Passive Investing is Best, Isn't it?

So why do we keep interfering – and how to stop

By Dr Steven Bates, November 2025

Passive investing beats active in the long run, right? The short answer is *yes in most cases*. The longer answer below is *not likely*, and that's because we humans tend to interfere, lacking the discipline and patience to let passive investing deliver.

This article explains why everyone should hold a passive portfolio of some kind but combine it with diversifiers so you can sleep well at night and resist the urge to tinker.

At first glance, the numbers favour passive investing, which, put simply, means buying and holding *the market*. We'll come back to what *the market* means in a moment.

According to many studies, most active managers underperform passive ones over time. This makes sense when you think about it. In total it's impossible for all active managers to beat their benchmarks, since they are trading against one another. There must be winners and losers, and with higher fees, active is bound to underperform *on average*. And that's the key: *on average*.

I was head of fund selection at a large wealth manager, and I assure you that there are managers who consistently outperform both peers and benchmarks. It comes down to skill, experience, data, technology and good risk management. But finding them, and occasionally replacing them when performance weakens, is a highly skilled and expensive job that a non-specialist cannot easily do.

Wealth managers will gladly sell you this advice in the form of fund recommendation lists but be careful. Once you add in all the fee layers: advisory, trading, custody and the manager's own fee, high positive alpha can reduce or turn negative. And the best managers, often hedge funds with dazzling long-term records don't all accept new capital.

The other statistic often quoted is that passively managed assets now exceed active, supposedly investors voting with their feet. However these figures can be misleading.

It's true that passive ETF inflows often surpass those of active funds, and may be higher in total in some areas. But this doesn't necessarily mean that investors are rejecting active management. Many active allocators such as wealth managers use ETFs as efficient tools to run active strategies. With increasing competition, ETF pricing has reduced. In some markets, it's now as cheap to gain exposure through ETFs as by holding individual stocks, bonds or futures. Trading costs have also fallen, where spreads (one cost of trading) are now far narrower than they were.

Now let's come back to *the market*. This can be a very subjective decision and therefore not as passive as people often claim.

For some it means all global listed equities, government and investment grade bonds. Others might add listed real estate and the most liquid commodities. Some narrow it down to developed equity markets. And for many investors there's the S&P 500, the so-called king of benchmarks, which is narrower still.

Furthermore, if you consider *the market* multi-asset, the next question is: *how much of each asset class*? That answer can be a complex decision, because the mix of equities, bonds and other assets changes the portfolio's risk dramatically. And what is your risk profile anyway, do you define that by volatility or by the worst drawdown?

So if you tell me you're a passive investor, explain how you decide what *your market* is, and how much of each asset to hold, without taking an active decision.

Then there's the question of *how much to invest, when and how often to rebalance*. Most people aren't lucky enough to be born with a huge sum of money to deploy and forget about. We usually save from income, starting small and increasing over time. But how much of our income should we invest, and how often? And if our benchmark is, say, 50% equities and 50% bonds, when do we rebalance after those weights drift? These are all active choices that affect both performance and risk.

After 30 years working in the investment industry, I've found that the best approach is usually to hold a broad, global, multi-asset portfolio, invest savings at least annually and rebalance either yearly or after large market moves. Always keep costs as low as possible.

This is not a simple task, which is why wealth managers are happy to sell you a discretionary portfolio that does it for you.

Or you can make life a little easier by buying a multi-asset ETF. Many exist (more decisions!) with attractive fees. Just make sure they're truly passive, not active in disguise. And understand all the costs: brokerage, management, and custody, as they soon add up.

So after all that preamble, what could go wrong with a simple passive investment?

Well, it's *you*, I'm afraid. Many of us will check performance too often, be pleased when it rises, anxious when it falls. Studies show that humans feel losses roughly twice as strongly as equivalent gains. This bias, called loss aversion, makes us prone to intervene, or worse panic, when markets drop. It's not often, but if panic takes hold, people often sell and usually not at an optimal moment. Worse, they delay reinvesting until too late in the recovery. This is a terrible investment strategy, and it's certainly not passive.

