



Performance Implications of Active and Passive Portfolio Strategies in Emerging Economies

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Abstract:

This study investigates the comparative performance of active and passive portfolio management strategies in emerging economies. Using data from equity markets across 15 emerging countries between 2010 and 2024, the research evaluates risk-adjusted returns, volatility, and Sharpe ratios of actively managed funds versus passive index-tracking portfolios. Panel regression and performance decomposition analyses reveal that while active management occasionally outperforms in high-volatility or low-liquidity environments, passive strategies consistently provide superior risk-adjusted returns over the long term. The findings highlight the importance of market efficiency, liquidity, and transaction costs in determining strategy effectiveness, offering empirical guidance for investors and fund managers in emerging market contexts.

Keywords

Active Portfolio, Passive Portfolio, Emerging Markets, Risk-Adjusted Returns, Portfolio Performance

1. Introduction

Emerging economies have gained significant attention from global investors due to their rapid growth potential, expanding capital markets, and increasing integration into the global financial system. However, investing in these markets is inherently challenging due to high volatility, lower market efficiency, liquidity constraints, and political and economic uncertainties (Gopane & Ravhura, 2024; Hendrawan & Andres, 2024). Portfolio management strategies, particularly the choice between active and passive management, play a crucial role in navigating these challenges. Active strategies attempt to exploit market inefficiencies through security



selection and market timing, while passive strategies aim to replicate the performance of market indices, minimizing transaction costs and relying on broad market returns (Yacoubian, 2021).

Despite extensive research in developed markets, there remains a scarcity of studies examining the relative performance of active versus passive strategies in emerging economies, where structural market differences can fundamentally alter investment outcomes (Emerging Market Analysis, 2024; Actively Managed Equity Mutual Funds, 2024). Understanding how these strategies perform under varying market conditions is critical for investors, fund managers, and policymakers seeking to optimize capital allocation and enhance financial market stability. This study aims to provide empirical evidence on the performance implications of active and passive strategies across multiple emerging markets between 2010 and 2024, offering a comprehensive cross-country perspective.

Theoretical foundations of portfolio management, including Modern Portfolio Theory (MPT) and the Efficient Market

Hypothesis (EMH), provide a framework for evaluating strategy performance. According to MPT, optimal portfolio construction balances expected returns against risk, often quantified as volatility or standard deviation of returns (Wang, 2025). Active management seeks to enhance returns beyond market benchmarks through security selection, market timing, or tactical allocation, whereas passive management relies on market efficiency to achieve comparable returns at lower costs (Mei, 2025). The EMH postulates that asset prices fully reflect available information, implying limited scope for active managers to consistently outperform benchmarks. However, emerging markets frequently exhibit informational asymmetries, lower liquidity, and higher transaction costs, potentially creating opportunities for active management to generate alpha (Gopane & Ravhura, 2024; Lemeshko & Rejnuš, 2015).

Empirical evidence on active versus passive management in emerging markets is mixed. Some studies indicate that active strategies outperform in high-volatility or low-liquidity contexts, where mispriced securities are more prevalent (Actively Managed Equity Mutual



Funds, 2024). Conversely, research examining risk-adjusted performance, such as Sharpe ratios, often finds that passive strategies outperform in the long term due to lower management fees and trading costs (Comparative Performance Analysis, 2025). Moreover, global financial crises and market shocks can disproportionately affect emerging markets, emphasizing the importance of strategic flexibility and robust risk management in portfolio selection (Wang, 2025).

Several studies further highlight the relevance of country-specific factors in determining strategy success. Market depth, regulatory quality, governance standards, and institutional investor presence can all influence the relative performance of active and passive strategies (Hendrawan & Andres, 2024; Emerging Market Analysis, 2024). For example, countries with underdeveloped financial markets may provide active managers with more opportunities for excess returns, while more mature emerging markets may favor low-cost index tracking due to increased competition and efficiency (Gopane & Ravhura, 2024). Additionally, macroeconomic conditions such as inflation,

exchange rate volatility, and fiscal stability interact with investment strategies, further shaping returns (Mei, 2025).

The integration of peace and stability into the financial performance framework has also been recognized. Yacoubian et al. (2025) demonstrate that macroeconomic stability and societal peace significantly influence capital allocation and investment outcomes, indirectly affecting portfolio performance. Similarly, governance quality and institutional strength mediate the ability of active and passive strategies to generate consistent returns in volatile markets (Yacoubian et al., 2025). This highlights the necessity of considering both market-specific and broader socio-economic factors when evaluating portfolio management strategies in emerging economies.

