Why active investing works in international equities

Fidelity research suggests active international allocations have topped index funds over time

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Key takeaways

- Many international equity investors have continued to prefer index-based exposures, even though Fidelity research concludes that active approaches in international equity markets have topped the performance of index funds over time.
- Active managers can use their expertise regarding local laws and regulations and the competitive environment to attempt to avoid problematic international securities and segments.
- The economic backdrop for inflation, geopolitics, and monetary policy could result in a broader range of potential winners and losers across multiple investment categories in the years to come, implying there may be greater opportunities for active managers across regions and countries.

Clients expect advisors to help them identify the right mix of investment vehicles and strategies relative to the risk they are willing to take. In some cases, this means taking advantage of low-cost index funds, and in others, it may involve active funds with the potential for index outperformance.

At Fidelity, we offer active and index mutual funds, exchange-traded funds, separately managed accounts, and pools in all major asset classes, and leave it to advisors to decide which is the best approach, based on client goals and preferences.

That said, advisors may want to consider active approaches alongside index strategies for their clients—including in less-efficient markets where active management can take advantage of fragmented information flow.

This may be especially true for international equities.

“Our latest research concludes that, overall, active approaches in international equity markets have shown a higher propensity to outperform index funds over time,” says Michael Scarsciotti, Head of Investment Specialists at Fidelity Institutional. “Therefore, even advisors who typically use all-index products might want to consider complementing them with an actively managed strategy in the international equity space.”

Metrics that matter

Exhibit 1: Active outperformance in international

Category	International benchmark	Start date	Hit rate	Active performance (net)	Index performance (net)
Global Large Cap	MSCI ACWI Ex USA	Sep-01	59%	0.46	-0.49
	MSCI EAFE	Jan-93	58%	0.73	-0.29
	MSCI ACWI	Jul-06	55%	0.15	-0.17
	MSCI World	Feb-12	35%	-1.01	0.21
Emerging Markets	MSCI Emerging Markets	May-03	59%	-0.08	-0.75

Past performance is no guarantee of future results. It is not possible to invest directly in an index. All market indices are unmanaged. Index performance is not meant to represent that of any Fidelity product. Average net performance of active and index funds calculated across common time frames. See Methodology section for details. Products evaluated for Active Performance are from the start date through 5/30/25 and include various fee structures. Red and green colors indicate underperformance or outperformance, respectively, vs. index performance. Hit Rate refers to the average percentage of active funds that outperform the average index fund in any given three-year time period. Source: Morningstar and Fidelity Investments, as of 5/30/25.

What's new in the research?

The conclusion that active tops index in international markets is not groundbreaking, although we think we approached the analysis in a unique way, using a "real world" perspective. We applied a somewhat different methodology that recognizes the fact that investors cannot buy an entire asset class or Morningstar category. Instead, they invest in an active or index fund designed either to outperform or track an index.

With this in mind, we studied the performance of active and index funds by including the major representative indices and the funds that use them as global benchmarks.

We chose this direct comparison rather than studying active fund returns compared with benchmark returns, since one cannot invest directly in an index, and because indexes do not account for fees. **See the methodology section for more details.**

Active approaches topped index approaches for four of the five major global benchmarks (Exhibit 1). For each, we calculated the net relative performance for both active and index, as well as the hit rate, which reflects the average percentage of active funds that outperformed index funds in any given three-year time period, using monthly data.[1] The hit rate is useful because the performance of active versus index varies over time.

