

Small-Cap Investors: Hang On!

Published May 4, 2017

Christopher Gannatti, CFA

Global Head of Research

We've all probably seen the "mountain charts" that litter investment marketing material of all sorts. If we had only had a few thousand dollars to put to work decades ago, we would have done quite well.

However, the reality for most investors is that drawdowns—specifically, periods where drawdowns cause significant declines in account values—cause them to become emotional and many sell out of strategies at the worst times.

Our friend Meb Faber [tweeted](#): "Small caps basically have a 20% drawdown every year. No wonder it's so hard to buy and hold stocks... (via @LeutholdGroup)."

One of the questions for the small-cap premium is: why should small caps theoretically deliver higher returns than large-cap stocks? Perhaps their higher drawdowns cause people to underprice small-cap stocks due to not being able to stomach their higher volatility.

If we can use the factors—often discussed of late—with a focus on mitigating the risk of large drawdowns, we believe that the end result is a more confident base of investors who can stay the course on their adopted strategies for longer periods of time.

Small-Cap Stocks—the Quintessential Long-Term Strategy

If holding equities over long periods of time has generated strong historical returns, holding small-cap equities has done even better. Looking at the smallest 30% of stocks from June 30, 1963, to February 28, 2017, there was an average annual return of 12.13%, or about 2% per year ahead of the broader market.¹ It may not sound like much, but on an initial hypothetical \$1,000, this difference in wealth accumulation equated to over \$286,000—yet another illustration of the power of long-term compounding of returns.

Small Caps Have Been Far from "Tame"

Showing how the drawdowns for small caps indeed have made it tougher for investors to hang on:

- Over the 53 nonoverlapping calendar year periods, 43 of them saw drawdowns of 10% or more in small caps. To put this in context, the market had drawdowns of 10% or more only 28 times.
- Nineteen years saw drawdowns of 20% or more. For the market, this figure was 13 years.
- Eleven years saw drawdowns of 30% or more—this was approximately a quarter of the total number of calendar years. For the market, this figure was four years.

Two bottom line conclusions come from these results:

1) If we assume drawdowns have important psychological impacts on investors, small-cap stocks have been much more “stressful” than the broad market.

2) Strategies built to mitigate the pain experienced by small-cap investors could be that much more noticed and appreciated, because it is more stressful to hold them for the long haul.

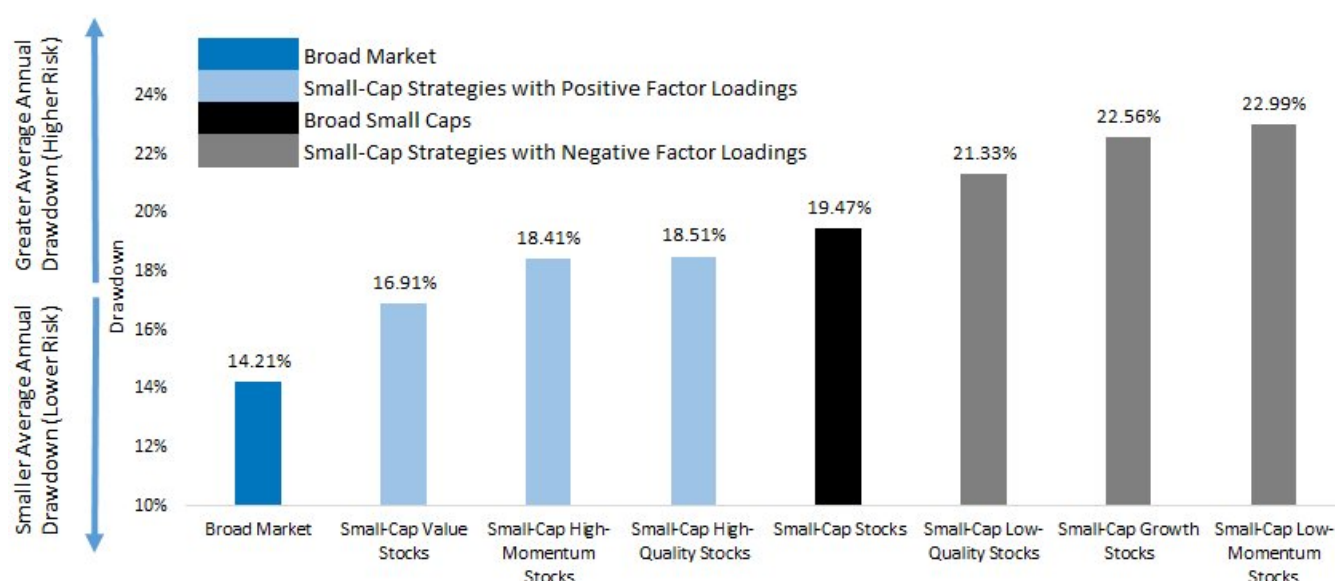
How Smart Beta Factors May Help with Longer Small-Cap Equity Holding Periods

