Index investing has flaws. Institutional investors can do better.

Imagine receiving this pitch:
"I have an investment strategy for you.
It aims to provide a rough representation of the market. It is mostly rules-based, with some exceptions.
We have no say in what we buy or sell. We outsource these decisions to another entity.
They will tell everyone what we are going to buy and sell, weeks in advance.
We have no flexibility on timing; we need to trade alongside our competitors exactly when told.
We cannot adjust the portfolio until the entity says so, which could be in 3, 6, or even 12 months.
Finally, this entity has no fiduciary duty to you.
How does that sound?"

This captures the essence of index investing. If an investor were to think of the most efficient way of building a broad market portfolio today, with a blank sheet of paper, it is hard to imagine that they would land on an approach that hinges on an index middleman. Indices were historically designed as barometers, not as investment portfolios. Institutions are now recognising that this model, which is over 50 years old, leaves returns on the table.

Index investing is sometimes conflated with passive investing. This is a misconception. Index investing is just one form of passive investing—one that we believe involves unnecessary shortcuts and rigidities. Rebalancing quarterly or annually is not good enough. Concentrating trading into a few days per year is not good enough. Discarding information about short-term drivers of returns is not good enough.

The cost of these inefficiencies adds up. We estimate the hidden cost of indexing to be 8 to 21 basis points in US all cap equities, a number that exceeds the typical fees paid by institutional investors using index strategies. The impact gets larger as we focus on small caps and look to other markets, reaching 86 to 205 basis points in emerging market small caps.

Dimensional, a $1 trillion systematic active manager, shares some DNA with index investing. Our co-founder, David Booth, was part of the team that designed the very first institutional index funds in the early 1970s—years before the first retail index mutual fund and nearly two decades before the first ETF. In light of the alternatives available historically, index investing has been a net positive for investors.

But we believe it's time for an update. Dimensional already manages over $100 billion in strategies designed to provide market-like exposures. These strategies are diversified, transparent and cost-effective. The philosophy—embracing market prices—is passive, but our implementation is active, free from the challenges and constraints associated with rigidly tracking an index.

In this article, we highlight some of the ways that we have supported institutional investors to go beyond indexation.

Buy the actual market

A couple of exceptions aside, almost all of the 269 broad US equity index funds and ETFs domiciled in Europe track large cap-only indices. In other words, they exclude small caps, which represent around 10% of the market. For investors desiring a true market exposure, ignoring small caps should be viewed as both an uncompensated reduction in diversification and an active bet.

Integrating small caps should be done properly, too, with adequate coverage. That means an eligible universe with a low enough market cap floor. As an example, Dimensional's broadest global all cap strategy counts nearly 15,000 stocks, compared with 10,000 for the closest comparable commercial index.

Besides adding to diversification, including small companies increases expected returns. Even after the exceptional recent run of mega cap stocks in the US, small caps have outperformed large caps in the long run. In developed markets, simulations spanning the past 50 years show a performance advantage of 30 to 50 basis points annualised for all-cap indices over large cap-only indices.

Clean up your exposure

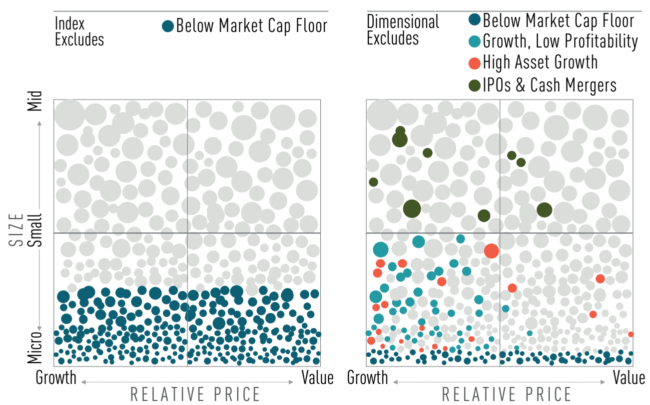
Certain parts of the market have distinctively low expected returns. We believe that excluding them can improve outcomes for investors without a meaningful loss in diversification.

Let's first look within small caps. Valuation theory tells us that companies with high valuations and low or negative expected profits have lower expected returns. In small caps, this group—which represents around five percent of the small cap market, or less than one percent of the total market—has delivered historical returns dramatically lower than the rest of the small cap market. Stocks with high asset growth, an even smaller part of the market, are worth excluding for the same reason.

Cash mergers are another example. When securities are the target of a cash merger, they reach the acquisition price and remain close to this level until the deal completes, creating a cash drag for investors. Avoid doubling down on these stocks.

