Active vs Passive ETF Performance: Key Differences

Compare how active ETFs perform versus passive ETFs, including returns, costs, risks, and tax implications.

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Although ETFs have become one of the most popular investment vehicles today, not all of them follow the same investment philosophy.

The two major categories—active and passive ETFs—take very different approaches to portfolio construction, fees, performance, and risk. Understanding the distinctions is essential for choosing the right strategy for your financial goals.

Below, we break down how active and passive ETFs differ, how each has historically performed, what drives that performance, and which type of investor each approach tends to suit best.

What's the Difference Between Active and Passive ETFs?

A passive ETF tracks a benchmark index such as the S&P 500, Russell 2000, or Nasdaq. These funds do not try to beat the market; they simply seek to replicate the index's performance with minimal tracking error.

Passive ETFs are designed for long-term investors who want broad exposure, tax efficiency, and transparency at a low cost.

An active ETF is managed by a portfolio manager or investment team who selects securities based on research, analysis, or quantitative models. Instead of tracking an index, they aim to outperform the market.

These funds rely on human decision-making, and therefore carry higher fees, but have the ability to generate higher returns or create a more customized investment strategy, depending on client need.

How Does Performance Typically Compare?

On average, passive ETFs have outperformed active ETFs, especially in large-cap U.S. equity markets. However, there are important exceptions. Active ETFs may outperform in environments where market volatility is high, economic cycles shift sharply, or indices become concentrated in a few mega-cap names. Moreover, active management can also reduce the risk profile of a fund by minimizing drawdowns or reducing volatility, which helps investors accomplish non-alpha-related goals.

Recent market activity has shown strong performance in niche categories like fixed income, covered calls, or thematic equities (such as artificial intelligence).

Passive wins more often overall, but active can outperform when market inefficiencies or strong managerial skill come into play.

What Factors Drive Performance in Active vs Passive ETFs?

Performance Drivers for Active ETFs:

- **Manager Skill (Alpha):** Outperformance depends heavily on the portfolio manager's ability to identify mispriced assets or market trends.
- **Market Inefficiencies:** Active ETFs tend to perform best in areas where information is harder to come by (e.g., small caps or emerging markets).
- **Portfolio Turnover:** Higher turnover enables tactical adjustments but also increases trading costs and potential tax drag.
- **Flexibility:** Active managers can raise cash, rotate sectors, hedge exposures, or avoid problematic companies.

Performance Drivers for Passive ETFs:

- **Low Fees:** Cost savings compound over time and significantly influence long-term returns.
- **Tracking Accuracy:** The closer the ETF mirrors its index, the more dependable its performance.
- **Tax Efficiency:** Low turnover and in-kind redemptions reduce capital gains distributions, although certain active managers, like Twin Oak, make tax-aware investing core to its management approach.
- **Market Structure:** Passive funds benefit from broad market growth and compounding.

Who Should Consider Active vs Passive ETFs?

Active ETFs may be ideal for high-net-worth clients seeking tax-aware strategies or downside risk tools, investors who believe in the manager's skillset, concentrated stock holders who need transition strategies, or income-focused investors who require downside protection.

Passive ETFs may be best suited for cost-sensitive investors with a long-term investment horizon, beginners who want broad diversification, hands-off investors who want a low-maintenance approach, or those who require predictability.

Most sophisticated portfolios use a mix of both, blending passive core holdings with targeted active satellite positions.

How Does Tax Efficiency Differ Between Active and Passive ETFs?

Across the ETF landscape, passive ETFs are generally more tax efficient, mainly because there is less turnover and fewer taxable events. However, active ETFs can provide specific tax-aware or tax-efficient benefits to high-net-worth investors or family offices, such as tax-loss harvesting or Section 351 exchanges, which can help transition certain holdings into an ETF while deferring capital gains.

Active or Passive: Which is Right For You?

Active and passive ETFs each play an important role in modern investing. Passive ETFs offer low cost, simplicity, and broad market exposure—making them a staple for long-term investors.

Active ETFs, meanwhile, provide tactical flexibility, potential for outperformance, and opportunities in less efficient markets.

Choosing between them depends on your goals, tax situation, investment horizon, and belief in active management. For many investors, the best approach is not “active or passive” but a balanced combination of both.

Definitions (as used by Twin Oak):

1. **Cost-effective ETFs:** As defined compared to hedge funds, which commonly charge a 2% management fee as well as 20% of the profits.
2. **Institutional Grade:** Investment strategies generally only accessible in private fund formats to accredited investors.
3. **Tax Alpha:** The amount of a gross return lost to the tax drag of an investment vehicle through realized taxable events.
4. **Low Cost:** Defined on a case-by-case basis but generally refers to solutions that are cheaper than private funds (2% management fees and 20% carry).

An investor should consider the investment objectives, risks, charges, and expenses of the Fund(s) carefully before investing. The prospectus and the summary prospectus contain this and other information about the Fund(s). You may obtain a prospectus and a summary prospectus by visiting twinoaketfs.com. Please read the prospectus or summary prospectus carefully before investing.

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1. **New fund risk:** The Fund is a newly organized, management investment company with no operating history.
2. **Non-diversification risk:** More of the Fund's assets may be invested in the securities of a single issuer than could be invested in the securities of a single issuer by a diversified investment company. This may make the value of the Shares more susceptible to certain risks than shares of a diversified investment company. The Fund has a greater potential to realize losses upon the occurrence of adverse events affecting a particular issuer.
3. **Counterparty Risk:** Some of the Fund's derivatives contracts are privately negotiated in the over-the-counter market. A counterparty defaulting on its payment obligations to the Fund will cause the value of an investment in the Fund to decrease.
4. **Derivatives Risk:** The Fund may use derivative contracts which can disproportionately increase losses and reduce opportunities for gains when stock prices, currency rates, or interest rates are changing.
5. **Illiquid Securities Risk:** The Fund may invest up to 15% of its net assets in illiquid investments which are instruments that the Fund reasonably expects cannot be sold or disposed of in current market conditions within 7 calendar days or less without the sale or disposition significantly changing the market value of the investment.
6. **Leverage Risk:** The Funds use of options, swaps, or other derivative instruments may result in losses to the Fund or may adversely affect the Fund's NAV or total return, because these instruments are more sensitive to interest rate changes.
7. **Options Risk:** Purchasing and writing put and call options are highly specialized activities and entail greater than ordinary investment risks from which the Fund may not fully benefit.
8. **New advisory risk:** This is a newly registered investment advisory and as a result, there is no long-term track record against which an investor may judge the Adviser, and it is possible the Adviser may not achieve the Fund's intended investment objective.

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