure is often the most appropriate route. However, this approach carries what we call "iceberg risk". You can sail forward confidently because markets, in general, rise over time—even if there are hidden risks below the surface. Nonetheless, when market conditions shift, pure passive strategies provide no mechanism for adjustment.

There are also passive strategies with a strategic overlay. These solutions, while still fundamentally passive, incorporate tactical tilts based on market views—adding a light layer of active judgement. They remain relatively low-cost but introduce an element of market positioning in an attempt to enhance returns or manage risks more dynamically.

It is not always about minimising cost. A purely cost-driven approach is likely to deliver outcomes close to the market average because it makes no attempt to exploit inefficiencies or manage risks proactively. Introducing systematic investing, strategic asset allocation overlays, or full active management gradually increases costs—but it also introduces the potential for better, more tailored outcomes.

Rather than asking "when" or "how" to blend active and passive strategies, advisers should first ask "what" the client's objectives are. The desired outcome—whether it be growth, income, downside protection, or capital preservation—should guide the construction of the appropriate blend.

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Combining Strategies

Risk Management and Diversification Benefits

Many investors are unaware of the concentration risks inherent in global index funds.

Although branded as "global", over 70% of the MSCI World Index, for example, is weighted towards US equities. Over the past decade, this US dominance has served investors well. Behaviourally, it is tempting to assume that what worked yesterday will continue to work tomorrow.

However, investment leadership changes over time. Markets or regions that have underperformed may become tomorrow's winners. Active managers can—and often do—diversify away from dominant trends, tactically reducing US exposure and increasing allocations to undervalued or overlooked regions and sectors. This flexibility helps manage risks and provides exposure to broader global opportunities that a passive global fund may overlook.

Thus, incorporating active strategies into a global allocation can serve as an effective hedge against concentration risks and future market surprises.

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Combining Strategies

Costs vs Value Debate

Blending active and passive strategies may raise portfolio costs modestly, but it also creates opportunities for improved long-term returns and more sophisticated risk management. The focus should not solely be on minimising cost, but on optimising the balance between cost and potential value added.

Opting for the cheapest route typically delivers a market-average return, before fees. But average may not always be sufficient for achieving client goals. A thoughtful blend of strategies can introduce the potential for outperformance without significantly increasing the overall cost burden.

Moreover, diversification itself is a form of risk management often overlooked in cost-centric discussions. True diversification—across regions, asset classes, investment styles, and factors—may involve a slight premium in cost but can materially improve the stability and predictability of long-term outcomes.

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Putting This in Place

The world of financial advice has evolved. With an increasing emphasis on holistic financial planning, advisers are rightly prioritising time with clients over the minutiae of portfolio management.

Consequently, outsourced investment solutions are growing in popularity. Model portfolios—either bespoke to a particular adviser practice or available "off-the-shelf"—offer a practical route to deliver diversified, actively managed, and cost-conscious investment strategies.

Advisers can then select model portfolios or discretionary solutions that align with their clients' risk profiles, objectives, and ethical preferences. This not only frees up advisers to focus on broader planning needs but also ensures clients benefit from professional, evidence-based investment management tailored to their goals.

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Conclusion

As the debate between active and passive investing continues, the evidence suggests that the most resilient portfolios do not reside at either extreme. Instead, they combine the cost-efficiency and consistency of passive strategies with the potential for outperformance, flexibility, and risk management that active approaches offer.

Passive funds provide a solid foundation, offering low-cost exposure to broad market indices—especially valuable in efficient markets such as large-cap US equities. Meanwhile, active strategies can uncover value in less efficient markets, respond dynamically to market changes, and access specialist themes that traditional indices might overlook.

Rather than asking whether active or passive is better, advisers and investors should focus on portfolio outcomes:

- What are the client's goals?
- What are their tolerance for risk and their time horizons?
- Where is cost efficiency most appropriate, and where might a more tailored or opportunistic approach be beneficial?

