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A COMPARATIVE STUDY OF INDEX FUNDS VS. ACTIVELY MANAGED FUNDS: POST-SEBI CATEGORIZATION ERA

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ABSTRACT

The 2017 SEBI mutual fund categorization and rationalization framework brought about a paradigm shift in the Indian fund management industry, and now the models need to be reshaped and investment strategies need to be revamped by investors. In this new landscape, this paper will study the dynamic performances of Index Funds and Actively Managed Funds. After referring to empirical research, market research, and theoretical research, we will study the performances in terms of risk-adjusted return, expense ratio, portfolio concentration ratio, and behavioral aspects in Index Funds and Actively Managed Funds. The result reveals that though Actively Managed Funds still hold more assets than Index Funds, yet in alpha generation, Actively Managed Funds have become increasingly struggling in the market in the large-cap segment due to stricter market regulations, and Index Funds have increased in growth rate but still persist in variable market cycles in terms of the structure of the respective indices. In this background, the final section of the paper will discuss how advances in technology due to Artificial Intelligence and Machine Learning will impact fund management models and research methodologies. The implication here indicates that the next decade will be very significant in fund management research because Actively Managed Fund models will find it difficult in terms of proximity with traditional models and generalization about superiority over Actively Managed Funds will be premature.

KEYWORDS: index funds, actively managed funds, SEBI classification, expense ratios, alpha generation, passive investment, performance of mutual funds.

INTRODUCTION

When the SEBI laid down the framework for categorizing mutual funds in October 2017, it is a surprise to state the extent to which it would go in altering the investment plans in the Indian capital markets. It made it clear that no more than one scheme in each category would be allowed in a single fund house, thus doing away with overlapping products. This is not merely a matter of housekeeping but reflects a different philosophy altogether.

The timing is especially fascinating. Globally, trends were already in favor of passive investment approaches, with index funds having gained an unprecedented share in developed markets. Yet, in India, the number of retail investors had been growing steadily, thanks to technology-enabled investment options. Here lay a mix that could perhaps be termed a "natural experiment" in the world of markets—whether actively managed funds could continue to lead if compelled to operate on an equal playing field?

This is an important question, as the active vs. passive management debate reaches beyond the way in which investment portfolios are constructed and intersects with issues of market efficiency, the processes of price discovery, and the general environment of financial intermediation. Market inefficiencies may be a challenge to the viability of active management as a viable and worthwhile investment alternative, given that, in an efficient market, the active manager's edge would effectively be a value-added expense. On the other hand, the presence of inefficiencies and information imbalances in markets has historically provided the skilled active manager with opportunities to produce alpha.

Literature Review and Theoretical Framework

Literature reviews

The Efficient Market Hypothesis has, for many years, formed the rationale for passive fund advocates. If stock prices reflect all outstanding information, stock picking becomes inconsequential – effectively, invest in the market portfolio for the lowest fees possible. This neat construct meets the unpleasant reality of emerging markets such as India, where information disparities are still significant, coupled with retail shifts that occasion temporary mispricings.

Many studies focusing on analysing the performance of mutual funds have reached remarkably divergent results based on location, horizon, and approach used. While some show that some managers have been consistent in outperforming others, indicating skills that are still quite rare in this area, some show that after adjusting for expenses, survivorship bias, and risk-adjustments, active management as a whole has underperformed its respective indexes consistently. This divergence has been mainly due to differences in the methodology used by researchers in adjusting for risk.

Talking specifically about India, there are various aspects that make the debate on actives and passives more complex compared to its Western counterpart. Market microstructure is quite different, with bigger impact costs and bid-ask spreads for the medium and small-cap market. The quality of corporate governance is more polarized for listed stocks, possibly identifying stocks deserving of research on a fundamental basis. Taxation was always more advantageous for equity mutual funds compared to equity investment, dictated by professional management.

In a related study, strategic management practice and their impact on organizational performance in Rajasthan-based companies were analyzed by Chaplot (2018). The importance of adaptability and efficient allocation of resources in determining organizational performance could be considered relevant in the context of fund management, where strategic decisions related to being active and passive in fund management have assumed importance. The question that firms need to answer is the basis of differentiation, costing, or expertise in asset management.