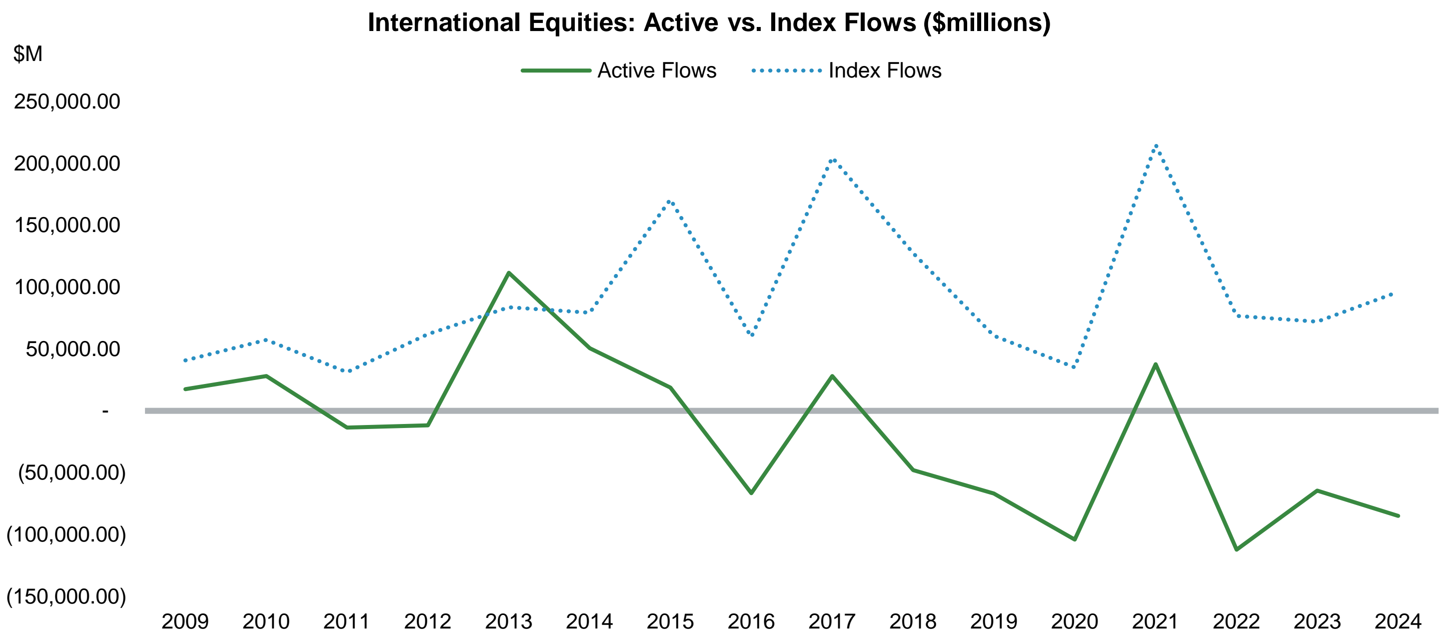
Conversely, index approaches topped the net returns of active among funds benchmarked to the MSCI World Index. Notably, the U.S. composed more than 70% of this index as of May 2025.

Note that the hit rates tend to be higher for the indices with the least U.S. exposure, with the MSCI ACWI ex-USA and MSCI Emerging Markets (no U.S. exposure) topping the list with a 59% hit rate.

The strategy of international investors

It may come as no surprise to many advisors that industry flows in the international equities segment have favored index funds and exchange-traded funds (ETFs) versus active funds in 14 of the past 15 years (Exhibit 2). This follows the broader trend of index funds taking share from actively managed equity funds over roughly the same time period. Fidelity's combined mutual fund and ETF active and passive flows over the past 15 years among international investors have shown a similar trend, despite an attractive hit rate for active international products.

Exhibit 2: Net industry fund flows among international investors



Net industry fund flows include U.S. open-end funds and exchange traded funds, including obsolete funds, priced in U.S. dollars. Data gathered and displayed annually. Source: Morningstar as of 6/9/25.

[1] Outperformance measures the hit rate for each three-year period, which is then averaged.

Possible reasons for active outperformance

Why have these active international funds outperformed? One reason may be that in international investing, selecting what not to own can be as impactful or even more impactful than what a portfolio manager chooses to own.

Therefore, a portfolio manager …

- can attempt to avoid companies with poor governance practices and state-owned entities that may have principal agency conflicts.
- may underweight large caps while overweighting lesser followed, less expensive stocks with strong ties to local economies, gaining potential performance and diversification benefits.
- may better understand the characteristics of companies in the index, thus avoiding certain names that could damage index performance at certain points in time.
- may be able to successfully hedge or otherwise manage certain political and currency risks within index positions.
- can take a differentiated view at different points in time and attempt to make a move ahead of the market.
- can adjust position sizing in periods of either indiscriminate selling or euphoric markets.
- may be able to anticipate the companies that will be added or dropped from an index prior to rebalancing.

