



How Allocators Unintentionally Limit Active Small Cap Performance

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Introduction – Institutional Investors Often Miss the Active Small Cap Opportunity

The benefits of active management in small and microcap are well defined given the inherent inefficiency within this arena of equity markets. For instance, over 70% of small cap strategies outperformed their benchmark over the trailing 10-year period in eVestment’s developed and emerging markets universes as of 12/31/25. Additionally, the median manager return is ahead of the respective style benchmark in 80% of the small cap style universes. ¹

Although the significant history of manager success in small and microcap makes the case for active management compelling, many institutional allocators are disappointed by their small cap investments having fallen short of the excess return potential. Over time we’ve consistently observed behavioral biases and well-intended but suboptimal processes inhibit allocators’ ability to exploit inefficiencies in small cap markets. Instead, ‘buy-high and sell-low’ tendencies are driven through a confluence of timing, market cycles and decision execution. In our experience, avoiding common return-eroding behaviors through a dedicated managed portfolio comprised of differentiated active managers improves small and microcap return capture over the medium and long term.

This paper addresses the challenges allocators face navigating small and microcap markets and outlines how the multi-manager investment framework improves investor outcomes.

By combining unique expertise, diverse skillsets and an opportunistic investment framework, while overlaying continual oversight, we believe a multi-manager portfolio improves the probability of consistent excess returns over a market cycle with less risk than a single manager approach.

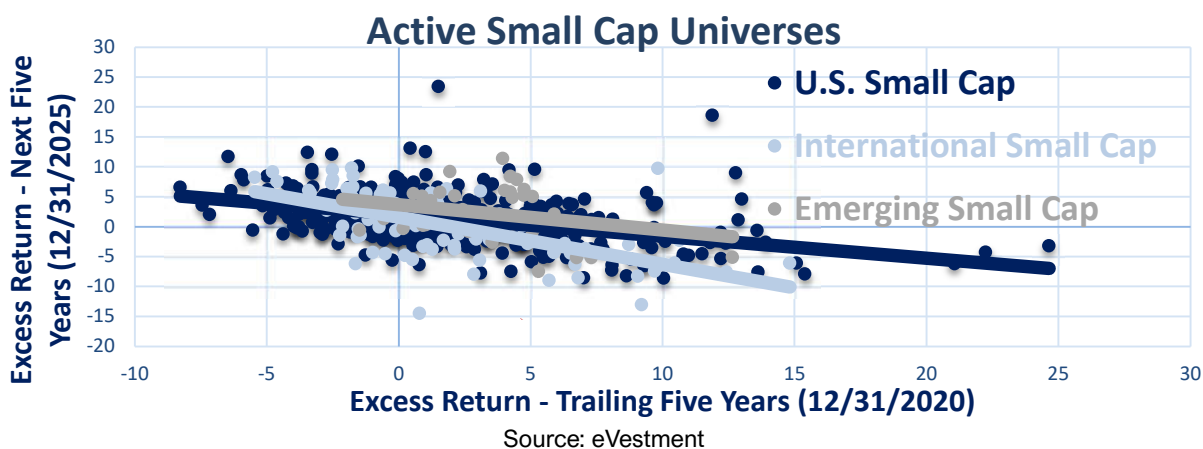
¹ In past Acuitas research papers, such as ‘The Case for Microcap’, we explored the sources of these inefficiencies: <https://acuitasinvestments.com/insights-whitepapers/>

Behavioral Biases: Performance Chasing and the Lane Changing Tax

One well-documented behavioral bias impacting institutional investors is performance chasing and arriving on the wrong side of mean reversion. Like commuters trying to navigate a traffic jam by jumping from lane to lane, endlessly trying to gain an advantage by sliding into a faster lane just as it slows to a crawl, investors can also find themselves falling victim to the ‘lane changing tax’. Institutional asset flows consistently draw from underperforming managers to ‘top of the box’ managers with stronger trailing returns, often just as the market environment shifts, resulting in a performance shortfall from the recently hired manager. To assess how effective the average investor has been at allocating to small cap managers, we reviewed investor mandate changes for institutional small cap asset managers over the period 2016 to 2025. During that time, institutional investors hired strategies ranking in the top quartile of their respective universes based on trailing 5-year performance approximately 60% of the time. Over 80% of new allocations went to strategies ranking above the median peer over the same trailing period. The behavior was consistent for terminations, as over half of the terminated strategies ranked in the bottom quartile over the trailing five years and over 90% of terminated strategies ranked below the median peer.