By blending both approaches thoughtfully, portfolios can potentially deliver:

- Improved diversification
- Better downside protection
- Access to forward-looking investment opportunities
- Enhanced long-term outcomes without a dramatic increase in cost

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Conclusion

Practical Next Steps for Advisers and Investors:

1. Clarify Objectives – Define what success looks like (e.g. growth, income, resilience).
2. Segment the Portfolio – Use passive for core exposures and active for satellite allocations or inefficient markets.
3. Review Costs in Context – Consider total cost in relation to added value and risk management.
4. Maintain Due Diligence – Whether active or passive, ensure ongoing monitoring, governance, and client suitability.
5. Educate Clients – Provide balanced narratives that go beyond simplistic “cheap vs expensive” comparisons.

The future of investing lies not in opposition, but in integration—balancing precision with opportunity, and cost-awareness with value creation.

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Appendix A: Active Fund Manager Selection

When evaluating active fund managers, consider the following criteria:

1. Philosophy and Process

- Is the investment process clearly articulated?
- Is it consistently applied across different market environments?
- Is there evidence of alignment between philosophy and actual portfolio holdings?

2. Performance and Risk

- How has the fund performed relative to its benchmark over multiple time periods?
- What level of risk (volatility, drawdowns) has been taken to achieve this performance?
- Are returns driven by skill (alpha) or by taking excess risk?

3. Team and Experience

- Who are the key decision-makers?
- What is their track record?
- Have there been recent team changes?

4. Governance and Transparency

- Are the fund's holdings and performance data published regularly?
- Is there transparency around costs and any performance fees?
- Are there mechanisms in place for ongoing oversight?

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Appendix A: Active Fund Manager Selection

5. Fit for Purpose

- Does the fund align with your portfolio objectives and time horizon?
- Is it complementary to other holdings (i.e. not overly correlated)?
- Does the manager exhibit a clear edge in the target market segment?

By applying a structured approach to manager selection, advisers can enhance the quality of their investment recommendations and avoid high-profile pitfalls.

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Appendix B: Passive Fund Manager Selection

1. Index and Methodology

- Is the underlying index clearly defined and appropriate for your investment objectives?
- How is the index constructed (e.g., market-cap weighted, equal weighted, rules-based screens)?
- Are there any biases or limitations in the index design that could affect outcomes?

2. Tracking Performance and Costs

- How closely has the fund tracked its benchmark over different time periods (tracking error)?
- What are the total costs, including the ongoing charges figure (OCF) and any trading costs?
- Has the fund experienced significant tracking drift or deviation?

3. Provider Strength and Experience

- Who is the asset manager or ETF provider?
- Do they have a strong record of operating passive strategies effectively?
- Are there material differences between providers offering exposure to the same index?

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Appendix B: Passive Fund Manager Selection

4. Structure, Liquidity, and Transparency

- Is the fund physically replicating the index or using synthetic replication?
- What is the fund's liquidity like (daily volumes, bid-ask spreads)?
- Are holdings, costs, and methodology disclosures clear and updated regularly?

5. Fit for Purpose

- Does the fund align with your portfolio's objectives, time horizon, and risk profile?
- Is it appropriately diversified or does it introduce concentration risks (e.g., heavy sector or stock tilts)?
- Does it complement your existing portfolio without creating unintended overlaps?

By applying a structured approach to passive fund selection, advisers can strengthen portfolio foundations, control costs, and ensure exposures are consistent with client goals.

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Appendix C: Useful Research Sources

SPIVA (S&P Indices Versus Active Reports):

<https://www.spglobal.com/spdji/en/research-insights/spiva/>

Morningstar Active/Passive Barometer:

<https://www.morningstar.com/lp/active-passive-barometer>

Investment Association UK Statistics:

<https://www.theia.org>

Vanguard Active/Passive Research:

<https://www.vanguard.co.uk/professional/advantage/research/active-vs-passive-investing>

FCA Study on Asset Management:

<https://www.fca.org.uk/publication/market-studies/ms15-2-3.pdf>