Similarly, active managers are arguably in a better position to **avoid secular risks that tend to diminish index performance over multiyear periods.**

For example, some active funds underweighted China, on average, from 2021 through early 2024, thus avoiding a market that had declined more than 40% over that time frame as measured by the MSCI China index. Some managers then relaxed those underweighted allocations when the index started to improve.

Lastly, when it comes to what managers choose to own, active managers can leverage research among stocks with little to no analyst coverage, taking advantage of lesser-followed opportunities.

Reasons to consider active going forward

Could the longer-term trend of outperformance of active approaches in international equities continue? It's possible, given shifting dynamics in the macro investment landscape.

The Fidelity Asset Allocation Research (AART) team believes a different backdrop for inflation, interest rates, geopolitics, and monetary policy could result in a broader range of potential winners and losers across multiple investment categories in the years to come.

This implies there may be greater opportunities for active managers across regions and countries, for example.

Some of the opportunities identified by the team include:

- Global exposures that could benefit from lower correlations
- Avoiding regions and countries with higher geopolitical risks
- Tilting toward or away from big themes, such as globalization or climate

Overall, the benefits of active or indexed strategies may be asset-class specific, client-specific, and environment-specific, which is why we offer both approaches.

That said, advisors who want to diversify their clients' allocations from the tech-centric U.S. might consider active international strategies in the mix. They have outperformed index approaches over time and, based on the views of AART, they may continue to do so, as the investing world appears to be changing in fundamental ways that could favor more-nimble strategies.

Past performance is no guarantee of future results. It is not possible to invest directly in an index. All market indices are unmanaged. Index performance is not meant to represent that of any Fidelity mutual fund.

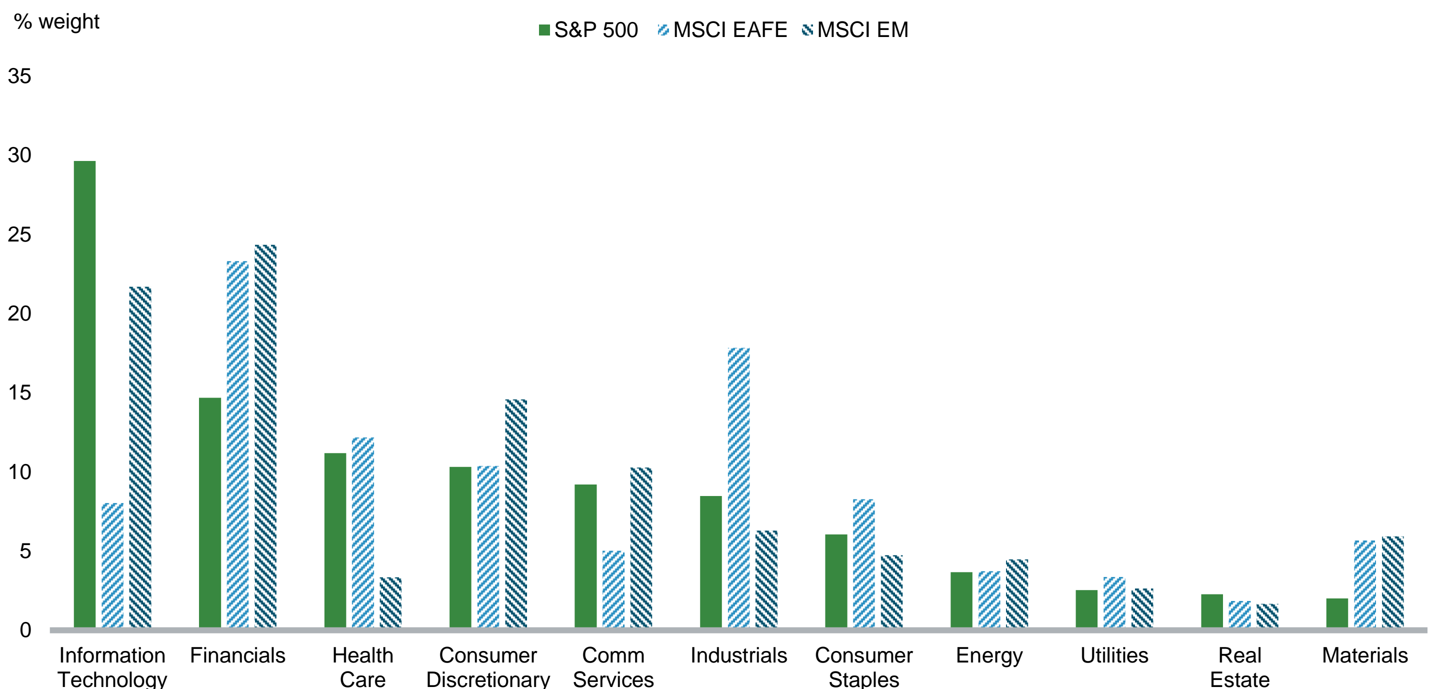
Why invest internationally?

