

The Economic Rose of Active Management

About the IIMI and an introduction to this paper

The Independent Investment Management Initiative (IIMI) is a member-led industry think tank representing over 50 specialist, entrepreneurial investment boutiques that are entirely focused on and aligned with the interests of their investors.

Conviction in active management runs through our membership. It's the task of many members' commercial teams to explain why they believe their funds can outperform passive alternatives. But, as IIMI, this is not our task. This paper is not a rehearsal of arguments as to why active investing might outshine passive. It's an exploration of whether the rise of passive investing may have had unintended consequences for the health of our industry. More fundamentally, it's also an examination of our responsibility as an industry – which we argue plays a role in the functioning of capital markets and indeed the real economy.

The economic role of active management

The FRC has revised the definition of stewardship, as follows: *'Stewardship is the responsible allocation, management and oversight of capital to create long-term sustainable value for clients and beneficiaries.'*

We would argue that this definition is too narrow. One might argue that it downplays sustainability. But, here, we focus on a different limitation; that it downplays the role of asset management in the real economy.

This tone is mirrored in the wider policy and regulatory conversation, particularly in the UK, with regards to much of asset management. Discussions around 'Productive assets' in the UK, for instance, are limited to private markets. Meanwhile the regulatory focus on value for money has arguably advantaged passive investing given its inherently lower cost base.

But why should regulators and policy makers care? We argue that overlooking the economic role of the industry, and amplifying trends towards passive investing, have consequences – consequences that run counter to aims of financial stability and long-term economic growth.

The rise of passive has implications for financial stability

Financial stability is one key area which may be impacted by passive investing. The ECB has outlined some of the ways in which the rise of passive investing can threaten financial stability (1). Passive investing may increase co-movement among stock returns, making markets more volatile. When passive managers experience inflows (for instance in one day) they must buy all constituents in an index in that same day. This increases co-movements and correlations between these constituents. Their review also finds that passive funds may increase equity market concentration, potentially leading to heightened idiosyncratic risks from the largest companies within the index. The key driver here is liquidity. Larger companies tend to be more liquid than smaller counterparts, but not proportionately more liquid relative to their size - given the huge size discrepancies in some cases. So passive fund flows may affect the prices of larger

companies more than smaller ones, adding to concentration risk (2). The disproportionate representation of larger companies creates issues if a few of them underperform – arguably, as we might have seen in US equity market in Q1 2025.

The quality and judgement of capital market participants matters

Aside from arguments from financial stability, we would highlight the economic function of capital markets. Active managers have a particularly important role to play in this economic function.

Whereas in a centrally planned system, government dictate the shape of the economy – which projects are financed, which jobs are created - in a free-market system this is outsourced. The question then becomes whether is being done with care and rigour. Business owners and managers make such decisions, generally funded by capital markets. Therefore, the quality and judgment of capital market participants matters.

Active management, by judging the quality of management teams and their capital allocation decisions, has an economic role. Bernstein therefore argues that: “the social function of active management is that it aims to direct capital to its most productive end, facilitating sustainable job creation and a rise in the aggregate standard of living”.(3)

Passive investing makes no such judgement. Index strategies are inherently return agonistic. Their value proposition is to provide market rate of returns at the lowest possible fees. Correspondingly, their business strategy relies on volume of inflow to offset low management fees - not return on investment. There is little inherent interest in the relationship between price and underlying valuation. By contrast, active strategies seek to exploit and correct market inefficiencies – the mispricing of financial and economic worth. Many also seek to influence management over a longer investment horizon to address these inefficiencies.

Importantly, there are reasons to suggest this type of long-term and engaged ownership benefits companies themselves. The George Washington University Law School’s Initiative on Quality Shareholders is a rich addition to research in this area. A quality shareholder is defined as one who, in contrast to passive or short-term investors: “studies individual companies, acquires substantial stakes in few, holds them for the long-term, and is available as needed to engage with management”. It finds that companies that attract high-quality shareholders tend to outperform the market and have several potential advantages such as more time to execute strategy, and better-informed stewardship efforts. (4)

“I do not believe that such concentration would serve the national interest.” – Jack Bogle

The differences in social function, incentive structure and strategy between passive and active have broad implications. Tellingly, the father of index investing, Jack Bogle, spoke to the concentration of stewardship power as the key drawback of index investing. Noting the increasing dominance of three large providers, he commented: “I do not believe that such concentration would serve the national interest.”. (5) While his primary concern was the concentration of power in three financial institutions; we see structural issues with respect to passive stewardship. Large index providers generally have little company specific interest and insights, whereas active strategies have insights about specific corporate history, opportunities, and risks. The counterargument is often that index providers are incentivised to correct systemic issues. However, as they are paid to match an index, not to beat it, there is little incentive to improve global risks which impact companies and instruments across markets. The returns may be lower; the fees will not be.

All the above highlights the economic grounds for active management – based on financial stability, economic function, and stewardship. These are key goals of regulators and policy makers – yet we see little recognition of this. The exception is in private markets – whose economic value is increasingly championed. The Pensions Regulator has recently highlighted the economic value of investing in UK ‘productive assets’ - which seem to exclude much of the public market. But active management helps steward the economy across both public and private markets – which are ultimately, in any case, connected. Alongside championing the role of private markets, and their particular value to the UK economy, we would argue for recognition of the role of thoughtful, active decision making across asset classes.

1. https://www.ecb.europa.eu/press/financial-stability-publications/fsr/focus/2024/html/ecb.fsrbox202411_03~87408e7fb3.en.html
3. [The Dominance of Passive Investing and Its Effect on Financial Markets | Paul Merage School of Business | UCI](#) – or the actual paper for a technical journey; [w28253.pdf](#)
2. Fund Management Strategy: The Silent Road to Serfdom: Why Passive Investing Is Worse than Marxism, Bernstein Research, August 23, 2016.
4. https://scholarship.law.gwu.edu/cgi/viewcontent.cgi?article=2769&context=faculty_publications
5. [Bogle Sounds a Warning on Index Funds - WSJ](#)

If you would like to know more about the Independent Investment Management Initiative, please visit our website www.theiimi.org or email enquiries@theiimi.org.