

The Impact of Passive Investment Growth on the Traditional U.S. Active Fund Management Model: A PEGTF-Based Strategic Response to Increasing Competitive Pressure

Ola Popoola Fcca

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Abstract: The research has critically examined the ways the growth of passive investments can impact the conventional active fund management activities in the US. The study utilised the concepts of secondary qualitative evidence and Resource-based View (RBV) framework to identify the factors driving competitive pressure and opportunities related to strategic adaptation. The research proposed PEGTF framework by the integration of innovation, transformation of business models, governance, alignment of investors and outcomes related to competitive performance.

Keywords: *Passive Investment, Active Fund Management, Competitive Pressure, Strategic Adaptation, Resource-based View, PEGTF.*

I Introduction

Background

The fund management industry in the US has experienced major structural shifts because investors have reshaped their investments towards passive investment products that are low cost. For instance, the index fund mutual funds and exchange-traded funds (ETFs) in the US possessed around \$10.9 trillion, reflecting 46% of the fund assets that are long-term compared to 2012's 22% [1]. Despite the fact that funds that are actively managed still represent 54%, the major shift towards passive investment has increased the degree of competitive pressure on the conventional active fund managers. Cost-centric competition has maximised the competitive pressure in the US active fund management organisations that has resulted in their performance as well. For example, the asset-weighted fund fees fell to 0.37% in 2022 from 0.40% in 2021 to target a savings of around \$9.8 billion for fund investors [2]. Meanwhile, the average fee for

handling active funds stayed significantly higher (0.59%) compared to passive funds (0.12%). In addition, despite the downturn of both stock and bond markets, investors put around \$609 billion of new money into ETFs in 2022 that has depicted the interest of investors to invest in passive income funds [3]. Considering this background, the present research is looking forward to assessing the ways the growth of passive investment impacts the conventional active fund management models in the US. Additionally, it tends to critically evaluate the strategic responses to maximised competitive pressure. The research integrates the Private Equity Growth Transformation Framework (PEGTF) to assess innovation in investment, transformation of business model, alignment of governance and competitive outcomes.

A Freelance Finance Consultant, UK

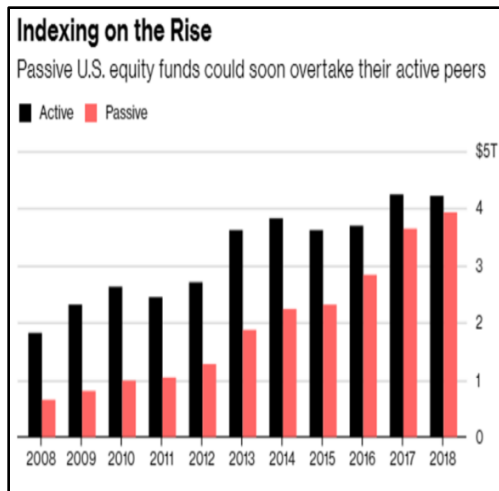


Figure 1: Comparison of Active and Passive Funds in the US

Aim

The aim of this research is to assess the impact of passive growth of investment on the conventional US active fund management models and establish a PEGTF-based strategic response to encounter maximised competitive pressure.

Objectives

- To examine passive investment growth and the implications of passive investment increase for the active conventional fund managers in the US
- To scrutinise competitive pressure that resulted from the growth of passive investment on the active fund management models.
- To evaluate the strategic responses consisting of transformation, governance, innovation and alignment of investment in actively managed funds.
- To establish a specific framework (PEGTF) to provide strategic responses to promote sustainable competitiveness within the conventional active fund managers in the US.

Questions

In what ways traditional fund managers in the US can provide strategic responses to the competitive pressure emerging from the growth of passive investment?

Problem Statement

The fund management industry in the US is presently facing significant competitive pressure due to the extensive growth of passive investments. For

instance, the ETFs in the US received around \$935 billion of new money that boosted the total ETF assets to \$7.2 trillion [4]. In addition, the intensified cost-centric competition is presenting strategic challenges for conventional active fund managers. Hence, the current investigation is looking to identify the ways active fund managers can provide strategic responses to increasing competitive pressure in the US fund management industry.