Advisors already know why clients should consider international investing in the mix—including the average overweight to the U.S. in many advisor-managed portfolios.

But the following are reasons to consider international investing now:

- We've been through a long cycle in which international investments underperformed U.S. markets. This has begun to change in 2025 due to a falling U.S dollar and inflationary impulses.
- International exposures provide diversification from the U.S. and could help protect investors from overexposure to a select group of seven U.S. information technology stocks that now compose more than 30% of the S&P 500 index (Exhibit 3).
- Countries and regions tend to be in various stages of the economic cycle compared with the U.S., which allows for differentiated economic exposures. With more volatility across global markets, diversification is an increasingly important portfolio attribute.
- Many international companies are long-term leaders of strategic industries and secular themes, including semiconductors, artificial intelligence, and alternative energy.
- Increased investor interest in the asset class could help drive up prices and increase valuations in multiple geographies.
- Relatively lower valuations and strong catch-up potential could lead to significant gains, especially for select emerging markets.
- International investing could keep clients from missing out on secular changes, including, for example, the shift toward much-needed inflation in Japan, which has contributed to a roughly 46% gain for the MSCI Japan Index from early 2023 through early June 2024, or the runup for financials stocks in the MSCI EAFE Index in the first half of 2025.
- Eventually lower policy interest rates in the U.S. could weaken the U.S. dollar, making international stocks relatively more attractive.

Exhibit 3: Portfolio diversification by sector, U.S. vs. international



Past performance is no guarantee of future results. Diversification does not ensure a profit or guarantee against loss. It is not possible to invest directly in an index. All indices are unmanaged. See appendix for index definitions and other important information. S&P 500 represents the U.S. MSCI EAFE represents the international equities market. MSCI EM represents emerging market equities. Source: Morningstar Direct, as of 3/31/25.

Methodology details

Funds vs. funds

For each major global subgroup, we sought to include the representative benchmarks, as well as all the index and active funds that track them. This includes all open-end (publicly available for investment) active and index mutual funds and exchange-traded funds for each subgroup. We then compared the average rolling 36-month performance of the active funds and index funds. We chose this direct comparison rather than studying active fund returns compared with benchmark returns, since one cannot invest directly in an index, and because indices do not account for fees. Also, we believe that evaluating active and index funds that track the same benchmark provides a more accurate comparison, given that benchmarks can vary significantly within a single asset class category.

Comparing time frames

We calculated active and index-based returns by aligning both groups to the same time periods. The time frames of analyses by benchmark differ because of the relatively shorter track record of indexed funds that track each benchmark, but in all cases the active and index returns align. Note that we included all funds that use the selected list of benchmarks, even if they fell within another Morningstar category. This is because advisors generally select building blocks for client portfolios based on the underlying benchmark exposure they are targeting. Also, we filtered to remove sector and country funds from the analysis.

Benchmark selection

During the process of benchmark selection, we identified those that represent at least 2.5% of total assets within the Global Category from Morningstar, have at least 30% of the assets tracking them classified as active, and have at least one index fund and more than one active fund tracking them. This approach sought to include only representative funds in the analysis. The 2.5% threshold ensured that we covered a solid proportion of assets and had sufficient funds to evaluate. The 30% active threshold ensured that we included enough active funds in the analysis while not limiting the number of benchmarks covered.

