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# Morningstar's Australian Active/Passive Barometer

## End of June 2023

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### Morningstar Manager Research

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### Introduction

The Morningstar Active/Passive Barometer measures the performance of active funds<sup>1</sup> against passive peers in their respective Morningstar Categories. The study spans over 700 open-ended strategies (around 3,000 share classes including exchange-traded funds) domiciled in Australia.

The Active/Passive Barometer evaluates the efficacy of active funds against a composite of passive fund performance within the corresponding category. In the inaugural edition of the Australian Active/Passive Barometer, we cover nine categories using the trailing three-year, five-year, and 10-year periods (ending June 30, 2023) for analysis. It gauges how the average dollar invested in active funds has fared versus the average dollar in passive funds within the specified categories across various time periods.

### Key Takeaways

- ▶ The study reinforces some of the long-held Morningstar views such as the superiority of active funds in categories like Australia mid/small blend and Australia large value equities, whereas low-cost passive funds remain dominant in efficient markets when representative indexes are available.
- ▶ There can be considerable variation in the level of excess returns and success rates across different time periods and market conditions. Thus, it is prudent to look at longer timeframes when making the active/passive decision.
- ▶ Owing to the rising trend of interest rates across most developed markets over the past three years, the outperformance of active funds over passive funds in the bonds — global category is not only seen through the trailing three- and five-year periods, but also through the 10-year period, offsetting a lengthy period of underperformance in the preceding years.
- ▶ The outcomes in the Australia mid/small blend category show clear and consistent dominance of active funds in this segment, outperforming their passive counterparts across the three-, five- and 10-year periods by a substantial margin.
- ▶ The passive approach holds the upper hand in the world large blend category. On aggregate, active managers in this category fail to compensate for their higher fees vis-à-vis the low-cost passive funds.
- ▶ Survivorship rates are a crucial data point to keep in mind when looking at the efficacy of active funds within a category. Even in categories which are favorable to active strategies, a low survivorship rate will adversely affect the chances of achieving one's return objectives. It is important to note that, in most cases, passive strategies have better survivorship rates than their active counterparts.

<sup>1</sup> The terms "strategy" and "fund" have been used interchangeably for improved readability.

## Approach

There are two key metrics we used for determining the efficacy of active funds.

1. Excess Return: The difference between the average return of an active fund over the average return for a passive fund in a particular category over the specified period.
2. Success Rate: The proportion (by count) of active funds outperforming the passive composite, over the various time periods, provided that the active fund has survived through the period.

*More detailed explanations for the metrics can be found in the Glossary section at the end of the report.*

Things to note:

- ▶ The distribution of fund returns within a category is not always symmetrical across the calculated average performance. This means that we can have an outcome where the average active fund can outperform the average passive fund, but the success rate is significantly below 50%.
- ▶ We use "beginning-of-period" Morningstar Categories for each fund (that is, the categorizations which would have been used by a potential investor at the time of the investment decision). Some funds may have subsequently migrated to other categories as the fund attributes change or as the classification system evolves.
- ▶ The study mitigates survivorship bias by including the applicable returns for funds which closed before the end of the period. The excess returns metric incorporates this factor, but the success rate does not account for fund closures and should be viewed in conjunction with the survivorship rates.

Limitations:

- ▶ Across all the categories, the number of passive funds is far smaller than the number of active funds. The number of passive funds with long histories is quite limited. Thus, we have capped our longest trailing period at 10 years, where we have at least three passive strategies with continuous records in each of the nine categories.
- ▶ In the United States, we calculate strategy returns on an asset-weighted average of the associated share classes. However, owing to the limitations of data availability in Australia, the return for each strategy is measured using equal-weighted returns for the share classes associated with it. As a result, the presence of funds that are listed on platforms and master trusts with higher total fees with lower assets will understate return in some cases.
- ▶ Similarly, the calculated average returns are not asset weighted—that is, the returns for all the funds are equally weighted. It is possible that the return of smaller funds may have an outside impact. The presence of sufficiently large sample sizes should mitigate (but not eliminate) this effect.
- ▶ The passive strategies within a category can include niche indexes which may behave quite differently from each other and from the typical category index return characteristics. The availability of investable indexes within the category is a key input in the passive composite calculations.
- ▶ For instance, there are several passive funds tracking the popular S&P/ASX 200 Index in the Australia large blend category. However, there is no universal "value" index and the passive funds composing the Australia large value category are dividend funds, which are not true representations of the opportunity set.

