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Small-cap funds are all the rage now but should you buy them?

Investors need to know that the small-cap category is flourishing because of the base effect

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Small-cap funds have suddenly become the darling of Indian investors. That is, if you go by data released by the Association of Mutual Funds of India (Amfi). The data explicitly states that small-cap funds, among all categories, were the biggest beneficiaries of a huge inflow of funds in the last six months.

Small-cap funds started gaining momentum in March after they delivered eye-popping returns to existing investors. Soon, the category featured on various trending sections of fintech brokers such as IndMoney, Groww, Kuvera, and Paytm Money. Then, herd mentality took over. Investors rushed in and started pouring their savings into the small-cap category.

“When any mutual fund category begins to deliver stellar returns, there is usually a heavy inflow into that category,” said Arun Kumar, head of research at Chennai-based FundsIndia. In this case, the category delivered high returns largely due to the base effect. It had suffered the most during the market crash of 2018-19 and the covid pandemic years.

Small-caps are generally more volatile than large- and mid-cap segments. So, when the markets slumped in 2020, small caps took a bigger hit. Thereafter, when the markets started rebounding, small-cap stocks shot up and people sat up and took notice.

“Most investors look at one-year or three-year returns but if you take the returns from 2018 levels, they aren’t that great,” said Kumar.

To be sure, while companies like Value Research and Morningstar assign ratings to mutual funds, retail investors tend to focus more on past returns than expert ratings.

However, the inflows coming into small-cap funds on the back of past performance is not always a good sign for the category. For one, smaller market cap companies have lower liquidity compared to large companies. This means that higher inflows could drive up their prices and make valuations unattractive. Two, the huge inflows into small and micro-cap stocks can come back later to haunt investors when the cycle turns and exerts redemption pressure.

“It is also important to see if the small-cap fund has outflow pressure. When there is redemption pressure, you need to be a lot more careful,” said Kumar. “We should actively monitor the pace and quantum of such outflows.”

It is in this context that Chandraprakash Padiyar, the fund manager of Tata Small Cap Mutual Fund, took a call recently to temporarily stop accepting further lump sum investments into the small-cap fund. Padiyar told *Mint* that the heavy inflows in the last couple of months made it difficult for the fund house to deploy additional funds without driving up stock prices. As a result, the cash level of Tata’s small-cap fund rose to 15% compared to an average 10%.

“Any stock that we buy, we want to add to it gradually but when you are getting five times the inflow of what you were getting every day, the cash level keeps going up and this starts impacting the performance of the fund at some point,” said Padiyar.

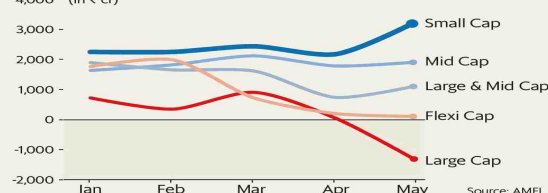
He added that if a lot of money starts

Are small-cap funds getting overvalued?

Investors are flocking into small-cap funds due to extraordinary past performance but valuations are now on the higher side. Tata Small Cap MF and Nippon India Small Cap Fund temporarily closed fresh lump sums, citing difficulty in deploying funds

Net Inflow in MF categories

4,000 - (In ₹ cr)



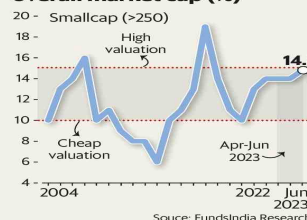
PE Ratio* of Nifty Smallcap 250 Stocks



Trending MF schemes on fintech apps

INDMoney Trending funds	Kuvera Investor choice	Paytm Money Top rated funds	Groww Sort by popularity
Quant Small Cap	HDFC Small Cap	Quant Small Cap	Quant Small Cap
Nippon India Small Cap	Quant Small Cap	Quant Infrastructure Fund	Quant Infra Fund
HDFC Flexi Cap Fund	HDFC Mid Cap opportunities	Nippon India Small Cap	ICICI Prud Commodities
Axis Small Cap	Tata Small Cap	Canara Robeco Small Cap	Nippon India Small Cap
SBI Small Cap	Nippon India Small Cap	ICICI Pru Small Cap	Canara Robeco Small Cap

