ACTIVE VS PASSIVE FUNDS

ARE SMALL-CAP INDEX FUNDS THE FUTURE OF INVESTING?

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TWO YEARS, BIG WINS: ARE SMALL-CAP INDEX FUNDS THE FUTURE OF INVESTING?

In 2023, small-cap index funds outperformed nearly 80% of actively managed funds, delivering a remarkable 48.09% return compared to the active funds' category average of 41.0%. This trend continued in 2024, with passive small-cap funds achieving a 27.25% return, edging past the active category average of 26.78%. This ongoing outperformance of passive strategies stems from their index-tracking nature, aligning them closely with market momentum. As companies grow in market capitalization—often fuelled by investor enthusiasm rather than intrinsic fundamentals—they enter the index, exposing passive funds to popular stocks during market rallies.

~80%

Passive Outperformed of the Active funds on the Year 2023

~ 48.09%

Index Funds -2023

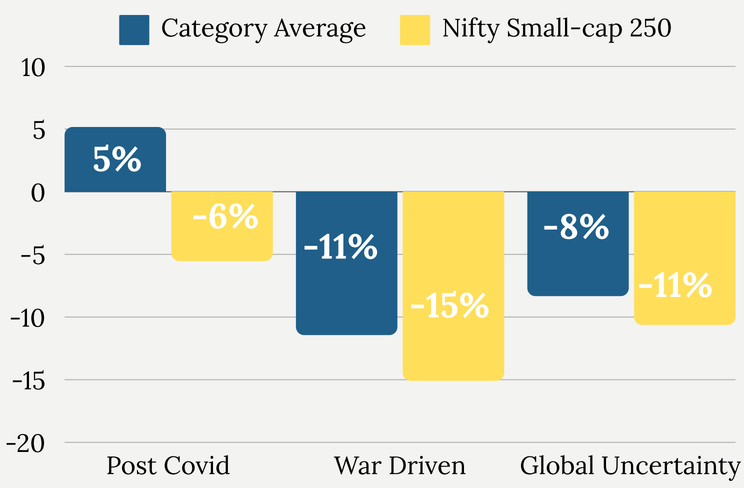
~41.0%

Active funds average - 2023

While this momentum-driven strategy boosts returns in bull markets, it can also heighten volatility during downturns. Additionally, the Nifty Small Cap 250 Index holds a diversified pool of 250 stocks, compared to the more selective average of around 90 stocks held by active small-cap funds, offering broader exposure that benefits from small-cap momentum. While passive funds have outperformed during recent bull markets, it's crucial to assess how they fare during bear markets and to analyze performance over a complete market cycle with both highs and lows. Examining results across diverse market conditions can provide a clearer perspective on which strategy may be more effective for long-term investing.

WHO REIGNS SUPREME IN BEAR MARKETS - CAPITAL PROTECTION

When examining historical performance across various bear market cycles, data shows that 90% of actively managed small-cap funds have outperformed the Nifty Small-cap 250 Index. This consistent outperformance underscores the value of active management, particularly in preserving capital and reducing downside risks during market downturns.



Active fund managers have the ability to make dynamic decisions in response to changing market conditions. For example, they can hold cash during periods of heightened volatility to reduce exposure to downside risk or strategically allocate capital to companies with strong fundamentals that are better positioned to withstand market turbulence, offering good risk-adjusted returns over the long term. This approach enables active managers to mitigate losses and focus on high-quality stocks with strong growth potential, even in challenging market environments.

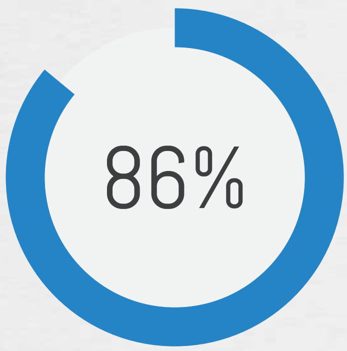
In contrast, passive funds are designed to track the performance of a specific index, which means they invest in the same stocks that make up the index, regardless of the individual companies' fundamentals. This approach doesn't allow for any flexibility or adjustments based on the current market conditions or the health of individual companies. During market downturns or corrections, passive funds are exposed to the same declines as the index. Since they cannot avoid poorly performing stocks, they experience the full impact of the market's losses.