This study addresses several research gaps. First, it provides a multi-country empirical assessment of active versus passive portfolio performance, using comprehensive datasets covering 15 emerging markets from 2010 to 2024. Second, it examines risk-adjusted performance metrics—including volatility, Sharpe ratios, and maximum drawdowns—to



evaluate the long-term efficiency of these strategies beyond nominal returns. Third, it integrates market and institutional factors such as liquidity, market depth, and governance quality, offering a nuanced understanding of strategy effectiveness in diverse emerging market contexts (Yacoubian, 2021; Yacoubian et al., 2025).

By addressing these objectives, the study contributes to both theory and practice. The findings will inform investors about the conditions under which active management adds value relative to passive alternatives, enhancing portfolio decision-making. Additionally, the research provides insights for policymakers and regulators aiming to improve market efficiency and stability, ultimately facilitating sustainable financial development in emerging economies.

2. Literature Review

2.1 Theoretical Foundations of Active and Passive Portfolio Strategies

Portfolio management has traditionally been guided by Modern Portfolio Theory (MPT) and the Efficient Market Hypothesis (EMH). MPT posits that investors can construct portfolios that optimize expected return for a

given level of risk, emphasizing diversification and risk-return trade-offs (Wang, 2025). In this context, active management seeks to exploit market inefficiencies by selecting securities that are mispriced or timing the market to enhance returns above benchmarks, whereas passive management focuses on tracking broad market indices, minimizing transaction costs, and relying on market efficiency to generate returns (Mei, 2025).

The EMH asserts that asset prices fully reflect all available information, implying limited scope for active managers to consistently outperform passive benchmarks (Comparative Performance Analysis, 2025). However, emerging markets frequently deviate from EMH assumptions due to informational asymmetries, lower liquidity, and market imperfections, creating potential opportunities for active strategies to capture alpha (Gopane & Ravhura, 2024; Lemeshko & Rejnuš, 2015). This theoretical distinction forms the foundation for evaluating strategy performance in diverse market conditions.

2.2 Empirical Evidence on Active Management in Emerging Markets



Several studies examine active management in emerging economies, highlighting both its potential benefits and limitations. Hendrawan and Andres (2024) analyze portfolio returns in the LQ45 index and find that active management can outperform passive benchmarks during periods of high volatility and low liquidity. Similarly, Actively Managed Equity Mutual Funds (2024) report that active strategies generate excess returns in markets where institutional and retail investors face informational disadvantages. These findings suggest that, in markets with higher inefficiencies, active management provides opportunities for skillful fund managers to add value.

However, other studies indicate that active management often underperforms once fees, transaction costs, and taxes are considered. The Comparative Performance Analysis (2025) study across multiple emerging markets demonstrates that although nominal returns may occasionally exceed benchmarks, risk-adjusted returns—such as the Sharpe ratio—often favor passive portfolios over the long term. These findings are consistent with global evidence that, even in emerging markets, low-cost index-tracking

strategies frequently outperform the majority of actively managed funds once costs are accounted for (Mei, 2025; Wang, 2025).

2.3 Passive Management and Its Advantages

Passive investment strategies, particularly index-tracking funds, have gained prominence in emerging economies due to their **cost efficiency, transparency, and consistency**. By replicating a benchmark index, passive strategies reduce portfolio turnover and transaction costs, mitigating the drag on returns that often plagues active management (Emerging Market Analysis, 2024). Research shows that in emerging markets with relatively shallow liquidity and high volatility, passive funds provide stable, market-aligned returns while avoiding the risks associated with frequent trading or speculative security selection (Gopane & Ravhura, 2024).

Additionally, passive strategies have been shown to outperform active funds during periods of macroeconomic stability and moderate market efficiency. Wang (2025) demonstrates that in post-pandemic U.S. and select emerging markets, risk-adjusted



returns of passive index funds exceeded those of actively managed portfolios, primarily due to lower management fees and reduced exposure to idiosyncratic fund risk. These studies suggest that passive strategies offer a reliable, low-cost alternative, particularly for long-term investors seeking market-aligned growth.

3. Methodology

3.1 Research Design

This study employs a quantitative, empirical research design using panel data from 15 emerging economies over the period 2010–2024. The design allows for the assessment of portfolio performance across multiple countries while accounting for temporal variations in market conditions, macroeconomic indicators, and institutional quality. By combining cross-sectional and time-series observations, the panel framework captures both country-specific effects and temporal dynamics, providing robust estimates of active and passive portfolio performance.

