

## Markets Insight

# Why small caps belong in your portfolio

The record suggests such stocks outperform over the long term

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The rationale for investing in the stocks of small companies is well established through empirical record, academic literature and decades of practical asset allocation. Over the past century, small caps have outperformed large caps by roughly 1.5 percentage points annually.<sup>1</sup>

The recent outperformance of large companies has obscured the benefits for long-term investors who allocate some of their portfolio to US and global small caps. Popular misguided narratives about the state of small caps have not helped.

Since small caps represent a meaningful part of the global market – about 10 per cent of the US by market capitalisation<sup>2</sup> – they belong in a diversified portfolio. These are companies from a variety of sectors and many have the potential for significant returns. After all, firms such as Nvidia were start-ups before they were giants.

Those worried about overexposure to the currently high-priced US market might find small-cap valuations compelling. While the aggregate price to trailing earnings multiple for US large caps has grown to more than 30 times – nearly double the average since 1963 of 17.6 – the ratio for US small-cap stocks is just 16.4.<sup>3</sup>

Spreading investment to small caps helps lessen the exposure investors have to top stocks such as the Magnificent Seven, which now account for more than 35 per cent of the weight of the S&P 500 index.

And there are good reasons to question the aberrational recent returns of US large caps.

Large caps beat small caps by more than 8 percentage points annualised (19.7 per cent vs 11.6 per cent, respectively) over the three years to June 30 2025, according to Dimensional indices.<sup>4</sup> But historical context for those two returns is important.

The S&P 500 index's return over that stretch was nearly double its long-run average since June 1927. Contrast that with US small caps, where returns hewed much more closely to their long-run average of 11.6 per cent for three years and 11.9 per cent since 1927.

Expecting a continuation of large-cap returns well in excess of the historical norm is a bet on further unexpected success stories for these firms.

As for small caps, much postmortem effort has been devoted to uncovering causes why they have trailed bigger peers in recent years. These have revolved around the idea of a “new normal” incorporating everything from the impact of private equity (resulting in fewer IPOs or older market debutants) to technology upheaval (mainly AI).

The volatility of stock return data makes it hard to identify trends like these in market pricing. But one data point makes a compelling case that a key mechanism responsible for the premium for investing

in smaller caps historically is alive and well.

Migration, when firms grow into the mid or large caps, has been a key driver of the long-run outperformance of small stocks. The good news for investors is that this migration has been occurring at roughly the same frequency even in recent years – 11 per cent in the last 10 years and 10.1 per cent since 1926.<sup>5</sup>

It's also worth noting that the data on the size premium has been rosier outside the US. In non-US developed markets, small caps have been about even with large caps over the past three years and have outperformed over the past half-decade.<sup>6</sup>

Some of the concern over the small-cap asset class has focused on deteriorating financials for firms of this size. These concerns are not unfounded but pertain primarily to one specific subset of the small-cap market – in particular, stocks with high valuations and low profitability. You don't need an economics degree to know that this combination of characteristics is bad for expected returns.

Excluding low-profitability growth stocks – the bottom quartile of companies ranked by operating profits as a percentage of net assets or book equity – substantially improves expected returns from small caps (15.17 per cent annualised for US equities since 1975 compared to 13.95).<sup>7</sup>

The largest and most successful companies of today were small caps once upon a time. A broadly diversified allocation to the small-cap market can help long-term investors capture future winners from today's smaller firms.