How often does this happen? Let's take a quick look at another facet of the problem. Turning to a single market now, the S&P 500, where long-term data (almost 70 years in this analysis) give a clear picture.

The table below shows how often the index has lost different amounts in a month, both the *theoretical* frequency predicted by a normal distribution (a statistical model of market moves) and the *actual* historical record.

	NUMBER OF YEARS BETWEEN OCCURRENCES	
1 MONTH LOSS	**THEORY**	**ACTUAL**
-20%	268,149	66
-15%	1,062	33
-12.5%	112	22
-10%	17	8
-5%	1	1

Table 1: Actual occurrences of monthly S&P 500 losses compared with theoretical prediction, data from 1960.

For small losses, theory works well: a 5% monthly loss happens about once per year in both theory and practice. But larger losses show a stark difference. A 10% loss should occur once every 17 years, but actually happens every 8. The biggest one-month loss of 20% should occur once every 268,000 years, yet in reality it's every 66. That's about 4,000 times more frequent.

It's these rare but painful drawdowns that test even calmest investor's nerve. And the S&P500 hasn't just fallen 20% and bounced back. Over the last 70 years, US equities have seen drawdowns of roughly 50% three times – twice in the last 25 years.

This is a well known feature of markets, they don't follow neat, bell-curve statistics. Instead they have "fat tails", which means more extreme events than theory predicts. Buying and holding such as market has delivered excellent long-term returns, but at high *emotional* cost.

In addition, studies show that investors rarely capture the full returns of the S&P 500. They lag significantly because of interference, usually triggered by the fear of loss. As the old saying goes: *time in the market beats timing the market*.

I wouldn't recommend holding just the S&P500 however, because there's another issue: concentration risk.

In recent years, the index has become dominated by a handful of stocks, often called *The Magnificent Seven*. No, not one of Yul Brynner's finest films but Alphabet, Amazon, Apple, Meta, Microsoft, Nvidia and Tesla.

As of mid 2025, these companies made up about 34% of index's total weight – and an even great share of its risk. They've performed extremely well, which is why they now dominate the index (it's a market-capitalization-weighted index after all).

The concern is their relative riskiness and how closely they move together. For instance, Nvidia and Tesla each have volatilities of 40-60% annualized, while the long term volatility of the S&P500 sits around 15-20%. In other words, owning the S&P500 today means making quite a big bet on a small group of correlated stocks.

So what's the solution?

I strongly recommend building a passive, globally diversified market portfolio, focused on liquid assets such as stocks and bonds, and investing whatever you can every year. Keep costs low and rebalance when needed. **Never sell this core portfolio.**

Then, add *diversifiers* that behave differently. Ideally, some will fall less than the market in a downturn or even rise. The aim is that your overall portfolio experiences smaller swings and shallower losses, helping you stay invested which is the best recipe for long-term success.

Looking at the figure below, this is a fairly typical portfolio I've seen at large wealth management firms: a substantial buy-and-hold market core, plus a range of diversifiers. Hedge funds, real estate, private equity and infrastructure can all offer lower correlation to traditional markets, though careful selection is key. There are hundreds of options, and professional advice is essential to choose the best. However, these assets are usually illiquid and not cheap.

I've also seen many clients holding their "darling" stocks – often inherited with emotional attachment. Sometimes they're just for speculation. That's fine, as long as the overall weighting remains modest.