Small-cap stocks, in particular, require more in-depth analysis and research due to inefficiencies and lack of transparency in the market. These factors create opportunities for skilled fund managers to identify mispriced stocks and generate alpha—excess returns beyond what the market or index provides. However, in a passive fund, a stock can be included in the index simply because it meets the market capitalization criteria, even if it is fundamentally weak or poorly managed. Passive funds cannot make exceptions, meaning they are forced to include such companies in their portfolio. On the other hand, active managers have the flexibility to exclude these stocks and focus on better-performing ones, which allows them to avoid risks and potentially outperform the index.

THE BATTLE FOR THE LONG-TERM CROWN: DO PASSIVE FUNDS OUTPERFORM IN THE END?

To determine whether passive funds can sustain their outperformance after the euphoria of a bull market, or if active funds ultimately outperform due to their advantage in limiting losses during bear markets, we analyzed the 5-year absolute returns. The findings are telling: 86% of actively managed small-cap funds outperformed on an absolute basis over five years. This highlights a key distinction: while passive funds may deliver attractive returns during bull markets, active funds often excel in the long term, especially when factoring in their ability to minimize losses during market downturns.

To illustrate this with an example: suppose two funds, Fund A (a passive fund) and Fund B (an actively managed fund), both start with an NAV of 100. In a bear market, Fund A drops by 20%, falling to an NAV of 80, while Fund B, with active management, declines by only 10%, reaching an NAV of 90. When the market recovers and both funds reach an NAV of 110, the percentage returns diverge. Fund A sees a recovery from 80 to 110, a gain of 37.5%, while Fund B's recovery from 90 to 110 reflects a gain of 22.2%.



On a 5 Year Period 86% of active managed funds have outperformed the index in absolute return terms

At first glance, Fund A seems to offer a better return. However, this apparent outperformance stems from Fund A's deeper initial decline in the bear market. The greater drop created a lower starting point, making the recovery appear larger in percentage terms. In contrast, Fund B's smaller decline in the downturn means it begins the recovery from a stronger position, which might seem like underperformance during the rebound, but in reality, it represents a more stable path.

Ultimately, both funds reach the same NAV of 110. This example underscores how passive funds, although they may outperform during a bull market or specific calendar years, typically suffer sharper declines during downturns. Active funds, by falling less during the bear markets, create a more stable growth trajectory over time, leading to comparable—or sometimes superior—absolute returns in the long term.

	NAV at Start	Bear Run	Bull Run
Fund A (Passive Fund)	100	80	110
Fund B (Active Fund)	100	90	110

	Returns During Bear Fall	Returns During Bull Rise
Fund A (Passive Fund)	-20%	38%
Fund B (Active Fund)	-10%	22%

This analysis reveals a key insight: while passive funds may shine in the short term, particularly in strong bull markets, the real benefits of active funds become apparent over longer periods, particularly after market corrections. Calendar-year returns can create a skewed perception, often favoring passive funds during bull runs and the Active during bear, but when we consider absolute returns over the course of an entire market cycle—including both highs and lows—the resilience of active funds becomes clear. Their ability to minimize downside risks and preserve capital during market corrections positions them for better long-term performance.

CONCLUSION

In the end, the choice between passive and active funds goes beyond short-term returns—it's about achieving steady, long-term growth. Active funds tend to perform better over time because their managers can adjust during downturns and focus on solid, high-quality companies. This flexibility helps active funds provide more stable, risk-adjusted returns, especially when markets get rough.

On the other hand, passive funds follow the index closely, which can work well in bull markets but requires investors to have a good understanding of economic cycles. Since passive funds don't adjust based on market conditions, they often appeal to institutional investors who can independently analyze market trends.

For most investors, active funds may offer a smoother ride toward long-term goals, with professional managers making careful adjustments to handle market ups and downs.

This table contains the data for the small-cap funds and index performance over a 5 Year period absolute returns and calendar year wise returns to come to the conclusion. YTD Period and data as of 24-Jun, 2024, Bandhan and Edelweiss are comparative new funds the absolute returns are since inception.