Data allows us to shift from looking at the behavior of small caps broadly and focus on small-cap value, small-cap high quality and small-cap high momentum. Each of these strategies starts with a focus on small-cap stocks and then applies a tilt toward a factor investment strategy.

The crucial question regards whether these premiums reduced the average drawdown experienced by small caps broadly, and an additional focus of interest is on the differences between small-cap value and small-cap growth, small-cap high quality and small-cap low quality, and small-cap high momentum and small-cap low momentum.

How Effective Were Smart Beta Tilts at Mitigating Maximum Drawdowns?

Average Annual Drawdown Differentials



Sources: WisdomTree, Kenneth French Data Library. Period includes calendar years between 6/30/1963 and 2/28/2017. Broad market refers to all U.S. publicly listed equities. Small-cap stocks are those in the bottom 30% of the total market capitalization of U.S. listed stocks. Within the strategies with positive or negative factor loadings, small caps are stocks below the median market capitalization of U.S. listed stocks. Stocks with positive factor loadings refer to those in the highest 30% on the basis of a particular measure (value, momentum, quality) and stocks with negative factor loadings refer to those in the lowest 30% on the basis of the same respective measures.

- **How Important Were the Factors?** The way we think about this is to take a factor tilt and then observe the opposite and see the impact. Small value and small growth are an example of such a pairing, and the data showed that small value, on average, mitigated maximum drawdowns versus small growth to the tune of about 5.7%. We saw similar results in looking at small high quality versus small low quality and small high momentum versus small low momentum, albeit to not quite the same degree as small-cap value vs. small-cap growth.
- **Did Factor Tilts Beat the Market?** Small value also tended to, on average, exhibit drawdowns 2.6% less than a broad exposure to small caps. In fact, tilting toward higher quality or momentum also tended toward less-severe drawdowns than small caps broadly.

Why WisdomTree Focused on Fundamentals

For more than 10 years, WisdomTree has been focusing on small caps through the lens of dividends and earnings—the [WisdomTree SmallCap Dividend Index](#) and the [WisdomTree SmallCap Earnings Index](#). Further innovation in 2013 led to the development of the [WisdomTree U.S. SmallCap Quality Dividend Growth Index](#). We've shown in prior posts that, to varying degrees, these Indexes tap into “small value” and “small quality.” We've designed them with a focus toward long-term, strategic holdings that attempt to help mitigate the risk of severe drawdowns, thereby helping investors deal with the realities of behavioral finance.

¹Source: Kenneth French Data Library. Data is from 6/30/1963 to 2/28/2017. Smallest 30% of stocks refers to stocks within the smallest 30% of the total market capitalization of the U.S. listed equity market. Broader market refers to all publicly listed U.S. equities.

Important Risks Related to this Article

Investments focusing on certain sectors and/or smaller companies increase their vulnerability to any single economic or regulatory development.