ABOVE THE FRAY

Does Pursuing Premiums Increase Risk?

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Research shows that diversified equity portfolios can pursue higher-than-market returns by systematically emphasizing stocks with certain characteristics, such as smaller market capitalization, lower price-to-book, and higher profitability. The potential for higher returns sounds nice, but investors may be wondering what tradeoffs this entails.

If the concern is higher volatility than the market, investors may be comforted by what the data tell us. A marketwide US stock index emphasizing small cap, value, and high profitability stocks, such as the Dimensional US Adjusted Market 2 Index, had higher returns than the Russell 3000 Index but a similar standard deviation from January 1979 to June 2024. And pursuing these premiums has not amplified market downturns—the worst 12-month and 36-month returns were similar to those of the Russell 3000 Index.

The primary tradeoff is tracking error, or the extent to which short-term returns differ from the market. Emphasizing stocks with higher expected returns can lead to underperformance relative to the market when premiums associated with these stocks are negative. For example, the worst 12-month period for relative return saw the adjusted market index lag the Russell 3000 Index by about 13 percentage points (0.52% versus 13.54%).

To be clear, potential for deviations from the market is a consideration, but similar volatility to the market implies pursuing premiums doesn't have to widen the range of outcomes for investment performance.

Exhibit 1
Volatility vs. Tracking Error
January 1979–June 2024

	Dimensional US Adjusted Market 2 Index	Russell 3000 Index
Return	13.28%	12.06%
Standard Deviation	15.82%	15.57%
Returns During Worst Absolute Return Periods		
WORST 12 MONTHS	-43.61%	-43.51%
WORST 36 MONTHS	-15.71%	-15.84%
Returns During Worst Periods of Underperformance for Adjusted Market 2 vs. Russell 3000		
WORST 12 MONTHS	0.52%	13.54%
WORST 36 MONTHS	21.61%	27.04%

Past performance is not a guarantee of future results.

In USD. Index data provided by Dimensional and Russell. Returns and standard deviations are annualized. The Dimensional indices represent academic concepts that may be used in portfolio construction and are not available for direct investment or for use as a benchmark. Index returns are not representative of actual portfolios and do not reflect costs and fees associated with an actual investment. See "Index Descriptions" for descriptions of the Dimensional index data. See "Appendix" for corresponding end dates for return periods represented in the chart. Frank Russell Company is the source and owner of the trademarks, service marks, and copyrights related to the Russell Indexes. Indices are not available for direct investment; therefore, their performance does not reflect the expenses associated with the management of an actual portfolio.

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GLOSSARY

Absolute return: The rate of return on an investment over a specified time period.

Market capitalization: The total market value of a company's outstanding shares, computed as price times shares outstanding.

Premium: A return difference between two assets or portfolios.

Price-to-book ratio (P/B): The ratio of a firm's market value to its book value, where market value is computed as price multiplied by shares outstanding, and book value is the value of stockholder's equity as reported on a company's balance sheet.

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

Relative return: The difference between the rate of return of two investments over a specified time period.

Standard deviation: A measure of the variation or dispersion of a set of data points. Standard deviations are often used to quantify the historical return volatility of a security or portfolio.

Appendix: End Dates for Return Periods

	Dimensional US Adjusted Market 2 Index	Russell 3000 Index
Returns During Worst Absolute Return Periods		
Worst 12 Months	2/28/2009	2/28/2009
Worst 36 Months	2/28/2009	3/31/2003
Returns During Worst Periods of Underperformance for Adjusted Market 2 vs. Russell 3000		
Worst 12 Months	3/31/1999	3/31/1999
Worst 36 Months	3/31/2000	3/31/2000

INDEX DESCRIPTIONS

The Dimensional indices have been retrospectively calculated by Dimensional Fund Advisors LP and did not exist prior to their index inception dates. Accordingly, results shown during the periods prior to each index's inception date do not represent actual returns of the index. Other periods selected may have different results, including losses. Backtested index performance is hypothetical and is provided for informational purposes only to indicate historical performance had the index been calculated over the relevant time periods. Backtested performance results assume the reinvestment of dividends and capital gains.

Dimensional US Adjusted Market 2 Index was created by Dimensional in March 2007 and is compiled by Dimensional. June 1927–December 1974: Targets all the securities in the eligible market with an emphasis on companies with smaller capitalization and lower relative price. The eligible market is composed of securities of US companies traded on the NYSE, NYSE MKT (formerly AMEX), and Nasdaq Global Market. Exclusions: non-US companies, REITs, UITs, and investment companies. Source: CRSP and Compustat. January 1975–Present: Targets all the securities in the eligible market with an emphasis on companies with smaller capitalization, lower relative price, and higher profitability, excluding those with the lowest profitability and highest relative price within the small cap universe. Excludes companies with the highest asset growth within the 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 eligible market is composed of securities of US companies traded on the NYSE, NYSE MKT (formerly AMEX), and Nasdaq Global Market. Exclusions: non-US companies, REITs, UITs, and investment companies. Source: CRSP and Compustat. The calculation methodology was amended in January 2014 to include profitability as a factor in selecting securities for inclusion in the index. The calculation methodology was amended in December 2019 to include asset growth as a factor in selecting securities for inclusion in the index.

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