

U.S. Small Cap Investing Redefined

Capturing Upside while Defining Risk in U.S. Small Cap Equities



[Marc Odo](#), CFA®, CAIA®, CIPM®, CFP® | Mar 29, 2016 | [Swan Blog](#)

“Families are always rising and falling in America.”

- Nathaniel Hawthorne, *The House of Seven Gables*

What Hawthorne said about American families can just as easily be applied to American companies. The table below contains snapshots of the top twelve holdings of the S&P 500 over the last several decades¹.

12/31/2015		12/31/2005		12/31/1995		6/30/1985	
Apple Inc	3.27	General Electric Co	3.28	General Electric Co	2.60	International Business Machines Corp	5.53
Microsoft Corp	2.47	Exxon Mobil Corporation	3.10	AT&T	2.23	Exxon Mobil Corporation	3.14
Exxon Mobil Corporation	1.81	Citigroup Inc	2.18	Exxon Mobil Corporation	2.15	General Electric Co	2.05
General Electric Co	1.64	Microsoft Corp	2.12	Coca-Cola Co	2.02	AT&T	1.72
Johnson & Johnson	1.58	Procter & Gamble Co	1.72	Merck & Co Inc	1.76	Motors Liquidation Co GUC Trust	1.67
Amazon.com Inc	1.45	Bank of America Corporation	1.64	Altria Group Inc	1.65	Amoco	1.30
Wells Fargo & Co	1.41	Johnson & Johnson	1.59	Royal Dutch Shell PLC ADR Class A	1.64	Ned Petroleum	1.16
JPMorgan Chase & Co	1.35	American International Group Inc	1.57	Procter & Gamble Co	1.23	Atlantic Richfield	1.07
Facebook Inc A	1.32	Pfizer Inc	1.52	Johnson & Johnson	1.20	E.I. du Pont de Nemours & Co	1.03
Berkshire Hathaway Inc B	1.28	Altria Group Inc	1.38	International Business Machines Corp	1.13	Sears Roebuck & Co	1.03
Alphabet Inc A	1.26	Intel Corp	1.33	Microsoft Corp	1.12	Chevron Corp	0.94
Alphabet Inc C	1.26	JPMorgan Chase & Co	1.23	Wal-Mart Stores Inc	1.11	BellSouth Corp	0.92

Source: Morningstar Direct

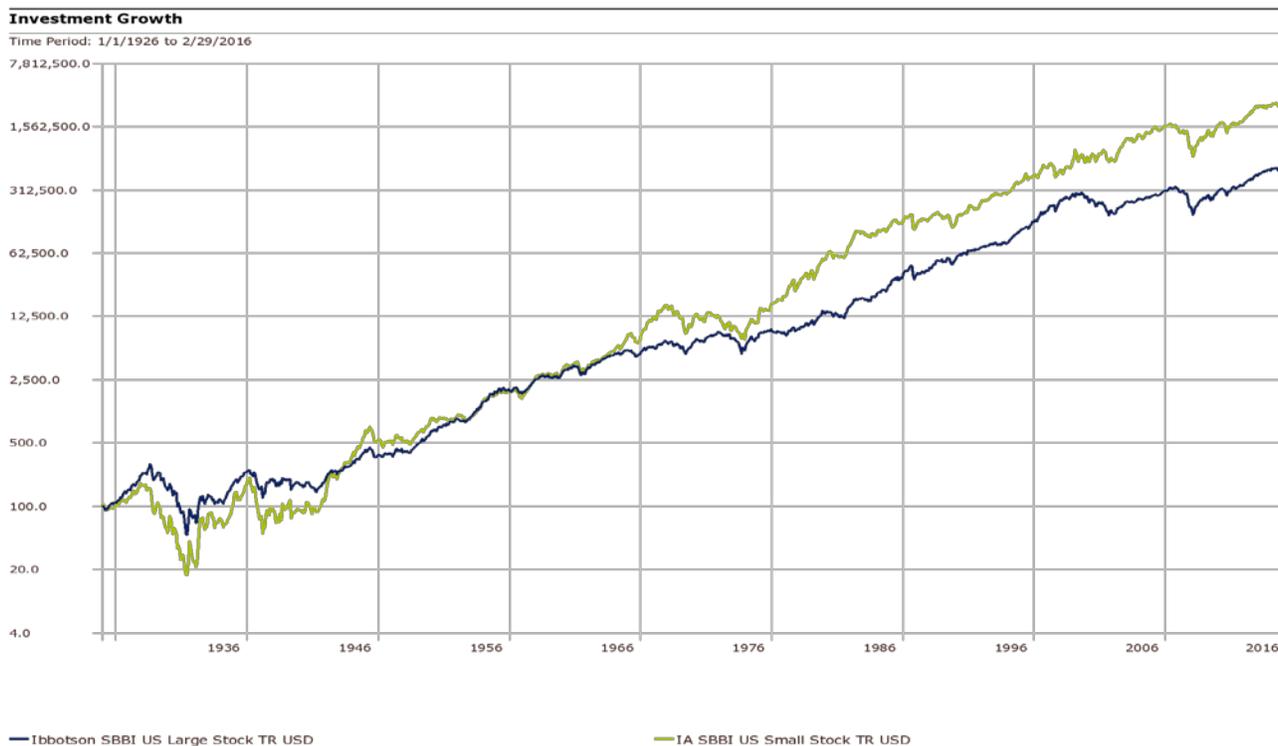
I'd like to interpret this table as evidence of the dynamic nature of the American economy. Joseph Schumpeter's "creative destruction" is on display, as the young and hungry supplant the old and staid. Not only are some of today's largest companies less than a decade or two old, they operate in industries that did not

¹ Source: Morningstar Direct. Top twelve holdings of Vanguard 500 Index fund (VFINX) used as proxy for S&P 500.

even exist 10-20 years ago. Contrast our economy with that of, say, France, where the youngest company in the CAC 40 Index was founded in 1967².