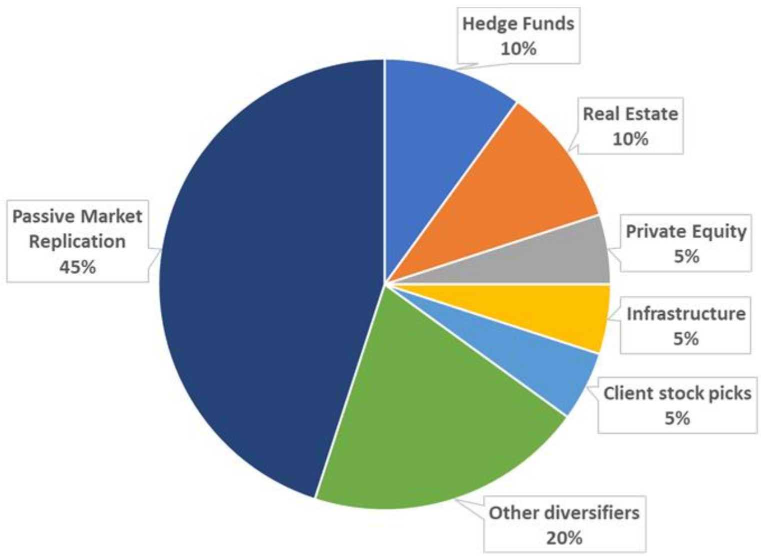

Figure 1: A stylized example of a portfolio often seen at wealth management firms.

Then there's a bucket I've labelled "Other diversifiers". In reality often held in cash, sometimes to a far higher degree than shown. Many investors view cash as a defensive asset. It's true that it can't fall in its own currency terms (aside from inflation), but it also won't protect you from market volatility and jump up when everything else drops. It's mostly a drag on performance.

And for those of you who see it as "dry powder" ready to invest during market dips, good luck with that. Studies on thousands of affluent and high-net-worth clients show that, including this cash, most underperform a simple buy-and-hold portfolio and often with higher volatility.

Over the years I have seen many candidates for this "Other diversifiers" bucket: *Smart beta, Multi-factor, Risk Parity, Minimum Volatility, Diversified Growth, Capital Preservation*, and more.

What matters, however, isn't the name but the **characteristics**. The best diversifiers share a few common traits:

1. **Rules-based**. Meaning not run by an individual or committee. I served on an investment committee for several years and despite a good track record, there was evidence of classic behavioural biases – *groupthink , anchoring, confirmation bias, recency bias and disposition effect*, among others. (You can look those up, there are enough to fill a master's thesis!)

2. **Diversified**. Not concentrated in a handful single stocks primarily. A pure single-asset exposure can be fine – in fact, it's often helpful for allocators to know precisely what they're getting, such as 100% equities or fixed income, so they have a clear place and benchmark in the overall portfolio.

3. **Diversifying**. They should behave differently from common benchmarks, exhibiting less correlation, smaller drawdowns and solid risk metrics, whilst still offering good upside. These aren't meant to "shoot the lights out", but to deliver modest outperformance over simple benchmarks across multi-year periods.

4. **Transparent**. The investment universe, approach, and risk controls should be clear. Some intellectual property may be proprietary but make sure the strategy has been thoroughly stress-tested and independently reviewed.

5. **Low cost**. Harder to define, but these tend to cost more than passive ETFs and less than active funds or hedge funds. A reasonable range is 0.3 – 0.6%, depending on the sophistication of the approach and size of your investment.

A proverb to finish: *The best time to plant a tree was 20 years ago. The second-best time is now.*

The same applies to investing. If you started 20 years ago and earned solid returns, you'll feel much more at ease than someone deciding what to do with a recent windfall. But start you must.

If you are young with limited means, there are plenty of low-cost online platforms where you can build an ETF portfolio. As your income grows, keep adding to it regularly. Yes, life events like buying a house, marriage and holidays can get in the way, but you'll wish you'd started earlier and been more disciplined once you reach your 50s, trust me.

As your wealth grows, by all means seek advice from a wealth manager to access the best performing and less liquid diversifiers they offer. But be sure to ask specifically for the "Other diversifiers". If they look puzzled, give them the checklist above and see what they come back with.

So yes, passive investing is best, in theory. But in practice, it only works if you build it wisely, leave it alone, and hold a few diversifiers that make it easier to sit tight when markets wobble. The hardest part isn't the market – it's you.

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