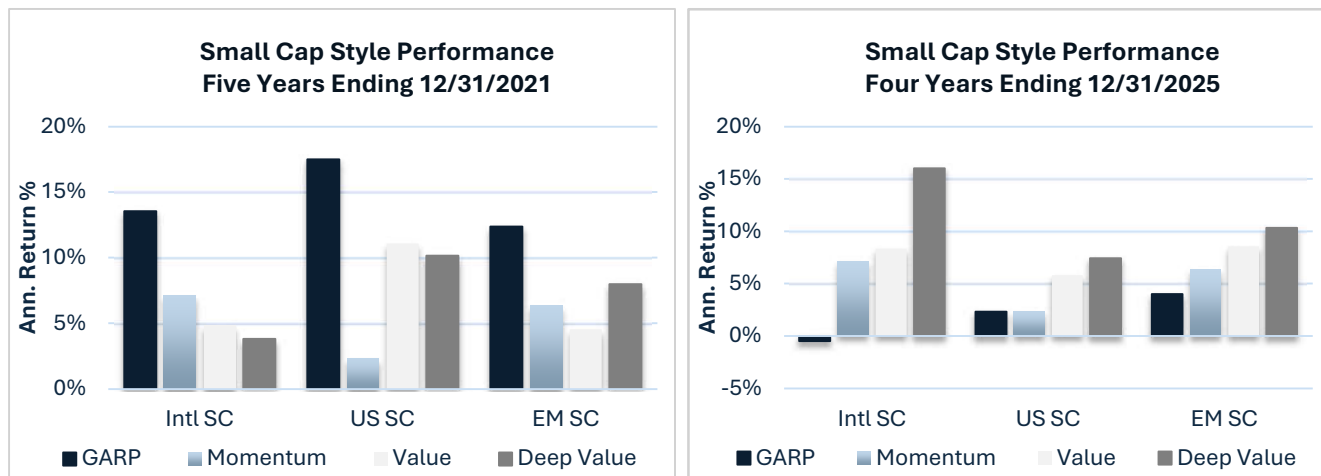
Unfortunately, the allocation behaviors cost allocators returns. We reviewed the performance of specific small cap reallocations over the past decade and found that newly hired small cap strategies trailed the performance of the strategy they replaced by over 2% annually over the next five years. Newly hired small cap strategies also trailed the median peer by over 1% during that period. The historical experience aligns with a simple simulation across the universe of small cap managers. Using fifteen years of data, a ‘buy top quartile - sell bottom quartile’ allocation strategy in small cap underperforms over the ensuing five years by an average of approximately 1.5%.

The charts below provide a scatter plot of managers’ trailing 5-year excess returns versus the following 5-year excess returns for the U.S., non-U.S. developed, and emerging markets small cap universes.



The data demonstrates that screening on past performance as a selection criterion is suboptimal. Despite being well versed in the power of mean reversion and the dangers of performance chasing, all investors, including the most experienced, are prone to trend-following behavior.

Today we are seeing these behavioral biases play out in real time in the world of small caps. From 2015 to 2021, institutions allocated heavily to quality-growth strategies (labeled GARP below) and away from value-oriented strategies. With strong performance and headlines promoting their success, search activity favored quality-growth strategies and assets grew.



Source: eVestment, Acuitas

When interest rates later rose and the market environment changed, leadership flipped, resulting in a period where on average, quality growth strategies performance was nothing short of terrible versus other investment styles by the end of 2025. In early 2026 we saw headline after headline of allocators terminating their quality-growth managers, most often replacing them with managers that invest using very different and recently successful, styles of investing.

Over the course of our collective careers, we have often seen similar scenarios, with investors chasing value strategies in the mid-90s, then growth strategies late in the tech bubble. This was followed by crowding into quantitative managers (often magnifying the exposure through leverage) just before the ‘quant meltdown’ of 2007, and back to value managers leading up to the Great Financial Crisis. This herding behavior has repeatedly proven counterproductive.

Decision Making Processes: Unintended Consequences

Institutional investors often employ risk-oriented parameters, like minimum asset thresholds and longevity of track record to streamline decision making. However, some of these parameters are counter-productive in capacity constrained areas like small and microcap.

With over 1000 small and microcap strategies listed in eVestment, it's easiest to cull the list by screening on readily observable metrics like an arbitrary minimum product asset threshold. However, asset growth is arguably the leading disruptor of a skilled small cap manager's ability to generate excess returns. Using our observations over the past five years of typical asset level hurdles used in institutional small cap searches, we calculated the impact on performance from using these screens. As we have written in multiple white papers, strategies with lower asset bases, that are often eliminated from searches due to asset level requirements, have performed significantly better than those that meet the asset threshold.