We also conducted sensitivity analysis for both the 2.5% and 30% thresholds and determined that they helped us achieve the goals outlined above. We did not include a specific threshold for the proportion of assets that must be indexed, except that they could not be zero.

How we reported the data

We analyzed the asset-class level results on equal-weighted and asset-weighted bases, as well as by oldest, cheapest, and all share classes, net and gross of fees. While there was some variation, trends were similar across the asset classes for each methodology. In each case, we used survivorship bias-free data from Morningstar Direct. We calculated the returns for both the active and indexed strategies as the average of 36-month rolling returns, updated monthly, over the respective time frame for each benchmark. Then, we counted the number of times active topped index (or vice versa) in the aggregate for each benchmark to determine the headline results by both benchmark and asset category. We presented the results on an equal-weighted basis to be as objective as possible. Also, we presented the results for each benchmark by the cheapest share class, net of fees, based on the assumption that price matters to both advisors and investors.

Other methodology notes

- Because the Morningstar Global Fixed Income category is heterogeneous, we analyzed the sub-asset categories to better compare similar funds.
- Within categories where we would lose a substantial proportion of assets because top benchmarks did not have at least 30% assets tracking them classified as active and at least some indexed funds tracking them, we added “missed” benchmarks that had a correlation of 0.99 or higher (rounded to two decimal places) with one of our included benchmarks.
- We only studied the correlations of initially excluded benchmarks that were significant to the category (more than 20% of category assets).

Past performance is no guarantee of future results. Diversification does not ensure a profit or guarantee against loss. It is not possible to invest directly in an index. All indices are unmanaged. See appendix for index definitions and other important information.

- We did not apply any fund filters based on fees, fund assets, or family size.
- We used the Morningstar definition of index fund to group funds. However, some funds labeled as index funds were smart beta or leveraged ETFs. Therefore, we implemented a tracking error threshold to remove funds not closely tracking their benchmarks. To do so, we first removed the bottom 10% of the tracking errors for each benchmark each month; for the remaining 90% of the distribution, we calculated the mean tracking error and used this as the threshold. When the threshold was below 50 basis points, we used 50 basis points as the cutoff to avoid excluding too many index funds. We did not implement a tracking error filter for benchmarks that have only one index fund.
- We did not consider the impact of taxes or transaction costs and therefore did not account for the relative tax efficiency of either active or index-based strategies. Tax efficiency is an important investment consideration, and it tends to be a function of portfolio turnover, which is not a factor that we included in our research. It is assumed by many investors that index-based strategies offer broad advantages from a tax-efficiency perspective. We would note that this is not always the case, as many low-turnover, active strategies also are managed for tax efficiency.

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Index definitions

S&P 500 index is a market capitalization-weighted index of 500 common stocks chosen for market size, liquidity, and industry group representation to represent U.S. equity performance.

MSCI All Country World ex U.S. Index is a market capitalization-weighted index that is designed to measure the investable equity market performance for global investors of large and mid cap stocks in developed and emerging markets, excluding the United States.

MSCI EAFE Index is a market capitalization-weighted index that is designed to measure the investable equity market performance for global investors of developed markets, excluding the U.S. and Canada.

MSCI All Country World Index is a market capitalization-weighted index that is designed to measure the investable equity market performance for global investors of developed and emerging markets.

MSCI World Index is a market capitalization-weighted index that is designed to measure the investable equity market performance for global investors of developed markets.

MSCI Emerging Markets Index is a market capitalization-weighted index that is designed to measure the investable equity market performance for global investors in emerging markets.

MSCI EAFE Small Cap Index is a market capitalization-weighted index that is designed to measure the investable equity market performance of small cap stocks for global investors of developed markets, excluding the U.S. and Canada.

MSCI Japan Index is a free float-adjusted market capitalization weighted index designed to measure the performance of the large and mid cap segments of the Japanese market.

MSCI China Index is a free float-adjusted market capitalization weighted index designed to measure the performance of the large and mid cap segments of the Chinese market, including Hong Kong, Shanghai, and Shenzhen.

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