The manner in which the tourism and hotel industry reacts to economic downturns, as outlined in a study by Choudhary and Madhwani in 2013, provides a fascinating analogy. The authors demonstrated that in periods of recession, money generation becomes constrained and needs to be repositioned. Managed funds also go through similar cycles when there are market upswings where index funds are as effective in their returns as are the actively managed funds.

The implications of tax policies in financial practices cannot be overlooked either. Mehta's thoughts on tax revenue structure explain how various components impact stability. Applying this concept to fund management, it can thus be hypothesized that hybrid models combining managerial fees with performance-related compensation may provide better staying power to asset managers straddling either side of the Active-Passive spectrum.

Mehta and Hiran (2023) studied the area of change management in medium-scale enterprises, highlighting the point that in any kind of change within an organization, the need is for systematic intervention and not reactions to the changes based on intuitions and impulses. Essentially, the change management in the mutual fund sector due to the intervention of SEBI can be said to be a forced change management process where the need has been to align the product offerings and the sales force functions. Those surviving in the changed arena with better performance are likely the actively-passively classified companies.

Technology Disruption in Fund Management

One area that might release as much promised change in the active vs. passive argument as AI/Mach Learn in the analysis of finance is the intersection of AI and ML in financial analysis. Research by Abid and Ramswaroop Bhambi in 2025 investigated the effects of AI on the accounting function and found the impact on the accuracy of financial reporting is that computerized models are closing the gap and in some instances rivaling human capability on pattern recognition and anomaly detection. For actively managed mutual funds, this is both an opportunity and a threat.

The implications are not merely at the portfolio selection stage. There are also AI applications for portfolio rebalancing, risk, and regulatory compliance. A descriptive analysis was provided by Dr. Mohammed Abid and Harsha Lohar in a work from 2025, showing how blockchain, ML, and cloud computing are revolutionizing financial data systems. The distinction between "active" and "passive" investing becomes obviated, as all decisions are made through an algorithm based on learned patterns, as fund managers are provided these technologies.

This technological progress may go some way to explain why index funds have proved so successful, even in a market where India is notorious for its inefficiencies. Sufficiently good quantitative models now exist that are able to spot inefficiencies just as well as a research analyst, and at a significantly reduced price, so that there is little economic point to costly active management. Of course, technology is not an infallible panacea—garbage in, garbage out is an ironclad principle of computer science.

The Post-Categorization Performance Evidence

Taking a closer look at performance data available from 2017 shows that things are not as black and white as "passive wins" or "active outperforms" stories. Large-cap equity schemes, where SEBI mandates a minimum of 80% investment in the largest 100 firms by market capitalization, have found it extremely tricky to produce alpha. Since everyone is fishing from the same pool, it is quite tough to swim to different shores. Thus, index schemes in this space have fared quite well compared to active schemes after adjusting for fees.

Mid-cap and Small-cap funds are a different story. Here, the investment universe is still wider, information disparities are present, but the role of a manager’s talent is relatively important. There are several actively managed investment funds that have generated strong excess returns; however, picking these investment managers ex ante in practice is hard for retail investors. The difference in expense ratios is less material if the absolute difference in returns runs into several percentage points per year.

"The sector and thematic funds find themselves in an interesting sweet spot. These are not index funds, but they lack the diversified focus to allow their managers to make enough decisions to be actively managed. The managers of these sector-themed technology funds appeared brilliant during the COVID-19 acceleration phase and not so brilliant in the normalization phase."

The aspect that has not received sufficient attention is related to error tracking. “In fact, many so-called actively managed investment portfolios were, prior to being sorted, closet indexers, meaning they followed their respective benchmark indexes very closely while levying fees associated with active investment management. This was minimized with this new system, where there is, ironically, a greater risk of increased tracking error, which may result in apparent subpar performance during market rallies, despite superior investment decisions over an entire market cycle if such decisions involve stocks that ultimately contribute to investment success.”