II Literature Review

Growth of Passive Investment and the Transformation of US Fund Management

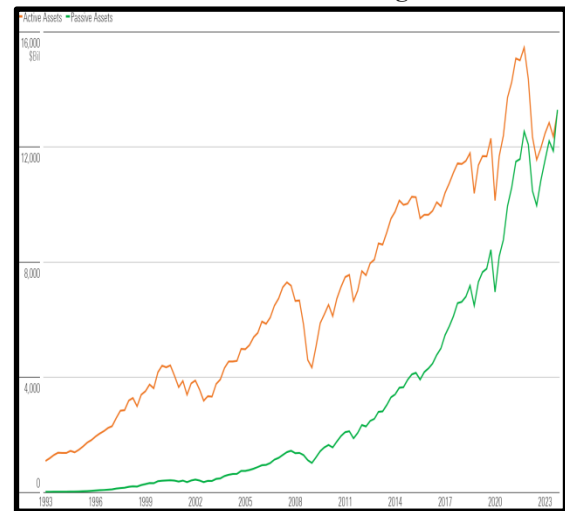


Figure 2: Growth of Active Funds vs Passive Funds

The transformation from active investing to passive investing can maximise the concentration of the fund management industry. It has been found that passive investing with the assistance of financial-stability risks can increase industry concentration and decrease the risks of liquidity at the same time [5]. On the other hand, the implications of security markets can help in pointing out the correlation on increased return, decreased security-centric information and dynamic fund-flows [6]. The research [5] presented stronger analysis regarding risk empirically and [6] offered wider market-level interpretation to support the assessment of competitive pressure on active managers.

Competitive Pressures on the Traditional Active Fund Management Models

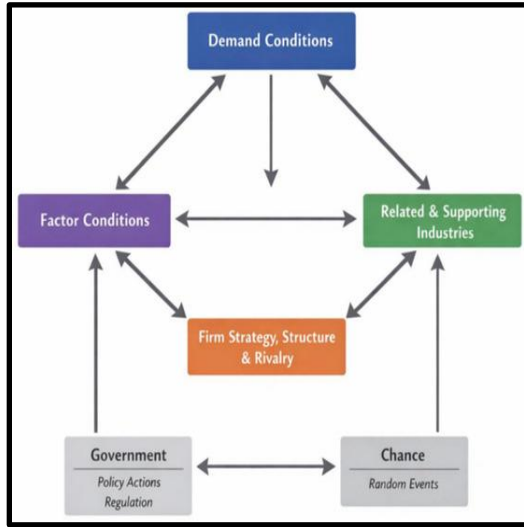


Figure 3: Competitiveness Framework

Competitive pressures on conventional active fund managers can be impacted by competition, concentration of ownership and governance. According to previous research, passive investors have the ability to transform governance and competition while challenging traditional concepts about funds that are passive [7]. On the other hand, entry in index-fund has the direct capability to impact the strategies of managers and decrease their growth while resulting in dynamic fee responses within their distribution channels [8]. The research study [7] elaborated on the structural mechanisms of fund management models compared to [8] that has highlighted the competitive impacts to maintain a strong base for the assessment of active managers' strategic adaptation to deal with competitiveness.

Strategic Adaptation of Active Fund Managers through Innovation and Business-model Transformation

The utilisation of game-theory can be effective towards supporting active fund managers in the adaptation of strategies to overcome market constraints, stressing strategic interaction, risk-aware decision-making and flexibility. For instance, it has been discovered previously that game theory is capable of innovating the ways managers adapt to different fund management models [9]. On the other hand, emphasising on flexible investment-fund architectures that are designed for technological SMEs to highlight the significance of adaptability and structural innovation [10]. Both of the studies

have focused on flexibility as a key response to the dynamic fund management climate, where [9] has prioritised strategic portfolio adaptation and [10] stressed on the innovation of fund-architecture.

