Enhanced indexing – bridging active and passive investing

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Introduction

Investment strategies that sit between passive and highly active management have gained increasing attention from investors. Often referred to as enhanced indexing, active indexing or smart beta, these approaches combine features of both investment styles.

Enhanced indexing strategies are typically priced close to passive products and are often offered through ETF structures, while still employing an alpha-generating investment process. Their objective is to outperform a reference index consistently by a modest margin, net of fees.

For investors favoring passive strategies, the attraction lies in the potential to match or modestly exceed index returns while keeping fees and deviation risk comparatively low. For active investors, enhanced indexing offers a lower-risk alternative with a higher probability of generating positive excess returns, albeit on a smaller scale.

Investment Concept

The objective of an enhanced indexing (EI) strategy is to outperform the reference index consistently by a small margin after fees. These strategies typically target annual excess returns of around 0.5-1% with a tracking error of approximately 1–1.5%. Information ratio targets, defined as excess return divided by tracking error, generally range between 0.5 and 1.

Many EI strategies use the same alpha model as their more active counterparts, particularly in quantitative investing. The key difference lies in implementation. Lower tracking error targets require a larger number of smaller active positions, leading to greater diversification of active risk.

This diversification tends to produce more stable relative performance, making prolonged periods of underperformance both less frequent and less severe. Recovery from periods of weak relative performance is therefore often faster. EI strategies also typically exhibit lower portfolio turnover than highly active strategies.

Enhanced indexing is particularly well suited to quantitative managers, as established alpha models can be transferred efficiently into an enhanced indexing framework. The approach works best in broad, diversified and liquid equity markets which are not fully informationally efficient. In such environments, factor premia such as value and momentum can be harvested efficiently through many small active positions.

The chart below illustrates this effect. Across several equity markets, enhanced indexing strategies have historically delivered higher information ratios than their more aggressive active counterparts, highlighting the benefits of broader diversification of active risk.

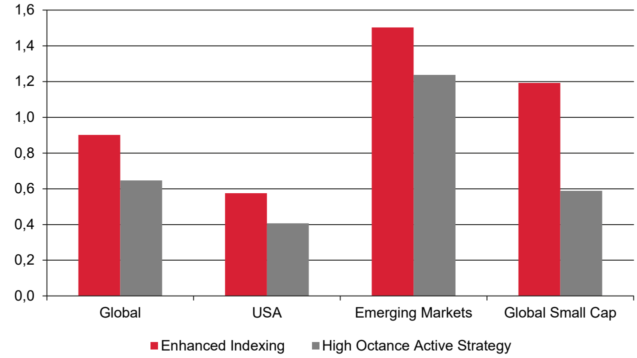
The Market for Enhanced Indexing and Active ETF

Enhanced indexing equity strategies have a long history. More than two decades ago, many mutual funds were managed using similar approaches, often described as semi-active strategies or closet indexers. At the time, however, they were typically priced in line with traditional active funds.

The growth of active ETFs and increasing demand for cost-efficient investment solutions have created a more favorable environment for these strategies. Today, enhanced indexing products are frequently structured as ETFs and are generally priced only modestly above passive alternatives.

While dedicated asset data for enhanced indexing strategies is not yet widely available, active ETF statistics provide a useful indication of market trends. In Europe, active equity ETFs account for around €60bn in assets, representing roughly 3% of the ETF market. Globally, active ETF assets have reached approximately $2trn and are expected to grow to 10 trn USD in the next 5-10 years. In 2025, active ETF launches reached levels comparable to passive ETF launches.

Information Ratio (outperformance divided by tracking error) of Enhanced Indexing and High Octane Active Strategies



Source: Swiss Life Asset Managers based on a proprietary stock selection model, Simulation period: 2006-2026, tracking errors of Enhanced Indexing strategies range between 1-1.5%.

Structure & Pricing

Most enhanced indexing strategies are structured as active ETFs. Ireland is a popular domicile because of its efficient fund framework and, in some cases, favorable tax treatment.

Fees are generally above those of comparable passive products but substantially below those of traditional active strategies.

Conclusion

Enhanced indexing occupies the middle ground between passive and highly active investing. Its appeal is based on a simple proposition: a higher probability of modest outperformance after fees, achieved through a broadly diversified portfolio of active positions and at costs close to those of passive investing. For committed index investors, enhanced indexing offers the opportunity to improve on benchmark returns without materially increasing risk. For active investors, it provides a lower-risk, lower-cost approach with a greater likelihood of generating positive excess returns.

Enhanced indexing is therefore best viewed as an additional tool for steering active risk rather than as a replacement for passive or traditional active management, complementing existing portfolios by introducing a measured amount of active risk into a passive core or diversifying the return sources of more concentrated active mandates.

The approach is therefore particularly well suited to investors with limited tolerance for the extended drawdowns in relative performance that can accompany high-conviction active strategies. Given these characteristics, we expect investor demand for enhanced indexing to continue growing in the years ahead.

Swiss Life Asset Managers

Swiss Life Asset Managers has more than 165 years of experience in managing the assets of the Swiss Life Group. This insurance background has exerted a key influence on the investment philosophy of Swiss Life Asset Managers, which is governed by such principles as value preservation, the generation of consistent and sustainable performance and a responsible approach to risks. Swiss Life Asset Managers offers this proven approach to third-party clients in multiple European locations.