Of course, none of these companies started out on the top of the tables. Whether ten years old or a hundred years old, every large company started off as a small company. According to a recent piece in *The Atlantic*³, Richard Foster of the Yale School of Management stated that the average lifespan of a company in the S&P 500 fell from 67 years in the 1920's to just 15 years today. Moreover, Foster predicts that by 2027 nearly 75% of the companies in the S&P 500 today will be replaced by new firms.

Those with a long-term time horizon willing to invest with the up-and-coming segments of the economy have been rewarded. According to Morningstar/Ibbotson's data, since 1925 small caps have averaged almost 2% more per year versus large caps. Academics have explored this "small cap premium" in great detail.



Source: Morningstar Direct

Source: Morningstar Direct. Graph is shown on a log scale.

² Excluding mergers. Source: <http://www.economist.com/news/europe/21670059-what-happens-when-left-wing-politicians-confront-new-technologies-leaders-driverless-cars>

³ <http://www.theatlantic.com/business/archive/2015/04/where-do-firms-go-when-they-die/390249/>

The downside, however, is that higher returns are coupled with higher risk. Many smaller companies will never become large companies, and many will die along the way. During periods of market turbulence small caps tend to have higher volatilities and drawdowns than their large cap cousins.

Date Range Jan 1925 – Feb 2016	Return (annualized)	Standard Deviation
Ibbotson SBBI US Large Stock TR	9.93%	18.84%
Ibbotson SBBI US Small Stock TR	11.88%	28.52%

Source: Morningstar Direct

Redefining U.S. Small Cap Investing

With both the upside potential and downside risks in mind, Swan Global Investments has recently applied the [Defined Risk Strategy](#) to small cap stocks. Since 1997 Swan has successfully remained invested in large cap companies while mitigating the downside risks via the intelligent and efficient use of options. Conceptually, the Defined Risk Strategy can be applied to any asset class with an investable exchange traded fund (ETF) and liquid enough options on the ETF, whether S&P 500, [emerging markets](#), foreign developed markets or others. Applying the DRS to other asset classes is explored in detail in the recent white paper “[Diversifying with the Defined Risk Strategy](#).”

No one knows what companies or industries might be born, evolve, or dominate our economy over the next ten or twenty years. Twenty years ago most people wouldn't have been able to conceive of social media, the iPhone or Amazon Prime, yet today many people couldn't imagine life without them. With small cap stocks investors have early exposure to the leaders of tomorrow.

See how the Defined Risk Strategy is applied to [U.S. Small Cap stocks](#) or for more information on the strategy call 970.382.8901.

About the Author:



Marc Odo, CFA®, CAIA®, CIPM®, CFP®, Director of Investment Solutions, is responsible for helping clients and prospects gain a detailed understanding of Swan's Defined Risk Strategy, including how it fits into an overall investment strategy. Formerly Marc was the Director of Research for 11 years at Zephyr Associates.

Important Disclosures:

Swan Global Investments, LLC is a SEC registered Investment Advisor that specializes in managing money using the proprietary Defined Risk Strategy ("DRS"). SEC registration does not denote any special training or qualification conferred by the SEC. Swan offers and manages the DRS for investors including individuals, institutions and other investment advisor firms. Any historical numbers, awards and recognitions presented are based on the performance of a (GIPS®) composite, Swan's DRS Select Composite, which includes nonqualified discretionary accounts invested in since inception, July 1997, and are net of fees and expenses. Swan claims compliance with the Global Investment Performance Standards (GIPS®). All data used herein; including the statistical information, verification and performance reports are available upon request. The S&P 500 Index is a market cap weighted index of 500 widely held stocks often used as a proxy for the overall U.S. equity market. Indexes are unmanaged and have no fees or expenses. An investment cannot be made directly in an index. Swan's investments may consist of securities which vary significantly from those in the benchmark indexes listed above and performance calculation methods may not be entirely comparable. Accordingly, comparing results shown to those of such indexes may be of limited use. The adviser's dependence on its DRS process and judgments about the attractiveness, value and potential appreciation of particular ETFs and options in which the adviser invests or writes may prove to be incorrect and may not produce the desired results. There is no guarantee any investment or the DRS will meet its objectives. All investments involve the risk of potential investment losses as well as the potential for investment gains. This analysis is not a guarantee or indication of future performance. Prior performance is not a guarantee of future results and there can be no assurance, and investors should not assume, that future performance will be comparable to past performance. All investment strategies have the potential for profit or loss. Further information is available upon request by contacting the company directly at 970.382.8901 or visit swanglobalinvestments.com 059-SGI-031516