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Winning for the Wrong Reason in Small Caps

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The small cap market has subsets of stocks with lower expected returns. In the US, small cap growth low profitability stocks have lagged the rest of the small cap space by more than eight percentage points, while high asset growth stocks have trailed by more than 12 percentage points.¹ However, sometimes the script gets flipped and these stocks unexpectedly outperform. While these periods of outperformance tend not to last, they can make it difficult to evaluate small cap manager relative performance.

Over the past year, the big winners in US small caps happened to have been low profitability and high asset growth stocks. As such, returns for US small cap funds were generally increasing with the amount allocated to these stocks.

When sorting the 10 largest funds in the category on weight in lower expected return stocks, we see a sizable difference in holdings there: 14.8% for the top tercile versus 4.4% for the bottom tercile. The average return for the top tercile was 43.1%, compared to just 33.1% for the bottom tercile. In other words, a larger allocation to the worst-performing small cap stocks was a tailwind over this period.

This illustrates one of the challenges with short-term performance: Sometimes managers win for the wrong reasons. ○○○

Exhibit 1
One-Year Return vs.
Weight in Lower
Expected Return
Stocks
Active US small cap equity
funds as of June 30, 2026



Past performance is not a guarantee of future results. Diversification neither assures a profit nor guarantees against loss in a declining market.

For educational purposes. Bloomberg data provided by Bloomberg. Dimensional Fund Advisors LP is an investment advisor registered with the Securities and Exchange Commission.

A Personal Note from Global Wealth Advisors

The third quarter of this year has been a continuation of positive double-digit returns in the US, Foreign and Emerging Markets. In fact, the Emerging Markets are still leading the major indices in both the year-to-date and one-year returns. Those stock markets are dominated by metal ore producers, and given the growth in demand of computer-related hardware, it is easy to see why they have done so well.

Here at home, inflation has been heating up, and the Fed increased the Federal Funds Rate by one-quarter of a percentage point last month. That brings the rate to 3.75% – 4.00% and the last time the Fed raised rates was the summer of 2023. There is speculation that the Fed may raise rates another quarter point by the end of this year.

In the US markets, the year-to-date returns have been led by the small and mid-sized companies while the larger firms have seen a pullback in their prices. Some of this is due to increases in goods and material costs and also pricing pressure and lower sales in consumer demand. Overall, corporate earnings are expected to remain positive, even with slightly higher rates, through year end. That should bode well for US stocks.

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The Practical Implications of Investment Theory

Many investment principles used to develop investment portfolios derive from one investment theory — the capital asset pricing model. What exactly is this theory and how does it apply to your investments?

The capital asset pricing model was developed over 50 years ago by Harry Markowitz, who won a Nobel Prize for his work. His theory centers on the concept that adding an asset to a portfolio that is not highly correlated with other assets in the portfolio can reduce the portfolio's variation risk. Before his theory, it was common practice to look for undervalued assets to add to a portfolio. His approach evaluated how a particular asset would impact the portfolio's risk and return. Whether it makes sense to add that investment to the portfolio depends as much on how the asset's return will vary with returns of other portfolio assets as it does on its own return prospects.

This theory provides the underlying rationale for asset allocation. The key is that the returns of different assets do not behave in the same manner during different economic times, so adding different assets can reduce the volatility in that portfolio. While the return of a diversified portfolio may be lower than that of investing solely in the best performing asset, this is typically viewed as an acceptable tradeoff for the reduced risk. Many people have also realized that it is difficult to identify the best performing asset in any given year, so a diversified portfolio provides more consistent returns.

- Some investment implications that have been drawn from this theory include:
- A properly diversified portfolio will combine assets that do not have highly correlated returns. Thus, when one asset is declining, other portfolio assets may be increasing or not decreasing as much.
- Rather than focusing on each investment's risk, investors should consider their portfolio's overall risk.
- Including a small percentage of a volatile investment may not increase a portfolio's overall risk, provided that investment's returns do not vary closely with other assets' returns in the portfolio.
- When small portions of stocks are added to an all bond portfolio, risk initially decreases, even though

stocks are more volatile than bonds. Thus, an all bond portfolio is not the lowest risk portfolio.