## Results

Of the nine categories covered in this study, we would like to draw attention to the three categories: bonds—global, Australia mid/small blend, and world large blend. The other six categories are covered subsequently in alphabetical order.

### Bonds—Global

- ▶ In bonds—global, passive strategies are benchmarked to market-cap-weighted indexes which are dominated by sovereign bonds and characterized by high duration. Meanwhile, active funds have a higher propensity for taking on credit exposure and have flexibility on setting duration. Duration measures interest-rate sensitivity, namely, the longer a fund's duration the more sensitive it is to changes in interest rates.
- ▶ Over the last few years, the rapidly rising interest-rate environment in developed markets has resulted in a strong period of relative performance for the average active fund versus the average passive fund. Overall, both resulted in a negative return. However, this category illustrates that the flexibility of active managers versus passive funds can lead to a meaningful upside over the long term.
- ▶ In Exhibit 1, it is not surprising that the active global bond funds show significant outperformance over passive funds over the past three years in a rising interest-rate environment. However, the active global bond funds also beat their passive competitors over longer time periods. Of the 14 active strategies that survived over the 10-year period, nine strategies outperformed the passive composite—a success rate of just over 64%.

**Exhibit 1** Morningstar Category: Bonds—Global

Category	Time Period	Active Funds Average Return (%)	Passive Funds Average Return (%)	Excess Return (%)	Active Funds Success Rate (%)	Active Funds Survivorship (%)
Bonds - Global	3Y	-3.2	-5.1	1.8	100	83
Bonds - Global	5Y	-0.1	-0.3	0.2	90	75
Bonds - Global	10Y	2.2	2.1	0.0	64	64

Source: Morningstar Direct. Data as of June 30, 2023. Returns have been annualized for periods exceeding one year.

### Australia Mid/Small Blend

- ▶ The results for the Australia mid/small blend category are also encouraging for active managers. The results support the Morningstar view that indexes tracked by passive funds in the Australia mid/small blend category, particularly the S&P/ASX Small Ordinaries, are not as efficient as they are in the other categories.
- ▶ The five-year returns distribution chart (Exhibit 3) shows five passive strategies, with the three bottom performers tracking the S&P/ASX Small Ordinaries Index. The other two passive strategies track indexes with a higher allocation to midcaps, which have performed relatively better. Despite the presence of a distinct underperforming outlier in the active cohort, the average return for active funds is much higher than the average passive fund return.
- ▶ The lower end of the market-cap spectrum carries ample inefficiencies through which active managers can add value over the passive benchmarks. Notably, the gap widens as we look at longer time periods

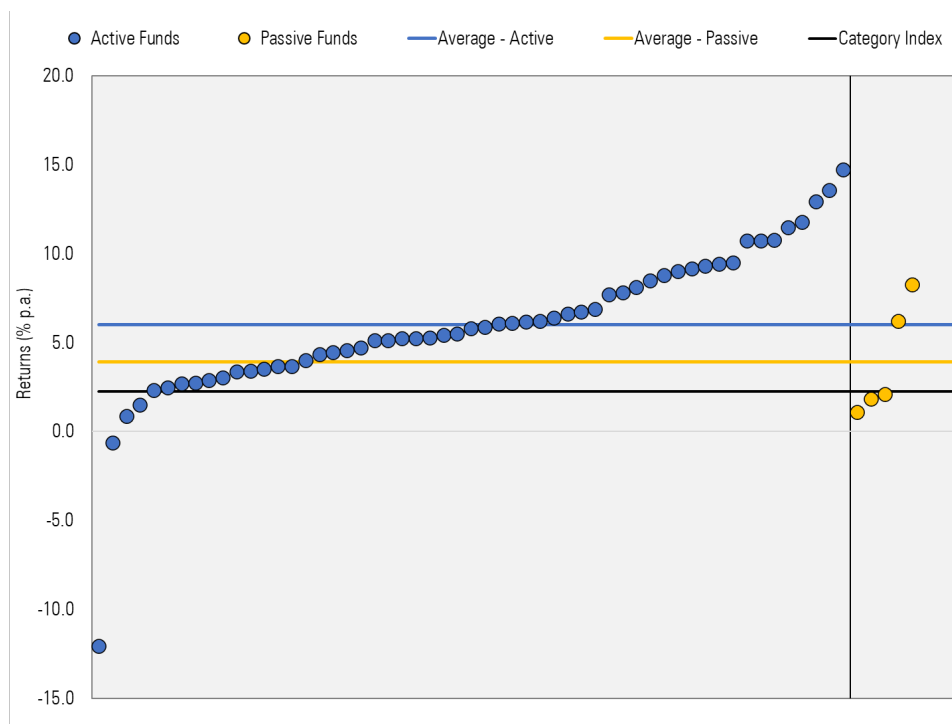
with a rising excess return and success rate for the active funds, standing at a success rate of almost 87% over a 10-year period.