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Small caps have outperformed large caps across markets

Annualised compound returns (%)



Source: Dimensional • US Dimensional US Small Cap vs S&P 500 (1928 to 2024) Developed ex US Dimensional International Small Cap vs MSCI World ex USA (gross div) (1970 to 2024) Emerging markets Dimensional Emerging Markets Small vs MSCI Emerging Markets (gross div) (1989 to 2024)

1. Based on the returns of Dimensional US Small Cap Index vs. S&P 500 Index from 1928 to 2025.
2. MSCI All Country World Small Cap Index was 10.8% of MSCI All Country World IMI Index as of December 31, 2025.
3. Based on Fama/French US small cap and large cap indices as of December 31, 2025. Delineation between large and small is the median market capitalization for stocks listed on the NYSE. Details available at [https://mba.tuck.dartmouth.edu/pages/faculty/ken.french/Data\\_Library/det\\_port\\_form\\_sz.html](https://mba.tuck.dartmouth.edu/pages/faculty/ken.french/Data_Library/det_port_form_sz.html)
4. Based on returns of Dimensional US Large Cap Index and Dimensional US Small Cap Index from July 1, 2022, to June 30, 2025.
3. Based on Fama/French US small cap and large cap indices as of December 31, 2025. Delineation between large and small is the median market capitalization for stocks listed on the NYSE. Details available at [https://mba.tuck.dartmouth.edu/pages/faculty/ken.french/Data\\_Library/det\\_port\\_form\\_sz.html](https://mba.tuck.dartmouth.edu/pages/faculty/ken.french/Data_Library/det_port_form_sz.html)
6. Based on returns of Dimensional International Small Cap Index vs. MSCI World ex USA (gross div) from 1970 to 2024, and Dimensional Emerging Markets Small Index vs. MSCI Emerging Markets (gross div) from 1989 to 2024.
7. Based on Dimensional US Small Cap Index vs. Dimensional US Unadjusted Small Cap Index from 1975 to 2024.

**Size premium:** The return difference between small capitalization stocks and large capitalization stocks.

**Valuations:** A measure of the price investors pay for companies' earnings.

**Profitability:** A company's operating income before depreciation and amortization minus interest expense scaled by book equity.

**Aggregate Price to Trailing Earnings Multiple:** The total market value of the companies in a particular category (e.g., small capitalization stocks) relative to their total combined earnings over the past 12 months.

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**Fama/French US Small Cap Research Index:** Courtesy of Fama/French from CRSP and Compustat securities data. Includes NYSE securities (plus AMEX equivalents since July 1962 and NASDAQ equivalents since 1973) with smaller market equity than the median NYSE firm; rebalanced annually in June. Fama/French and multifactor data provided by Fama/French.

**Fama/French US Small Cap Research Index:** Courtesy of Fama/French from CRSP and Compustat securities data. Includes NYSE securities (plus AMEX equivalents since July 1962 and NASDAQ equivalents since 1973) with larger market equity than the median NYSE firms; rebalanced annually in June. Fama/French and multifactor data provided by Fama/French.

**Dimensional Emerging Markets Small Index:** January 1990-present: Compiled by Dimensional from Bloomberg securities data. Market-capitalization-weighted index of small company securities in the eligible markets, excluding those with the lowest profitability and highest relative price within their country's small cap universe. The index also excludes those companies with the highest asset growth within their country's small cap universe. Profitability is defined as operating income before depreciation and amortization minus interest expense divided by book equity. Asset growth is defined as change in total assets from the prior fiscal year to current fiscal year. The index monthly returns are computed as the simple average of the monthly returns of four subindices, each one reconstituted once a year at the end of each quarter of the year. Maximum index weight of any one company is capped at 5%. Countries currently included are Brazil, Chile, China, Colombia, the Czech Republic, Greece, Hungary, India, Indonesia, Kuwait, Malaysia, Mexico, Peru, the Philippines, Poland, Qatar, Saudi Arabia, South Africa, South Korea, Taiwan, Thailand, Turkey, and the UAE. Exclusions: REITs and investment companies. The index has been retrospectively calculated by Dimensional and did not exist prior to April 2008. Accordingly, the results shown during the periods prior to April 2008 do not represent actual returns of the index. The calculation methodology for the index was amended in January 2014 to include profitability as a factor in selecting securities for inclusion in the index. The calculation methodology for the index was amended in November 2019 to include asset growth as a factor in selecting securities for inclusion in the index. Prior to January 1990: Fama/French Emerging Markets Small Cap Index.

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