Navigating Market Volatility: Active vs. Passive Investing

Passive investing has grown rapidly in recent years, reshaping how portfolios are built and managed. With benefits like low costs, transparency and broad market exposure, passive strategies have become a staple for many investors. However, while passive investing offers compelling advantages in stable markets, it can also introduce meaningful risks — particularly during periods of heightened volatility or economic disruption.

We'd like to take a moment to outline the key differences between passive and active investing, and to share our perspective on how active management can play a critical role in navigating market turbulence and managing downside risk.

Understanding Passive Investing: Broad Exposure, Limited Flexibility

Passive investing typically involves tracking a benchmark index like the S&P 500. These strategies offer:

- Low-cost access to a diversified basket of securities.
- Market-matching returns rather than attempting to outperform.
- Minimal turnover and high transparency.

However, during sharp drawdowns or economic shocks, passive investors remain fully exposed to all segments of the index — including sectors or companies that may be overvalued, structurally weak or highly sensitive to macroeconomic shifts. Passive strategies are rules-based by design, meaning they invest in all index constituents regardless of valuation, earnings trends or risk profiles.

This lack of flexibility can become problematic during periods of stress. For example, if a sector such as technology, financial, or real estate experiences deteriorating fundamentals, passive portfolios have no mechanism to reduce exposure or reallocate elsewhere. Many broad indexes are also market-cap weighted, which can create concentration risk: where a small number of large stocks exert an outsized impact on portfolio performance.

A good example is the Magnificent 7 which includes Apple (AAPL), Nvidia (NVDA), Microsoft (MSFT), Amazon (AMZN), Alphabet (GOOG, GOOGL), Meta (META) and Tesla (TSLA). These seven companies alone make up 33-35% of the S&P 500, largely the result of significant technology outperformance in recent years. If these companies falter, the entire index suffers and passive investors absorb the full impact.

While passive strategies are well-suited for long-term participation in market growth, they lack the tools to actively manage risk in the face of market corrections, policy shocks or rapidly shifting investor sentiment.

The Case for Active Investing: Flexibility and Forward Thinking

Active strategies aim to outperform a benchmark through selective security choices, tactical shifts and forward-looking risk management. Key advantages of active investing include:

- Security selection based on fundamentals, valuation or quality.
- Dynamic asset allocation across sectors, styles or asset classes.
- Risk mitigation through cash holdings or tilts toward defensive areas when appropriate.

In volatile markets, this flexibility can make a meaningful difference. Active managers are not constrained by an index and can respond in real time to new information. For instance, if a sector's earnings outlook weakens — such as technology in 2022 — or if headline risks increase, as we've seen recently with renewed tariff concerns, active managers can reduce exposure or exit entirely.

They also have the ability to avoid crowded trades, where investor enthusiasm has pushed valuations too high and created vulnerability to a reversal. And perhaps most importantly, volatility often creates market dislocation, where price movements temporarily disconnect from company fundamentals. Active managers can take advantage of those opportunities, adding high-quality businesses at attractive valuations.

While active management doesn't guarantee outperformance, it can offer an added layer of risk control, adaptability and judgment that passive strategies cannot provide — particularly when markets are driven more by emotion, momentum or policy uncertainty than fundamentals.

Lincoln IM&R's Perspective: Be Active, Even with Passive

Lincoln's Investment Management and Research (IM&R) team doesn't view active and passive investing as mutually exclusive. We believe the most effective approach is a thoughtful blend of both. Passive strategies can be excellent for cost-efficient, broad market exposure, especially in core portfolio allocations. But we don't believe in a "set it and forget it" approach. We stay active even with our passive positions. That means making deliberate decisions about how much exposure to take, which sectors to emphasize and when it may be prudent to shift allocations. Markets evolve, risk factors change and we believe portfolios should adapt accordingly.

By combining passive building blocks with active oversight, we aim to stay nimble — trimming exposure where appropriate, leaning into opportunities when they arise and reducing risk when markets signal caution.

Final Thoughts

Our goal is simple: to align your portfolio with your long-term objectives, while making smart, timely adjustments along the way. We're constantly evaluating market conditions, identifying risks and opportunities and actively managing your investment strategy with care and conviction.

Volatile markets often cause investors to review their investments and revisit their financial goals. If you would like to learn more about appropriate investment strategies for you, speak with your financial professional today.

All investments are subject to risk, including the risk of principal loss. You should consider the investment objectives, risks, charges and expenses before you invest or send money.