**Exhibit 2** Morningstar Category: Australia Mid/Small Blend

Category	Time Period	Active Funds Average Return (%)	Passive Funds Average Return (%)	Excess Return (%)	Active Funds Success Rate (%)	Active Funds Survivorship (%)
Australia Mid/Small Blend	3Y	8.8	7.5	1.4	63	94
Australia Mid/Small Blend	5Y	6.2	3.9	2.3	73	89
Australia Mid/Small Blend	10Y	10.1	7.2	2.9	87	77

Source: Morningstar Direct. Data as of June 30, 2023. Returns have been annualized for periods exceeding one year.

**Exhibit 3** Five-Year Returns Distribution for Australia Mid/Small Blend Category (in Ascending Order of Returns)



Source: Morningstar Direct. Data as of June 30, 2023. Category Index: S&P/ASX Small Ordinaries Index.

**World Large Blend**

- ▶ The world large blend category illustrates the advantage of passive funds. The level of outperformance of the passive funds may vary depending on the time period and the prevailing market conditions. However, most active managers struggle to make up for the difference in fees compared with the passive funds.
- ▶ The world large blend opportunity set is dominated by U.S. equity exposure which forms around 70% of the category index (MSCI World ex Australia Index). The U.S. equity market is highly efficient and liquid, which makes it an uphill task for active managers to add value on a consistent basis.



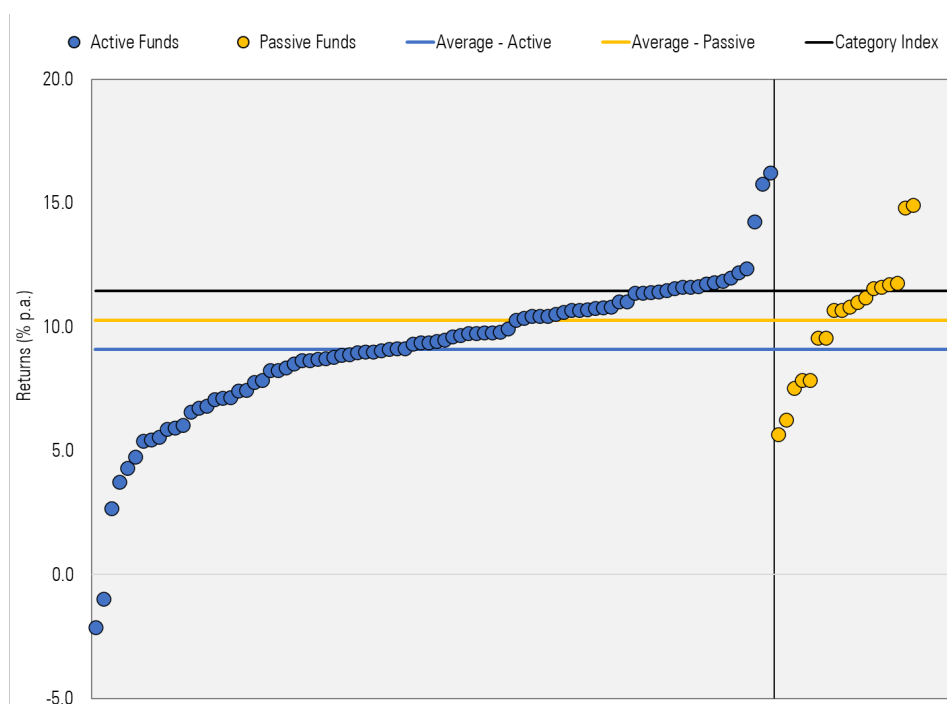
- In the five-year returns distribution chart (Exhibit 5), the top performing funds had a substantially higher allocation in U.S. equities compared with the bottom performing funds over this period. This rings true for both active and passive strategies, pointing to the importance of understanding the country weighting for both active and passive funds given the significant performance of the U.S. market in recent years. The success rate of active funds has increased as the time period extends, standing at just under 44% over the 10-year period.