Governance, Investor Alignment and Sustainable Competitive Advantage

Effective governance and investor alignment in the process of fund management activities can help in the achievement of competitive advantages for organisations. Previous studies have assessed the structural and governance mechanisms of venture capital organisations [11]. It identified the differences between the governance mechanisms of traditional organisations and venture-capital organisations. On the other hand, [12] critically assessed the 60 high net-worth investors and highlighted that impact-centric investors seek both high financial returns and sustainability outcomes. [11] highly stressed on investor allocation and governance incentives and [12] has emphasised on impact investing instead of active fund management.

Theoretical underpinnings

The research seeks to utilise the Resource-based View (RBV) theory that can be effective towards explaining the ways unique investment expertise, organisational and technological resources can promote differentiation. The integration of the RBV framework can assist firms to achieve sustained competitive advantages by the development of valuable, rare, inimitable and non-substitutable resources [13]. Considering the perspective of active fund management, the resources may include expertise in investment, portfolio managers who are experienced, technology infrastructure, and strong relationships with investors. Passive investment products generally compete with the assistance of low costs and high scales that maximises the significance of unique resources that drive active managers to present values that are differentiated. The concepts of RBV can enable active fund managers to provide strategic responses related to the growth of passive investment. Overall, the utilisation of RBV's concepts can enhance the PEGTF focus on business model transformation, innovation, governance and outcomes related to competitive performance.

Literature gap

The existing literature has provided key evidence related to the growth of passive investments and its

possible influence on fund fees, financial markets, governance and market competition. For instance, it has been identified that index-fund entry strategies can impact managers' adaptability and reduce the growth of active funds [8]. Yet, the literature stays fragmented towards identifying the ways conventional US active fund managers can transform their resources and capabilities in systemic manners to respond to high competitive pressure. In addition, there is limited research that connects innovation, business model transformation, sustainable competitive outcomes and investor alignment with the growth of passive investments in a single framework. There is also limitedness in the utilisation of RBV's concepts to address the specific competitive pressure in the fund management industry. Hence, the current research seeks to address this research gap by the application of RBV's concepts via PEGTF framework to present a strategic response that is structured from the viewpoint of US active fund managers.

III Research Methodology

Research philosophy and approach

The interpretivism research philosophy has been used for the assessment of subjective interpretations of passive investment of growth on the US active fund management model by referring to PEGTF based strategic responses. Interpretivism philosophy directs detailed assessment of factors and variables in subjective notion referring to the context [14]. The mentioned philosophy assists in exploring the context of response to manage competitive pressure encountered by managers in regard to active fund management. On another note, an inductive approach is used for assessing information from secondary sources and further moving towards broad generalisation. Inductive approach directs in generating theoretical context from the specific context of investigation [15]. Mentioned philosophy and approach ensure in obtaining comprehensive information gathering regarding active fund management context.

Data collection and Research design

Secondary qualitative data collection method used for gathering pertinent data from secondary sources. Secondary data refers to information that has been gathered previously for different purposes and

includes sources such as journals and other existing sources [16]. The adherence to the secondary data collection directs in reliance on exploratory research design. Exploratory design intends to find out "what is happening" further seeking new information for answering questions in a new light [17]. The secondary sources from journals are collected in this research for comprehensive insight generation on subject matter.

Data analysis

Thematic analysis technique is further used for assessing the secondary information by considering patterns in reference to objectives of the research. Thematic analysis includes assessment of qualitative information through identification and further reporting of patterns for derivation of relevant interpretations [18]. Thematic analysis directs in exploring competitive pressure in regard to passive investment growth in active models of fund management. The analysis directs in generating detailed and key findings related to the context of the research in regard to fund management.

IV Findings And Discussion

Findings

Growth of Passive Investment and Its Impact on Traditional Active Fund Management

The results show that passive investing has swelled rapidly across the fund management industry in the US due to reduced expense ratios, the diversification appeal of market tracking products and investor demand. The expansion of passive investment has put the traditional active managers on the defensive as they become less attractive relative to investors looking for the lowest cost and market exposure [19]. The literature also suggested that passive investment has a significant impact on asset flows, market concentration and investment activities. This puts more pressure on active managers to show unique value in terms of investment expertise, unique strategy and superior investor results.