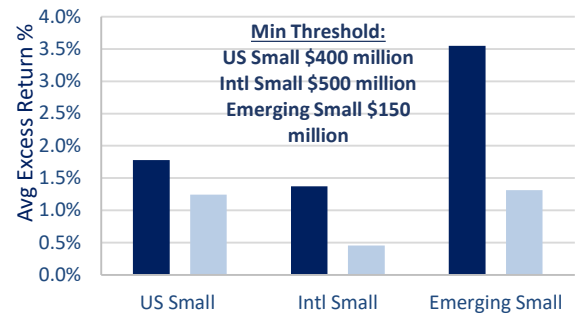
On the surface, the screens and biases embedded in institutional investors' processes make intuitive sense. All else equal, it is understandable that allocators prefer strategies with a history of delivering excess returns. Relying on large, well-resourced strategies in use by many other respected allocators provides comfort and perceived safety. Unfortunately, these preferences also result in headwinds that hurt returns, as can be observed in the chart above. Even when allocators are aware of these headwinds and seek to overcome them, there are often structural barriers such as board approvals and consultant recommendations that can be extremely difficult to overcome. It begs the question, why aren't allocators able to overcome these negative biases?

- **Perceived Safety:** Despite the fact that the biases outlined above result in worse returns, they do provide a sense of security. It feels like a smarter bet to hire a large, brand name manager with a sizeable asset base, and there is a sense of safety in numbers. In addition, there may be career risk in going against the herd and selecting a strategy with poor recent performance and/or less recognition. Not all smaller strategies are good investments, nor should allocators always select recent underperformers, but we believe avoiding artificial constraints can improve returns. Investors should include smaller strategies and those that have faced recent performance headwinds in their allocation considerations because they present a richer opportunity set when seeking powerful future returns.
- **Decision-Making Dynamics:** In most cases, in order for investment professionals to propose a product for inclusion in an institutional portfolio they must work through several layers of decision-makers – their immediate team, the investment committee, the board – with each layer moving the decision further away from the people with the most intricate understanding

Avg Excess Return: Below & Above Asset Min

10 Years Ending 12/31/2025

■ Below Min Threshold ■ Above Min Threshold



of product specific strengths and performance drivers. While a level of oversight is necessary, every additional layer of decision-making increases the distance from the point of greatest insight. The less directly involved a decision maker is in building a detailed knowledge of the product and the peer universe, the more likely they are to lean on the perceived safety of assets, performance, and a brand name, unintentionally sabotaging their team's work. These issues are particularly challenging in a group setting with multiple layers where confirmation bias and bandwagon effects tend to be amplified.

- **Limited Resources - Teams are Spread Thin:** The overwhelming majority of investment research teams we come across are challenged with broad coverage responsibilities. To keep their heads above water, professionals seek efficiencies. Again, asset hurdles and track record requirements, used to pare down the universe of managers, seem like reasonable tools, absent an understanding of how damaging they are to future returns. Unfortunately, there is no 'cheat code' to efficiently optimize manager universes, although in our experience a good place to start is doing exactly the opposite of what feels comfortable on the surface. We sympathize with teams grappling with limited resources, as they are stuck between a rock and a hard place. In contrast, Acuitas intentionally focuses only on small and microcap markets, allowing broader and deeper coverage of the least efficient investment universe, where depth and specialization are most impactful.
- **Narrow Investment Framework:** It can be incredibly difficult to achieve a well-balanced portfolio in certain asset classes. Allocators may think they've achieved portfolio balance by using a value and a growth manager, but there are dramatically different investment approaches within each style. Substyles come in and out of favor, sometimes dramatically, as demonstrated above with the quality-growth managers. For example, the one-year performance differential within international small cap growth managers is over 90% as of 3/31/2026! Even 'all weather' strategies go in and out of favor, which can be particularly hard to tolerate. Periods of underperformance are inevitable over a market cycle and will test investors' patience. In our experience, it is very different to theoretically understand a product's underperformance potential versus experiencing it in real time. Typically, allocators run out of patience before the natural investment cycle comes back into a specific product's favor, leading to the pattern of exiting products right before the cycle turns.

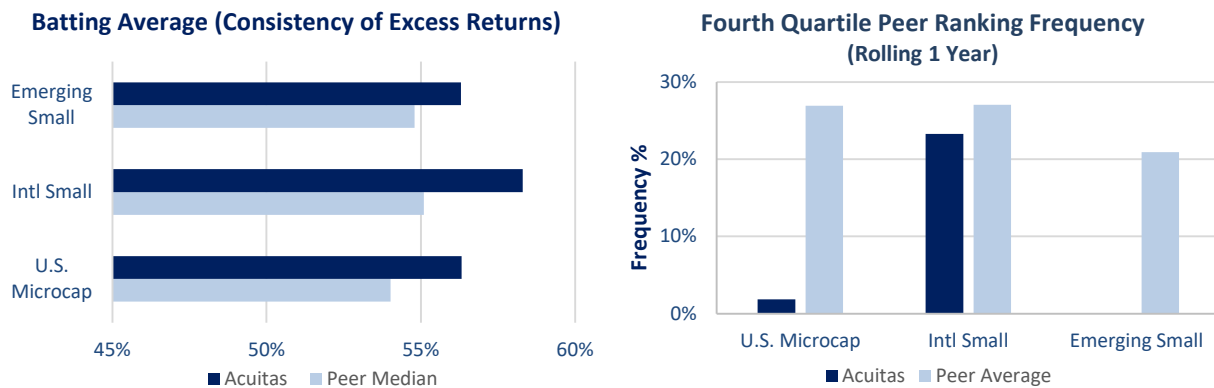
A Sound Multi-Manager Process Overcomes These Challenges