**Exhibit 4** Morningstar Category: World Large Blend

Category	Time Period	Active Funds Average Return (%)	Passive Funds Average Return (%)	Excess Return (%)	Active Funds Success Rate (%)	Active Funds Survivorship (%)
World Large Blend	3Y	11.1	13.2	-2.0	29	85
World Large Blend	5Y	8.9	10.4	-1.5	36	81
World Large Blend	10Y	11.6	12.0	-0.4	44	78

Source: Morningstar Direct. Data as of June 30, 2023. Returns have been annualized for periods exceeding one year.

**Exhibit 5** Five-Year Returns Distribution for World Large Blend Category (in Ascending Order of Returns)



Source: Morningstar Direct. Data as of June 30, 2023. Category Index: MSCI World ex Australia Index

## Australia Large Blend

- ▶ The Australia large blend category is one of the largest categories in terms of sample size. Over the three-year and 10-year trailing periods, active funds have performed slightly better than the passive peers on average. On the other hand, passive funds fared better than active funds over the trailing five-year period.
- ▶ Active managers can claim an edge in the Australia equity market, but the inconsistency in delivering excess returns and the relatively fine margins make it difficult to draw a solid conclusion.

### Exhibit 6 Morningstar Category: Australia Large Blend

Category	Time Period	Active Funds Average Return (%)	Passive Funds Average Return (%)	Excess Return (%)	Active Funds Success Rate (%)	Active Funds Survivorship (%)
Australia Large Blend	3Y	10.9	10.6	0.3	64	86
Australia Large Blend	5Y	6.1	6.6	-0.5	44	82
Australia Large Blend	10Y	8.1	7.9	0.2	55	78

Source: Morningstar Direct. Data as of June 30, 2023. Returns have been annualized for periods exceeding one year.

## Australia Large Value

- ▶ The Australia large value category is an unusual one as there is no standard, passively investable "value" index. The passive funds in this segment are all dividend-focused funds which, by virtue of their methodology and the resulting stock selection universe, fall under the value style. However, the passive strategies have a limited opportunity set since a sizable chunk of the value stock universe gets screened out on account of the index-specific dividend-yield criteria.
- ▶ Given that the active strategies in the category have greater flexibility and a wider stock selection universe than their passive counterparts, it is not too surprising that they demonstrate superior performance and a consistently high success rate.

### Exhibit 7 Morningstar Category: Australia Large Value

Category	Time Period	Active Funds Average Return (%)	Passive Funds Average Return (%)	Excess Return (%)	Active Funds Success Rate (%)	Active Funds Survivorship (%)
Australia Large Value	3Y	12.5	10.8	1.6	87	81
Australia Large Value	5Y	6.1	5.3	0.8	74	82
Australia Large Value	10Y	7.5	5.8	1.7	100	80

Source: Morningstar Direct. Data as of June 30, 2023. Returns have been annualized for periods exceeding one year.

## Australia Real Estate

- ▶ The internal dispersion of returns within the Australia real estate category is quite low. This is a result of a narrow, concentrated stock universe combined with most active managers tending to not stray too far from the benchmark weights of popular indexes.