Competitive Pressure Created by Passive Investment Growth

The findings highlighted some of the key challenges for traditional active managers, including fee compression, soaring expectations for performance and high investor volatility, as well as increased competition from new products. However, passive

funds which are typically based on index tracking, enjoy many economies of scale, and relatively low expense ratios, making it harder for traditional active funds [20]. Moreover, on-going benchmarking further pressurises active managers to demonstrate superior performance or services as an alternative to the higher costs charged. Such pressures include a need to adapt the traditional active management approach rather than using only traditional portfolio management techniques.

Strategic Adaptation through Business Model Transformation and Innovation

The findings of the research indicate that an active manager may react by engaging in investment innovation, adaptation of new technologies, developing new products or business model transformation. Distinctive strengths and efficiencies can be reinforced using advanced analytics, AI, personalised investment solutions and flexible fund structures [21]. Another possibility is to review fee structures, channels and product offerings with the goal of making them more responsive to investor expectations. These changes can enable US active fund managers to use the resources and capabilities that they already possess to develop something unique that passive products cannot easily simulate.

PEGTF-based Strategic Response to Increasing Competitive Pressure

Framework Overview

The study offers the Private Equity Growth Transformation Framework (PEGTF) as an ideal model of ensuring that private equity has become the solution to the inclusive economic development of the US. The framework merges five related layers consisting of Investment Ecosystem Development, which addresses mobilization of capital and investor

alliances; Innovation Enablement, which provides investment in technology, startup acceleration, and digitalization; Enterprise Growth Support, which enhances management capacity and operational functioning; Governance and Sustainability, which considers ESG concepts, transparency, and ethical investment activities; and Economic Transformation Outcomes, which indicates job creation, inclusion, and expansion. PEGTF links investment activity with innovativeness in a particular industry, independent governance, and overall economic transformation goals, unlike the traditional frameworks in which the main focus is on the financial returns.

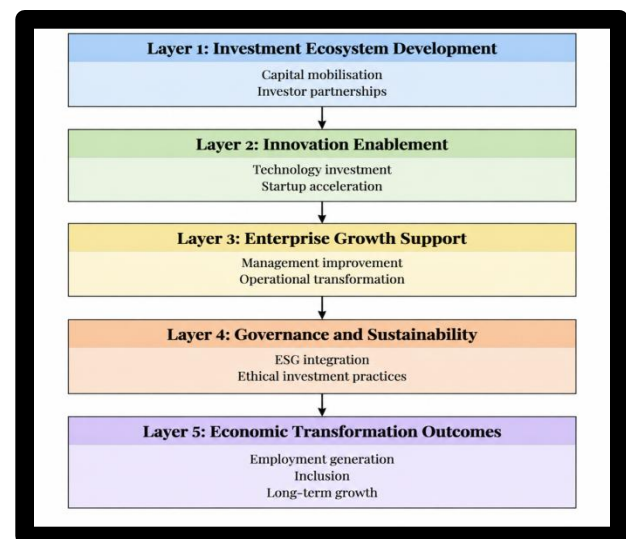


Figure 4: PEGTF Framework

The model shows how investment resources are changed into enterprise resources and long-term economic results.

TABLE 1. COMPARISON OF EXISTING FRAMEWORKS AND PEGTF

Framework	Focus	Limitation	PEGTF Contribution
PE Value Creation Model	Financial returns	Investor-focused approach	Adds economic transformation perspective

ESG Framework	Sustainability	Limited innovation integration	Combines sustainability with innovation capability
Development Models	Economic growth	Limited private equity integration	Introduces investment-driven transformation mechanisms

Framework Validation Approach

PEGTF needs to be evaluated further in the future by expert validation and through case studies to enhance academic soundness. The US private equity professionals, investment specialists, and policy makers can be used as experts to validate the relevance and practicality of the framework [24]. Also, cross country validation in other countries can

The proposed architecture shows the channel of how the results of transformation come about because of private equity [22]. This starts with Private Capital Sources such as, investment funds, development finance institutions and then Investment Selection of potential enterprises [23]. Through these investments, Enterprise Innovation, technology adoption as well as operational enhancement becomes achievable leading to Value Creation and thus eventual contribution to the transformation of the economy in terms of employment, competitiveness as well as sustainable development.