- Investors should consider how varying percentages of different asset classes will affect their portfolio's risk and return before deciding on an asset allocation.

Managing Your Portfolio

Consider this investment process to incorporate this theory:

- **Determine your risk/return preferences.** You should assess the potential downsides as well as upsides for various investments to get a feel for how much risk you can tolerate.
- **Decide on an asset allocation mix.** Your asset allocation strategy represents your personal decisions about how much of your portfolio should be allocated to various investment categories. After considering your risk tolerance, time horizon for investing, and return needs, you can form a target asset allocation mix. Within broad investment categories, make allocation decisions for each category. Not only will each individual's allocation strategy differ, but your strategy will vary over time.
- **Select individual investments.** Investigate a wide range of options, but make sure you understand the basics of each, examining the types of risk they are subject to as well as their historical rates of return. Your selections should fit in with your overall asset allocation.
- **Rebalance periodically.** Over time, your asset allocation will stray from your desired allocation, due to varying rates of return on your investments. Determine how much variation you are willing to tolerate, perhaps 5% or 10% from your desired allocation. If portions of your portfolio have strayed more than that, you should take steps to get your allocation in line. However, first determine if there are ways to do so without incurring tax liabilities. Selling assets from taxable accounts may result in taxable transactions. Instead, you may want to make new investments in underweighted assets, redirect periodic income to other asset classes, or take withdrawals from overweighted assets.

Please call if you'd like to discuss your investment portfolio in more detail. ○○○

Interest Rates and Debt

In simple terms, an interest rate is the cost of borrowing money. Understanding interest rates and how they work is essential to making smart financial decisions.

Interest Rate Basics

An interest rate is the amount a borrower (or debtor) is charged by a lender (or creditor) to borrow money. It is usually expressed as a percentage of principal. By charging interest, a lender is compensated for lending you money. By paying a certain amount of interest every time you make a payment, you also help to lessen the financial blow to the lender if you default on (or fail to pay back) the loan.

How Interest Rates Are Determined

A variety of factors influence interest rates. Some are macroeconomic, or related to broad economic trends. In the U.S., the Federal Reserve (the country's central bank) sets what is called the Fed funds rate, which is the amount banks charge each other for certain types of loans. The Fed funds rate, in turn, influences other interest rates, including the prime rate — the interest rate a bank charges its best (or least-risky) customers. The prime rate then influences other consumer interest rates, such as those for cars, credit cards, and mortgages. The Fed uses its ability to set interest rates to influence the broader economy, lowering interest rates to stimulate growth or raising them to combat inflation.

Of course, broad economic trends aren't the only factors that affect what interest rate you're charged. A lender will also look at your overall creditworthiness and then offer an interest rate based on how risky the lender believes it is to loan you money. If you have defaulted on debts in the past and have little income, a lender may only offer you a loan at a very high rate or even decline to loan you money at all, because it fears there's a

good chance you won't pay the money back. On the other hand, if you've always paid your debts promptly and have a good income, you may get a lower rate.

Finally, the interest rate you're charged depends on the type of loan you want. One reason mortgage loans tend to have lower interest rates is because they are secured loans, meaning you promise an asset as collateral when you get the loan. If you fail to make payments, the lender has the right to claim that asset (in the case of a mortgage, the house). On the other hand, credit cards tend to have high interest rates because they are unsecured loans, meaning you offer nothing as collateral in exchange. If you fail to pay your debt, the lender has fewer options for recovering what you owe.

The Cost of Borrowing Money

Whether you're borrowing a lot or a little and whether you're rich or poor, the same basic principle applies: the higher the interest rate, the more it will cost you over the long term to borrow money.