- ▶ As a result, active managers on average tend to underperform the passive funds over longer periods, unable to compensate for their higher management fees.

#### Exhibit 8 Morningstar Category: Australia Real Estate

Category	Time Period	Active Funds Average Return (%)	Passive Funds Average Return (%)	Excess Return (%)	Active Funds Success Rate (%)	Active Funds Survivorship (%)
Australia Real Estate	3Y	7.7	7.8	-0.1	57	88
Australia Real Estate	5Y	2.4	3.3	-0.9	43	88
Australia Real Estate	10Y	7.0	7.3	-0.3	44	87

Source: Morningstar Direct. Data as of June 30, 2023. Returns have been annualized for periods exceeding one year.

#### Bonds—Australia

- ▶ Similar to the global bonds category, the passive funds in bonds—Australia are characterized by longer duration sovereign issuances compared to the active peers. As such, the recent interest-rate regime has been unfavourable for passive funds, weighing heavily, in the three-year figures, but the contest is borderline over the five-year and 10-year trailing periods.

#### Exhibit 9 Morningstar Category: Bonds—Australia

Category	Time Period	Active Funds Average Return (%)	Passive Funds Average Return (%)	Excess Return (%)	Active Funds Success Rate (%)	Active Funds Survivorship (%)
Bonds - Australia	3Y	-2.6	-3.7	1.1	74	91
Bonds - Australia	5Y	0.5	0.3	0.1	54	91
Bonds - Australia	10Y	2.1	2.2	-0.1	52	89

Source: Morningstar Direct. Data as of June 30, 2023. Returns have been annualized for periods exceeding one year.

#### Emerging Markets

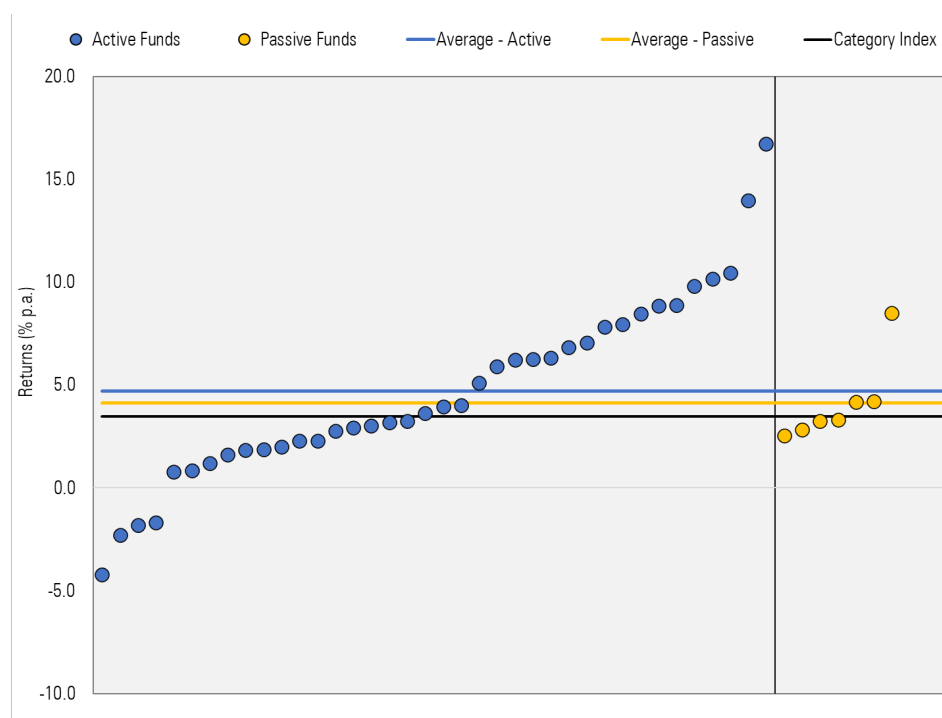
- ▶ The emerging markets category acts as a good example to demonstrate the non-uniformity in the distribution of returns. Over the three- and five-year periods, the average return for active funds is significantly higher than the return offered by the average passive fund. Yet, the success rate for active funds is observed to be below 50%, which is counterintuitive.
- ▶ The skew in the two metrics highlights the importance of good fund selection, particularly within a category with a large internal dispersion of returns. The three-year returns distribution chart (Exhibit 11) below illustrates this skew. Even though only 17 of the surviving 38 active funds outperformed the passive composite, outsized returns from a couple of the funds elevated the average active return considerably.