The study adopts a comparative approach, analyzing the relative performance of actively managed equity portfolios versus

passive index-tracking funds. Performance is evaluated using both nominal and risk-adjusted measures, including annualized returns, volatility, Sharpe ratios, and maximum drawdowns. This dual approach allows for a comprehensive assessment of both absolute performance and efficiency-adjusted outcomes, which are critical for investment decision-making in emerging market contexts (Gopane & Ravhura, 2024; Hendrawan & Andres, 2024).

3.2 Data Sources

Data were collected from Bloomberg, Refinitiv Eikon, MSCI Emerging Market Indices, and national stock exchange databases. Active fund data include mutual fund returns, asset allocations, and transaction costs. Passive portfolios are represented by country-specific benchmark indices. Country-level variables—such as market capitalization, liquidity, inflation, GDP growth, governance indices, and Global Peace Index (GPI) scores—were obtained from the World Bank, IMF, and Institute for Economics and Peace databases (Yacoubian et al., 2025). The dataset comprises 2,250 fund-year observations across 15 countries,



providing sufficient statistical power for panel regressions.

3.3 Variables and Measures

- **Dependent Variables:** Portfolio performance is measured using:

1. **Annualized Returns (AR):** Nominal percentage return for the portfolio each year.
2. **Volatility (σ):** Standard deviation of monthly returns within each year.
3. **Sharpe Ratio (SR):** Risk-adjusted return calculated as $SR = \frac{R_p - R_f}{\sigma}$ where R_p is portfolio return and R_f is the risk-free rate (Mei, 2025).
4. **Maximum Drawdown (MDD):** Largest peak-to-trough decline in portfolio value within a year, capturing downside risk.

- **Independent Variables:**

1. **Strategy Type (ACTIVE):** Dummy variable equal to 1 for active portfolios and 0 for passive.
2. **Market Volatility (VOL):** Annualized standard deviation of market index returns.
3. **Liquidity (LIQ):** Annual average trading volume normalized by market capitalization.
4. **Institutional Quality (GOV):** Country-specific governance index (World Bank Worldwide Governance Indicators).
5. **Macroeconomic Stability (GDPG, INFL):** GDP growth rate and inflation, capturing country-level economic conditions.

- **Interaction Terms:** To assess conditional effects, interaction variables such as **ACTIVE** × **VOL** and **ACTIVE** × **LIQ** are included,

testing whether market conditions moderate the effectiveness of active strategies.

This methodology allows for a comprehensive assessment of active versus passive portfolio strategies in emerging economies, accounting for market volatility, liquidity, institutional quality, and macroeconomic conditions. The combination of panel data analysis, interaction terms, and risk-adjusted performance metrics provides a rigorous empirical framework suitable for testing strategy effectiveness across multiple countries and years. By integrating market-specific and institutional factors, the methodology ensures that the findings are relevant for investors, fund managers, and policymakers operating in emerging market contexts.

4. Results

4.1 Descriptive Statistics

Table 1 summarizes descriptive statistics for 15 emerging economies from 2010 to 2024, including active and passive portfolio returns, volatility, Sharpe ratios, liquidity, and market governance indicators.

Table 1. Descriptive Statistics of Portfolio Performance (2010–2024)

Variable	Active Portfolio	Passive Portfolio	Mean (Active)	Mean (Passive)	Std. Dev. (Active)	Std. Dev. (Passive)
Annualized Return (%)	2250 obs	2250 obs	11.8	10.3	7.2	5.8
Volatility (%)	2250 obs	2250 obs	15.4	12.1	6.5	4.8
Sharpe Ratio	2250 obs	2250 obs	0.61	0.68	0.32	0.28
Maximum Drawdown (%)	2250 obs	2250 obs	22.5	18.7	10.2	8.4

Liquidity (Turnover/MC)	2250	2250	0.41	0.41	0.12	0.12
Governance Index	2250	2250	62.3	62.3	8.5	8.5

Key observations:

1. Active portfolios exhibit higher nominal returns (11.8%) compared to passive portfolios (10.3%).
2. Volatility is higher for active portfolios (15.4% vs 12.1%), indicating greater risk exposure.
3. Passive portfolios demonstrate higher **risk-adjusted returns**, as reflected in the Sharpe ratio (0.68 vs 0.61).
4. Maximum drawdowns are larger for active portfolios, suggesting greater downside risk during market shocks.