Fund Name	5 YEARS
Quant Small Cap Fund Growth	498.1%
Bank of India Small Cap Fund	338.7%
Nippon India Small Cap Fund - Growth	333.9%
***Bandhan Small Cap Fund**	305.3%
Canara Robeco Small Cap Fund	295.7%
***Edelweiss Small Cap Fund**	288.3%
Tata Small Cap Fund	277.1%
Kotak Small Cap Growth	273.0%
Category Average	271.8%
Invesco India Smallcap Fund	265.8%
HSBC Small Cap Fund Fund	260.8%
Union Small Cap Fund	256.1%
SBI Small Cap Fund Regular Plan Growth	247.7%
Axis Small Cap Fund	243.6%
ICICI Prudential Smallcap Fund Growth	242.3%
Franklin India Smaller Companies Fund Growth	239.2%
LIC MF Small Cap Fund	237.4%
DSP Small Cap Fund Growth	237.4%
Sundaram Small Cap Fund	219.0%
HDFC Small Cap Fund Growth	217.9%
Aditya Birla Sun Life Small Cap Fund Growth	159.4%
NIFTY SMALL CAP 250	**230.2%**

Legal Name	YTD - 2024	2023	2022	2021	2020	2019
Aditya Birla Sun Life Small Cap Fund Growth	25.04	39.39	-6.46	51.36	19.79	-11.54
Axis Small Cap Fund Regular Growth	22.24	34.04	2.62	58.22	22.37	19.38
Bandhan Small Cap Fund Regular Growth	35.29	53.6	-6.13	52.45		
Bank of India Small Cap Fund Regular Growth	27.97	40.8	-1.62	70.83	52.24	4.28
Canara Robeco Small Cap Fund Regular Growth	24.65	32.33	6.79	70.81	41.82	
DSP Small Cap Fund Regular Plan Growth	21.99	41.21	0.46	58.9	33.12	0.74
Edelweiss Small Cap Fund Regular Growth	22.37	42.13	1.65	67.5	34.8	
Franklin India Smaller Companies Fund Growth	27.8	52.15	3.58	56.37	18.69	-5.02
HDFC Small Cap Fund Growth	20.61	44.84	4.59	64.88	20.17	-9.49
HSBC Small Cap Fund Fund Regular Growth	26.92	46.05	1.01	77.41	15.46	-8.15
ICICI Prudential Smallcap Fund Growth	22.69	37.94	5.75	61	22.76	10.03
ITI Small Cap Fund Regular Growth	30.98	51.93	-4.35	31.97		
Invesco India Smallcap Fund Regular Growth	27.92	44.1	-0.69	62.33	24.86	3.85
Kotak Small Cap Growth	26.63	34.83	-3.07	70.94	34.21	5.04
LIC MF Small Cap Fund Regular Growth	35.01	33.4	2.42	64.69	18.96	-4.43
Mahindra Manulife Small Cap Fund Regular Growth	31.76	57.18				
Motilal Oswal Small Cap Fund Regular Growth	27.43					
Nippon India Small Cap Fund - Growth	29.98	48.92	6.54	74.34	29.24	-2.52
PGIM India Small Cap Fund Regular Growth	17.29	23.92	-5.33			
Quant Small Cap Fund Growth	30.6	46.38	9.5	88.05	75.1	-23.51
Quantum Small Cap Fund Regular Growth	15.87					
SBI Small Cap Fund Regular Plan Growth	28.57	25.3	8.14	47.56	33.62	6.1
Sundaram Small Cap Fund - Institutional Plan - Growth Option	54.85		-		27.36	-5.16
Sundaram Small Cap Fund - Regular Plan - Growth Option	17.96	45.29	-2.11	60.35	26.16	-6.06
Tata Small Cap Fund Regular Growth	28.77	33.51	8.18	70.52	23.05	2.56
UTI Small Cap Fund Regular Growth	23.39	35.32	-0.63	55.35		
Union Small Cap Fund Regular Growth	18.64	41.38	-1.01	62.14	30.17	2.41
Nifty Smallcap 250 TR INR	**27.25**	**48.09**	**-3.64**	**62.34**	**25.46**	**-8.26**

This table contains the data for the small-cap funds and index returns during the market bear runs, used for the analysis.

Periods of Market Corrections		Category Avg	Nifty smallcap 250	Outperformance With Index
Inflation and Supply Chain Disruption	19-10-21 to 25-10-21	▲ 5.2	-5.5	**61%**
War Driven Volatality	12-4-22 to 11-5-22	▲ -11.4	-15.1	**96%**
Growth Slowdown	20-12-23 to 26-10-23	▲ -3.6	-4.9	**96%**
Inflation Persistence	19-10-23 to 26-10-23	▲ -5.0	-5.6	**92%**
Earnings Disappointment	07-02-24 to 13-02-24	▲ -3.3	-4.8	**96%**
Global Uncertainty	04-03-24 to 13-03-24	▲ -8.3	-10.6	**100%**