Small-cap share in overall market cap (%)



Before stopping inflows, fund managers normally do three things

1. Increase cash and cash equivalents	2. Increase the number of stocks	3. Increase allocation toward large & mid-cap
Average	Average	Average
In May	In May	In May
Nippon Smallcap	Cash level (in %)	No. of stocks
SBI Smallcap	2.4	168
HDFC Small Cap	3.5	171
Axis Small Cap	15.1	52
DSP Small Cap	16.5	52
	7.7	72
	7.9	72
	15.6	84
	11.7	90
	4.7	72
	4.9	73
		29.8
		27.9
		16.9
		16.5
		11.3
		10.5
		18.9
		20.4
		12.6
		11.8

chasing stocks, it can lead to higher valuations of these stocks and reduce returns in the future. “So it makes sense to wait for some time and let things settle down,” said Padiyar. “We are hoping to deploy this excess cash in the next 1-2 months, but only when we deploy this cash will we think about opening our fund.”

The largest small-cap fund, run by Nippon India Life Asset Management, has also halted fresh inflows with effect from 7 July, pointing to the difficulty in deploying funds.

Kumar said there are a few ways to check if a small-cap fund is having difficulty in deploying its funds. Typically, fund managers have three options before stopping inflows. They can increase its cash and cash equivalents component; increase the number of stocks held; or allocate more money to large and mid-cap stocks.

He said that these metrics should be looked at on a fund-to-fund basis and not the category as a whole. This is because unlike the large-cap category, where schemes have a large overlap of holdings, the small-cap category has a much wider pool to choose from and hence, each small-cap scheme is very different from the other.

“It is difficult to generalize since each

fund handles size issues differently. For instance, Nippon chooses to invest in more stocks to tackle its large assets but others may choose to remain concentrated,” said Kumar. “It is better to look at each scheme individually to gauge if they are struggling to invest more.”

Are the valuations expensive?

Nirav Karkera, head of research at Fisdrom, said the small-cap category has taken exposure to only about 75% of the total number of stocks available in the NIFTY Smallcap 250 basket. The category has been looking well beyond the primary benchmark for opportunities. “One must acknowledge that smallcap funds’ success is attributable to strong bottom-up stock selection practices, and availability of opportunities at reasonable valuations is critical.”

While the broader market valuations across conventional valuation metrics may indicate that valuations are not expensive, the same may not hold true for all stocks; especially ones that have garnered the highest institutional interest, he added.

To put this in context, the price-to-earnings ratio of Nifty Smallcap 250 with mutual fund holdings stands at 58, whereas the average price multiple for stocks without any institutional exposure is at 25.

Kumar, who heads research at FundsIndia, looks at the small-cap market capitalization as a portion of the overall market capitalization to gauge if the small-cap valuations are in the expensive, moderate, or cheap territory.

According to him, the small-cap market cap generally hovers in the range of 10-15% of the universe. When this percentage goes beyond 15%, it is a sign that small-caps have become expensive and when it goes below 10% it’s a sign that investors are pessimistic. Currently, the small-cap market capitalization to the total universe is hovering around the higher side of 14.8%.

“Whenever it crosses 15%, it is generally on the expensive side, and close to 10 is cheap,” said Kumar. “Right now we are somewhere close to 14, so it is neither too expensive nor too cheap.”

This indicator had last shown such attractive valuation levels in 2020 when it fell to 10%. It was in the overbought territory in 2017 when it breached the 15% mark to touch 17%.

Experts *Mint* spoke to said that investors should exercise caution while selecting small-cap funds. They are volatile in nature and run the risk of being illiquid when the markets turn bearish. Although small-caps funds haven’t had a major redemption pressure in the past, that doesn’t mean it will never happen in the future.