For most people, the challenge with debt and interest rates is balancing their short-term financial situation with their long-term goals. In general, it is advantageous to pay off a loan as quickly as possible no matter the interest rate, since you'll pay less interest overall. (Occasionally, there may be some exceptions to this rule, such as if you can claim the mortgage-interest deduction.) But if your budget is tight, the lower monthly payment that comes with taking a longer time to pay off the loan may be worth it, despite the higher overall interest costs.

If you are not cautious, however, high interest rates and low payments can send you into a debt spiral that it is difficult to escape. Making low payments on a high-interest debt can leave you paying as much in interest as you originally owed and sometimes more.

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The Future is Unknown, So Plan Accordingly

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I saw a great Forbes article recently that reinforced the fragility of forecasting using a quarter-century-old anecdote about the Pentagon changing the way they identify future threats. The change stemmed from a review of how quickly the geopolitical landscape evolves—yesterday’s adversaries can become tomorrow’s allies. Rather than focusing on one specific forecast, it was

more prudent to be prepared for all possible outcomes.

This echoes what we often say at Dimensional: plan, don’t predict. We all have views about what the future may bring: companies that will succeed, economies that will grow, markets that will take off. Markets set prices based in part on the aggregate of these expectations. So, market prices already represent a forecast of the future. However, some investors may let

their personal forecasts drive their asset allocation decisions. Dogmatic adherence to forecasts dictates concentrated investments that fall short in the event the future differs from our predictions. Diversifying portfolios is a tacit admission that we don’t have a crystal ball. You reduce the range of outcomes by preparing for what you can’t see coming.

Country stock market returns are a good example of this. Going all-in on one country because you have a view on where their stocks are headed opens you up to a wide range of outcomes. The average difference between the best- and worst-performing developed market countries over the past two decades was over 50 percentage points. Get your call right, and you’ll look like a hero. Get it wrong, and you’ll be as apoplectic as when Chevy Chase’s character loses the rock paper scissors game in Vegas Vacation.

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Exhibit 1
Best and Worst Yearly
Developed Market
Returns
2006–2025

Year	Worst Performer	Worst Return (%)	Best Performer	Best Return (%)	Best-Worst Difference (%)
2006	JAPAN	6.2	SPAIN	49.4	43.2
2007	IRELAND	-20.1	FINLAND	48.7	68.8
2008	IRELAND	-71.9	JAPAN	-29.2	42.7
2009	JAPAN	6.3	NORWAY	87.1	80.8
2010	SPAIN	-22.0	SWEDEN	33.8	55.8
2011	AUSTRIA	-36.4	IRELAND	13.7	50.1
2012	SPAIN	3.0	BELGIUM	39.6	36.6
2013	SINGAPORE	1.7	FINLAND	46.0	44.3
2014	PORTUGAL	-38.2	US	12.7	50.9
2015	CANADA	-24.2	DENMARK	23.4	47.6
2016	DENMARK	-15.8	CANADA	24.6	40.4
2017	NEW ZEALAND	11.7	AUSTRIA	58.3	46.6
2018	AUSTRIA	-27.4	FINLAND	-3.4	24.0
2019	FINLAND	9.5	NEW ZEALAND	38.2	28.7
2020	UK	-10.5	DENMARK	43.7	54.2
2021	NEW ZEALAND	-17.1	AUSTRIA	41.5	58.6
2022	SWEDEN	-28.4	PORTUGAL	0.2	28.6
2023	HONG KONG	-14.8	ITALY	37.1	51.9
2024	PORTUGAL	-25.2	SINGAPORE	32.3	57.5
2025	DENMARK	-13.5	SPAIN	82.4	95.9
Average		-16.4		34.0	50.4

Past performance is no guarantee of future results. Investing risks include loss of principal and fluctuating value. There is no guarantee an investment strategy will be successful. Indices are not available for direct investment. Their performance does not reflect the expenses associated with the management of an actual portfolio.

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