Name	10/2021 to 10/2021	04/2022 to 05/2022	12/2022 to 12/2022	10/2023 to 10/2023	02/2024 to 02/2024	03/2024 to 03/2024
Aditya Birla Sun Life Small Cap Fund	▲ -5.39	▲ -12.25	▲ -3.84	▲ -5.57	▲ -3.52	▲ -7.80
Axis Small Cap Fund	▲ -5.13	▲ -10.36	▲ -3.01	▲ -4.40	▲ -2.95	▲ -7.51
Bandhan Small Cap Fund	▼ -6.33	▲ -12.22	▲ -3.56	▲ -5.53	▲ -4.23	▲ -9.40
Bank of India Small Cap Fund	▼ -7.35	▲ -12.85	▲ -3.93	▲ -5.21	▲ -3.99	▲ -7.94
Baroda BNP Paribas Small Cap Fund	-	-	-	-	▼ -5.29	▲ -9.28
Canara Robeco Small Cap Fund	▼ -5.68	▲ -11.29	▲ -3.38	▲ -4.31	▲ -3.16	▲ -8.38
DSP Small Cap Fund	▲ -4.97	▲ -11.08	▲ -4.14	▼ -5.62	▲ -3.21	▲ -8.70
Edelweiss Small Cap Fund	▼ -5.67	▲ -11.12	▲ -3.74	▲ -4.41	▲ -3.13	▲ -7.73
Franklin India Smaller Companies Fund	▲ -4.70	▲ -10.88	▲ -3.72	▲ -5.26	▲ -3.26	▲ -8.13
HDFC Small Cap Fund	▲ -5.22	▲ -12.96	▲ -3.35	▲ -5.17	▲ -3.26	▲ -7.87
HSBC Small Cap Fund Fund	▼ -7.04	▲ -12.07	▲ -3.89	▲ -5.27	▲ -4.22	▲ -9.67
ICICI Prudential Smallcap Fund	▲ -4.00	▲ -9.79	▲ -2.90	▲ -4.79	▲ -3.51	▲ -7.27
Invesco India Smallcap Fund	▲ -4.50	▲ -11.81	▲ -3.54	▲ -3.71	▲ -3.79	▲ -8.48
ITI Small Cap Fund	▲ -2.63	▲ -11.15	▲ -3.90	▲ -4.96	▲ -3.97	▲ -9.23
Kotak Small Cap	▲ -4.95	▲ -10.00	▲ -3.02	▲ -4.91	▲ -2.85	▲ -6.56
LIC MF Small Cap Fund	▼ -6.03	▲ -11.43	▲ -4.31	▲ -5.56	▲ -1.63	▲ -10.57
Mahindra Manulife Small Cap Fund	-	-	▲ -2.04	▲ -5.56	▲ -4.49	▲ -8.49
Motilal Oswal Small Cap Fund	-	-	-	-	▲ -3.21	▲ -8.28
Nippon India Small Cap Fund -	▼ -6.65	▲ -12.14	▲ -4.27	▲ -4.93	▲ -3.56	▲ -7.90
PGIM India Small Cap Fund	▼ -5.57	▲ -12.64	▲ -4.05	▲ -4.05	▲ -1.82	▲ -7.19
Quant Small Cap Fund	▲ -4.63	▼ -17.03	▼ -5.14	▼ -6.04	▲ -4.49	▲ -10.06
SBI Small Cap Fund	▲ -3.68	▲ -8.11	▲ -3.84	▲ -5.34	▲ -1.41	▲ -6.67
Sundaram Small Cap Fund	▲ -5.26	▲ -12.49	▲ -2.81	▲ -4.75	▲ -2.46	▲ -7.90
Tata Small Cap Fund	▲ -2.50	▲ -6.91	▲ -3.78	▲ -4.97	▲ -2.30	▲ -9.48
Union Small Cap Fund	▼ -5.96	▲ -11.46	▲ -2.92	▲ -4.46	▲ -4.16	▲ -9.28
UTI Small Cap Fund	▲ -4.93	▲ -11.31	▲ -3.43	▲ -4.64	▲ -2.97	▲ -8.65
Category Average	▲ -5.16	▲ -11.45	▲ -3.60	▲ -4.98	▲ -3.31	▲ -8.33
NIFTY SMALL CAP 250	-5.54	-15.09	-4.91	-5.62	-4.84	-10.63

For more such information stay connected!

THANK YOU!

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