What are the pros and cons of investing in passive funds?

As a mutual fund investor, you have a major decision to take – should you go the active route or should you pick passive funds? There are many advantages of mutual funds and it is also true that both these routes have their own pros and cons. However, if you are in a long-term investing journey, then it can be quite rewarding to consider investing in passive funds. Let us take a look at the nuances of these two mutual fund types, and arrive at the best option for your individual requirements.

What are passive funds?

Passive funds are mutual fund schemes which do not undertake an active investment strategy. Rather, they stick to the market and help you attain returns which are in line with the growth of the market. Therefore, passive fund managers do not make any attempt to generate alpha, i.e., returns in excess of benchmark, preferring to move along with the progress depicted by the larger market. Passive funds can be of two types – index funds, which invest their corpus based on the composition of the underlying benchmark and exchange-traded funds, which are similar to index funds, but these can be traded on exchanges. Now that you know what a passive fund is, let us consider how they work and why they could help you enjoy sustainable returns over the longer term.

How do passive funds work?

You will find passive funds everywhere – from the stock market to debt and commodities, there is a passive fund tracking the movement of every market. Passive funds, based on their underlying strategies and investment models, pick a benchmark and then buy the same assets as the ones in the benchmark. These funds also stick with the actual weightage of the securities listed on the index. For instance, a Nifty50 index fund will invest its corpus in the 50 companies comprising the underlying Nifty50 benchmark and it will also stick to the weightage enjoyed by these companies. So, if company A enjoys X% weightage on the Nifty50 index, then the index fund will also invest X% of the corpus in company A stock, thus aligning itself completely with the benchmark. One major feature of passive funds is that such funds do not frequently buy or sell securities, since they are only focused on tracking the benchmark.

Active funds vs. passive funds

Most asset management companies offer both active and passive funds, to cater to the varying needs of investors. In comparison to passive funds, active funds take consistent steps to realise short-term gains and generate alpha for the investors. Active fund managers track the market constantly and try their best to beat the market in terms of returns. And this is the reason why active funds charge a higher fee than passive funds – while passive funds stick with the market, active funds are always seeking gains and undertake frequent purchase and sale of securities. However, history indicates that, over time, both active and passive funds end up generating similar returns as it is impossible to beat the market consistently.

Pros of passive funds

- Lower charges: The biggest benefit of investing in passive funds is the significantly lower fee on these funds when compared to active mutual fund schemes. This is because of two factors – low transaction charges due to infrequent trades and low fund management fees due to the passive nature of management. This means that a majority of your investment goes into purchasing units of the fund, which result in higher returns at the end of the investment period.
- High transparency: Another benefit of passive funds is that these schemes are exceedingly transparent since they mimic the benchmark they are based upon. So, at any given time, you can be certain of where your money is being invested.
- Potential for diversification: Since these funds invest in all the components of the underlying benchmark, they are usually well-diversified and not concentrated in any one security. This also translates into lower risk compared to active funds.

Cons of passive funds

- Inability to generate alpha: Passive funds do have some cons, including the fact that they cannot take advantage of market opportunities, because fund managers are not undertaking active trades.
- Lower short-term returns: The inability of passive funds, when it comes to generating alpha, could lead to comparatively lower returns than active funds, in the short term. However, these tend to even out over time.

If you are someone who is keen on a long-term investment, and do not wish to track your portfolio regularly, then investing in passive funds is a great opportunity for you to participate in the growth of the market.