Investor Behavior and Product Selection

The money flows from retail investors show interesting patterns. For instance, despite an increasing amount of evidence that leans towards cost-efficient indexing in some areas, actively managed funds remain to attract most new money. This could be due to several issues: sophisticated distribution channels working in favor of products with high commissions, recency perspective from focusing on recent successes, financial illiteracy regarding expense ratio differences, or even well-founded concerns regarding passive management in an infant market environment.

Note that the same investors for whom index funds may provide optimal “U.S. equity market coverage” prefer actively managed portfolios for India. It is true that the distinction based on geography may stem from considered views on differing efficiencies in markets. It may also represent Zimmermann's observation that trends in the asset management industry “are usually spread over a few decades.” Another factor that disturbs the simplified world presented in the article is the existence of exchange-traded funds. These funds provide investment opportunities that are not actively managed in the same way that mutual funds are but that involve intraday tradability.

From a behavioral finance standpoint, the benefits offered by actively managed funds are more than those derived by index funds, which offer nothing but returns. They provide the benefit of control, comfort, explanations for market actions, and the sense that investors are actors, not passengers, while index investors have to accept the return of the market with no explanations for what happened, as everything goes up or down mechanically.

Evolution of Regulatory Agencies and Market Structure

The framework of Categorization by SEBI did not take place in a vacuum. This was accompanied by other regulatory measures such as stricter disclosure norms, risk labeling, and limits on the commissions paid to distributors in direct plans. All these measures combined improved transparency but unleashed even more pricing competition, which is exactly the environment in which passive investment approaches are supposed to excel.

Going forward, a likely noteworthy development in regulations is ongoing evolution. The proposed additional cuts in expense ratios will squeeze profitability in active management. The increased need for detailed performance attribution could be better at determining whether they create value-addition ability or are simple price takers. The debates in regulations about social and environmental issues could make indexing complicated, as passive-active definitions may not be clear.

Market structure is also important here. With the rise of index funds, questions have arisen over their impact on price discovery and corporate governance around the world. Who is going to conduct research to make markets efficient if everybody is indexing? The paradox of passive investing would depend on active price-setters but reduce their viability has not caused problems in India yet because of the continued domination of active management.

Limitations and Future Research Directions

There are several challenges which make it difficult for any assessment of this decade be conducted. A seven-year time series is too short a period for adequate assessment of performance through a full market cycle, especially when that cycle contains an event as uniquely volatile as that introduced by the COVID-19 pandemic. There are also issues of survivorship bias, as poorer-performing mutual funds are merged or shut down. The appropriate attribution model for fund manager skill vs. lucky asset allocation requires complex mathematical models that contain a number of assumptions.

Future studies can focus on testing the impact of machine learning integration on the active-passive performance gap, determine to what degree regulatory standardization initiatives have positively impacted investors, as well as exploring how changes to tax policies influence mutual fund choice. A more behavioral approach could be taken by looking at individual portfolio holdings as opposed to mutual fund performance to achieve more informed findings. A comparison between other evolving markets following similar regulatory policies could help separate country-specific impact from overall global trends.

CONCLUSION

Nor has the post-sebi-came-an-angle kind of 'SEBI classification era' solved the active-passive funds debate in a decisive manner so much as it has helped focus the terms of engagement in the debate. Now, in the most efficient market segments, such as the large-cap market in India, the value-for-money factor in the form of indexed schemes poses challenges that normal active fund managers find tough to surpass. Similarly, in the so-called mid and small-cap market segments in countries like India where the market efficiency levels are relatively lower due to lack of efficiency on the sell side in many

It does appear, however, that the via mediis, expensive active Investment Funds that actively follow the market, has become impracticable. There appears to be an important choice to make, one that was not previously an issue in this manner: pay top-dollar premiums to truly unique active Investment Fund advice, or opt to follow passive Investment Funds. The beauty of the current UMR lies in this choice.

Perhaps the most profound takeaway, however, is that investment in funds means aligning strategies with markets, investors, and financial objectives, not merely in favor of active or passive investment. With the ongoing influence of technology in the processing of information, it is also likely that the classifications of 'active' versus 'passive' investment will itself require a paradigm shift. There is, of course, the continuation of the imperative for discerning investors to get beyond the categorization.

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