Another example is initial public offerings (IPOs), which typically underperform over their first year of listing. Assess IPOs on a case-by-case basis. Wait for the expiration of post-offering activities that might impact the price discovery process, instead of buying them when an index tells you to do so.

Exhibit 1: Exclusions within small caps



Use a daily, flexible process

Markets continuously price new information. Most indices, however, rebalance quarterly, semi-annually or annually. For large cap indices, infrequent rebalancing means not owning securities that have migrated from the small or mid cap space. For small cap indices, that means maintaining exposure to stocks that might not qualify as small caps anymore, resulting in style drift. A daily process means that the portfolio holds what it is supposed to hold, reducing opportunity cost.

A daily process also enables a manager to consider short-lived drivers of returns. Momentum, for instance, decays within a few months. Other effects, such as price reversals or the information in securities lending markets (expensive-to-borrow stocks typically underperform), decay within a few weeks.

Finally, a daily process ensures that trading is spread out through the year, helping lower transaction costs. Unless they are prepared to take on tracking error, index funds do not have this luxury. Looking at 10 US indices, we found that index additions outperformed in the month leading to reconstitution by 4.1% on average, only to underperform by 5.7% over the following 20 trading days. To investors forced to buy at the peak, such price pressure should be considered a cost.

Get the most out of securities lending

Besides providing valuable information about short-term differences in expected returns, securities lending markets can provide revenue to participants. That revenue can be material. In emerging markets, for instance, securities lending revenue can offset over one-third of the ongoing charges of a strategy. That is, when done effectively. Investors should ask two questions.

First, how much revenue is generated? Due to operational constraints, index funds may not be able to lend in some of the highest-earning securities lending markets, such as Taiwan and Korea. An index-agnostic, flexible approach has no such issue.

Second, who keeps the revenue? We believe that profits should get back to investors, and that costs should be competitive. A manager using a lending agent from the same parent company might result in a higher lending cost than could otherwise be achieved, effectively creating a shadow management fee.

Consider meaningful tracking error

As discussed earlier, investors should not equate investing in an index-based strategy with getting a passive exposure to the market. Indices are not the market. Different index providers make different choices and cut different corners, leading to tracking error between different indices on the same asset class.

Rather than accepting inadvertent tracking error in this way, investors can be more deliberate. They can decide to marginally deviate from the market if it leads to an increase in expected returns or a reduction in risk. Our Core Equity Market solutions, for instance, put a mild emphasis on smaller, cheaper and more profitable stocks while keeping a link with market prices.

Exhibit 2: Annualised tracking error, Jan. 2006-Dec. 2025

	S&P 500	Dimensional US Core Equity Market
vs. S&P 500	-	1.6%
vs. MSCI USA	0.6%	1.4%
vs. Russell 1000	0.8%	1.1%
vs. MSCI USA IMI	1.3%	0.8%
vs. Russell 3000	1.3%	0.7%

To learn more

Index funds get big decisions right. Diversification should be high. Fees, turnover and monitoring costs should be low.

But low fees do not mean low total cost of ownership. And low turnover does not necessarily mean effective implementation. Tying oneself to an index means leaving returns on the table. A better approach is available—one that bypasses the index middleman. In an age when index strategies form large parts of institutions' allocations, every basis point saved matters.

Dimensional is driven by research and evidence. Please do not hesitate to contact us if you would like to see some of the underlying research papers and empirical studies that have helped other institutions consider this important topic.

Eric Geffroy is an Investment Director and leads Dimensional's EMEA Investment Solutions Group (eric.geffroy@dimensional.com)
Andy Taylor is a Regional Director, leading Dimensional's UK Institutional and Consultant Relations business (andrew.taylor@dimensional.com)

Dimensional

Exhibit 1: For illustrative purposes only. Index exclusions shown are illustrative only and are meant to demonstrate how a broad market index may refine the total investable universe. Companies are plotted on market capitalisation (vertical axis) and price-to-book (horizontal axis), and the size of the dots is proportional to companies' market capitalisation. Profitability is measured as operating income before depreciation and amortization minus interest expense scaled by book. Growth, Low Profitability refers to companies with the lowest profitability and highest price-to-book. High Asset Growth refers to companies with high asset growth.
Exhibit 2: In USD. "Dimensional US Core Equity Market" refers to the Dimensional US Core Equity Market Index, a broadly diversified index that implements Dimensional's exclusions and puts a mild emphasis on size, value and profitability. More information is available upon request. 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. Indices include gross dividends. Indices are not available for direct investment; therefore, their performance does not reflect the expenses associated with the management of an actual portfolio.