As small and microcap specialists, Acuitas continuously seeks to capture known performance drivers, thereby 'setting the winds at our back' to improve clients' ability to attain more consistent excess returns. We have tailored our multi-manager investment framework to avoid the obvious headwind and exploit other investors' behavioral biases.

- **Avoid Artificial Constraints:** Over the long term, being comfortable is mutually exclusive from being excellent. The comfort gained from simplistic screening based on assets under management and/or recent performance is no substitute for depth and breadth in manager due diligence research. In fact, it is counterproductive, leading to a pool of products less likely to meet performance expectations going forward. Acuitas' investment process intentionally avoids such constraints, maintains an open-mindedness, and emphasizes broad idea generation. We explicitly seek lower asset products that are often in the 'sweet spot' of their performance life cycle. Further, instead of employing screens to narrow the universe, we rely on our comprehensive manager due diligence research to identify high quality, skilled managers where we have confidence in their ability to outperform going forward and we have the investment autonomy to hire them.
- **Efficient Decision-Making:** All Acuitas investment professionals are involved in research, portfolio construction, and manager decisions for client portfolios. This minimizes the distance between the point of greatest insight (manager due diligence research) and final decision-making on product selection. The result is improved investment process execution, with the ability to be nimble and opportunistic in manager selection thus avoiding slippage in decision-making. Our clients appreciate that we can hire managers and upgrade portfolios efficiently, without having to navigate cumbersome decision-making processes that can dilute selection insights and delay decisions.
- **Focus:** By focusing on a specific segment of the investment universe (small and microcap) and having a robust and experienced investment team, we are well-resourced and able to provide unique expertise. This allows us to always keep a close eye on all aspects of our investment process. We can spread the net wide when it comes to idea generation, develop a nuanced understanding of managers' investment processes and expected return patterns, and continuously look for ways to upgrade portfolios, ideally before issues show up through underperformance. In this way, we effectively act as an extension of our clients' staff, providing small and microcap expertise so clients can focus their attention efficiently elsewhere.
- **Effective Portfolio Balance:** Having an array of products with complementary risk and return drivers improves the odds and consistency of outperforming over a market cycle. Multi-manager strategies are less reliant on a single manager's success and represent more balanced exposures. Extensive due diligence research improves the ability to understand headwinds and tailwinds that various strategies will experience over market and life cycles. The multi-manager portfolio will tend to have a mix of winners and losers. Invariably, the magnitude and duration of underperformance will test one's patience, but a nuanced understanding of each product's role in the portfolio improves decision making and enables patience when warranted, while driving portfolio upgrades when competitive advantages have eroded. The net result is higher risk-adjusted return potential.

Concluding Remarks

The appealing excess returns associated with investing in active small and microcap strategies can be difficult to realize due to inherent behavioral biases, cumbersome decision-making processes, and a lack of dedicated resources. Acuitas’ multi-manager approach addresses allocation challenges through its focus, extensive ongoing manager due diligence, efficient decision-making, avoidance of counter-productive constraints, and the enforcement of a disciplined framework for manager selection and portfolio construction. The end result – more consistent outperformance – is demonstrated in the charts below that show the frequency of Acuitas outperformance versus the peer universe, as well as the infrequent periods of fourth quartile performance.



Source: eVestment. Data reflects since inception of Acuitas Composite strategy as of 12/31/25. Inception Dates: Acuitas US Microcap July 2011, Acuitas International Small Cap January 2013, Acuitas Emerging Markets Small Cap July 2015. eVestment Manager Peer Universes: US Microcap Equity, ACWI ex-US Small Cap Equity, and Global Emerging Markets Small Cap Equity.

Acuitas multi-manager portfolios, built to perform throughout a market cycle, have delivered **more consistent excess returns than the average peer and a lower incidence of fourth quartile peer rankings** thus, increasing the chances of clients realizing the return premium associated with active small and microcap.



Disclosures

Performance

Past performance is not a guarantee of future returns. Investing in securities involves risk of loss that investors should be prepared to bear. Investments in small and microcap companies may be less liquid and prices may fluctuate more than those of larger, more established companies.

Investment Strategy

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