#### Exhibit 10 Morningstar Category: Emerging Markets

Category	Time Period	Active Funds Average Return (%)	Passive Funds Average Return (%)	Excess Return (%)	Active Funds Success Rate (%)	Active Funds Survivorship (%)
Emerging Markets	3Y	4.8	4.1	0.7	45	88
Emerging Markets	5Y	3.8	3.1	0.7	50	82
Emerging Markets	10Y	5.7	6.0	-0.4	38	88

Source: Morningstar Direct. Data as of June 30, 2023. Returns have been annualized for periods exceeding one year.

**Exhibit 11** Three-Year Returns Distribution for Emerging Markets Category (in Ascending Order of Returns)



Source: Morningstar Direct. Data as of June 30, 2023. Category Index: MSCI Emerging Markets Index

**Global Real Estate**

- Currency returns play a key role in the global real estate category. For instance, measured in Australian dollar terms, the unhedged version of the Morningstar category index (FTSE EPRA Nareit Developed) outperformed the currency-hedged version by 2.5% to 3% on an annualized basis across the three-year, five-year, and 10-year trailing periods. However, we do not have a separate category for currency-hedged global real estate funds owing to constraints on the minimum number of funds to form a meaningful grouping. As a result, a mix of currency-hedged and unhedged strategies in the same category dilutes the currency effect when looking at the aggregate numbers.
- The relative performance of active funds compared to the passive funds in the category has been quite volatile and skewed. Thus, there is no clear pattern to the efficacy of active fund performance in the category, once again emphasizing the importance of selecting funds carefully. ■■

**Exhibit 12** Morningstar Category: Global Real Estate

Category	Time Period	Active Funds Average Return (%)	Passive Funds Average Return (%)	Excess Return (%)	Active Funds Success Rate (%)	Active Funds Survivorship (%)
Global Real Estate	3Y	3.8	3.5	0.3	36	89
Global Real Estate	5Y	1.0	0.5	0.5	60	88
Global Real Estate	10Y	4.6	4.8	-0.2	19	78

Source: Morningstar Direct. Data as of June 30, 2023. Returns have been annualized for periods exceeding one year.



## Glossary

### Equal-Weighted Returns

To calculate the return figure for strategies with multiple share classes, we take the simple average of the monthly returns for each share class in the group and compound those returns over the same period. When a fund becomes obsolete, its historical data remains in the sample. Funds that incept or are moved into the category after the start of the period are not included. The currency for the return calculations is the Australian dollar.

### Excess Return

The excess return is the difference between the average return of an active fund over the average return for a passive fund in a particular category over the specified period. This figure includes returns for strategies which may have merged or may have become obsolete after the start of the calculation period.

A positive (negative) number indicates that an investment divided equally across the active funds in a particular category outperformed (or underperformed) an equal investment divided equally across the comparable passive funds.

### Success Rate

The success rate indicates what percentage of funds that started the sample period went on to survive and generate a return in excess of the equal-weighted average passive fund return over the period. This approach differs from the convention of using a single representative index to gauge success. We do not consider magnitude of outperformance in defining success—a fund that just barely beat the benchmark alternative counts as much as a fund that significantly outperformed.

The success rate is the likelihood of a randomly selected active fund outperformed the comparable passive composite. For instance, a figure of 50% implies that an investor would have had an equal chance of out- or underperforming the average passive fund performance had they arbitrarily selected any active fund which survived through the particular timespan. This metric should be viewed in conjunction with the survivorship rate of the active funds within the category.

### Survivorship

To calculate survivorship, we divide the number of distinct funds (based on unique Fund ID at the beginning of the period) that started and ended up the period in question by the total number of funds that existed at the onset of the period in question (the beginning of the trailing one-, three-, five-, and 10-year periods).

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