Discussion

The findings highlighted that the growth of passive investments has critically intensified the degree of competitive pressure on the conventional US active fund management models with the assistance of lower costs, and dynamic preferences of investors. However, the evidence suggest that active managers are capable of responding by the exploitation of distinctive resources and capabilities instead of taking part in sole price competition. Innovation in investments, technological abilities, transformation of business models, alignment of investor expectations and governance can fortify differentiation. The findings of the study are in line with the concepts of RBV, and the proposed PEGTF framework incorporated the dimensions within a structured framework from the pressure of passive investment to competitive performance outcomes. Hence, the PEGTF framework has provided an integrated approach towards addressing the strategic challenges that are identified in the investigation.

V Conclusion

This study adds to the strategic model explaining the role of private equity in building the contexts of active fund management by investing, innovating and

determine the ability of PEGTF to fit in various institutional and investment settings [25]. This method of validation enhances the role of this framework since it shows that the framework can be utilized outside theoretical formation. The framework offers a combined tool of aligning investors, enterprises, governments and development institutions to the next generation of sustainable economic development in the US[26]. transforming in its economy. Private Equity offers crucial capital and competency to develop, compete, and survive in an enterprise. The proposed framework should be validated in future research with empirical studies, comparisons across the region, and long-term investment outcomes.

The research derives the concluding note that growth of the passive investment has ensured intensification of competitiveness on the active fund management models in the US. The information is derived that active fund managers have a requirement of strategic adaptation towards maintenance of differentiation and provision of value to investors. The theoretical context of the resource-based view states that the presence of adequate resources such as technology infrastructure, investors and others has been considered as the vital source of attaining competitive advantage. The proposed context of the PEGTF has been explored in regard to integration of the innovation, governance, alignment of investment and transformation of business model. The application of the framework supports active fund managers in shaping sustainable capabilities and raising responding ability to changing conditions of the market.

VI Recommendations

Recommendations for Governments

The governments need to tighten investment regulation rules, offer tax subsidies, craft investment protection policies, and aid startup ecosystems to enhance the involvement of private equity [4]. Investor confidence can be built by making financial systems transparent, instituting policies on innovation, and maintaining effective institutional frameworks [1], [3]. Supportive Government policies and transparent framework strengthen the investment environment shaping response to competitive pressure.

Recommendations for Private Equity Firms

Strategies of long-term impact investment and incorporating ESG measurement practices and building up local capabilities, through collaborating with enterprises, should be embraced by the private equity firms. These strategies are capable of enhancing sustainable value creation, quality of governance and the results of innovations [7], [22]. The strategies can serve as milestones in regard to effective management of active fund management in the US context.

Recommendations for Entrepreneurs

Entrepreneurs need to build on the aspects of governance and ensure better financial transparency as well as create business templates which can be scaled. The presence of better organizational capabilities will be able to raise investment preparedness and enable long-term enterprise expansion via privatized equity partnerships [8], [16].

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VII Limitations And Future Research

The main limitation of the research is regarding sole reliance on secondary data collection and existing information that limits accessibility to the real context information from the human participants. The lack of first-hand information from the investors, industry professionals and others raises limitations in the study. The study solely focuses on the US fund management segment that restricts the study in assessing the context of other financial markets. Based on this, future research can focus on including a primary data collection method for gathering responses from human participants in the real context. The survey and interview both or either one of the primary methods can be used in the future research for addressing the limitation of this study. The comparative analysis could be conducted in the future research through considering US and other countries in regard to fund management.

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