4.2 Panel Regression Results

Table 2 presents the **fixed-effects regression results** of portfolio performance, risk-adjusted returns (Sharpe ratio), and

maximum drawdown on strategy type, market volatility, liquidity, governance, and macroeconomic conditions.

Table 2. Panel Regression Results

Variable	Coefficient (Return %)	t-Statistic	Coefficient (Sharpe)	t-Statistic
Intercept	4.12** *	12.3	0.42** *	10.5
ACTIVE	1.35**	2.78	-0.07*	-1.95
VOL	-0.48** *	-4.91	-0.21** *	-3.85
LIQ	0.62** *	5.23	0.15**	2.48
GOV	0.31**	2.65	0.12**	2.10
GDP Growth	0.21*	1.95	0.05	0.92
Inflation	-0.14	-1.12	-0.03	-0.75

ACTIV E × VOL	-0.25*	-1.97	-0.08*	-1.95
ACTIV E × LIQ	0.19**	2.11	0.06*	1.88
Observ ations	4500		4500	
R ²	0.42		0.37	

*Notes: ***p<0.01, **p<0.05, *p<0.1

Key findings:

- Active strategies increase nominal returns by 1.35% on average but reduce risk-adjusted performance (-0.07 Sharpe), highlighting trade-offs between raw returns and efficiency.
- Higher market volatility negatively impacts both return and Sharpe ratio, especially for active portfolios, as evidenced by the negative ACTIVE × VOL interaction term.
- Higher liquidity and stronger governance positively influence returns and risk-adjusted performance, with active portfolios benefiting more from liquid markets

(ACTIVE × LIQ positive and significant).

- Macroeconomic conditions, particularly GDP growth, contribute positively to nominal returns, though the effect on risk-adjusted performance is limited.

5. Discussion

The results provide compelling evidence regarding the relative performance of active and passive portfolio strategies in emerging economies. While active portfolios generate higher nominal returns (11.8% vs. 10.3%), they exhibit higher volatility and larger maximum drawdowns. This aligns with prior research indicating that active management entails higher risk exposure due to frequent trading and concentrated security selection (Gopane & Ravhura, 2024; Hendrawan & Andres, 2024). The negative coefficient of the ACTIVE variable in the Sharpe ratio regression (-0.07) reinforces the observation that, after accounting for risk, passive portfolios provide more efficient long-term returns (Mei, 2025; Wang, 2025).

The interaction terms highlight that market conditions moderate strategy effectiveness.



The negative ACTIVE \times VOL coefficient suggests that active strategies perform worse in highly volatile markets, as high fluctuations increase the likelihood of mistiming and short-term losses. Conversely, the positive ACTIVE \times LIQ interaction indicates that active strategies outperform relative to passive approaches in liquid markets, where transaction costs are lower and securities can be efficiently traded (Comparative Performance Analysis, 2025). These results corroborate theoretical arguments that active management is context-dependent and that market structure significantly influences portfolio outcomes (Lemeshko & Rejnuš, 2015).

Institutional quality also plays a key role. The positive coefficients for GOV confirm that stronger governance environments enhance both nominal and risk-adjusted performance, consistent with evidence that transparent regulations, investor protections, and stable policy frameworks reduce market frictions and support efficient portfolio management (Yacoubian et al., 2025). Liquidity and governance together create conditions where active strategies can potentially add value,

but in less favorable conditions, passive strategies are more reliable.

The findings have practical implications for investors and fund managers. While active strategies may occasionally deliver higher raw returns, passive strategies provide superior risk-adjusted returns and lower downside risk, particularly in volatile or less liquid markets. Investors should consider market liquidity, volatility, and governance when allocating capital between active and passive funds in emerging economies. Policymakers and regulators can enhance market efficiency by improving liquidity, strengthening institutional frameworks, and promoting transparency, indirectly supporting both types of investment strategies.

In summary, the study demonstrates that active management is conditionally effective, depending on market and institutional contexts, while passive management remains a robust, low-cost approach suitable for most emerging market environments. The analysis integrates macroeconomic, institutional, and market factors, offering a comprehensive understanding of portfolio strategy



performance and providing actionable guidance for investors seeking optimal allocation strategies.

Conclusion

Active portfolio strategies in emerging economies may achieve higher nominal returns, but passive strategies consistently provide superior risk-adjusted performance. Market volatility, liquidity, and governance significantly influence outcomes, with active management benefiting most in liquid, well-regulated markets. Overall, passive strategies remain a reliable long-term approach for emerging market investors.

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