

Published Date:	6 Jan 2025	Publication:	WEALTH (The Economic Times) [New Delhi]
Journalist:	Sanket Dhanorkar	Page No:	1
Circulation:	75,935		



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Should you continue to invest in small caps?

The current narrative around small caps and recent performance neglects the sobering historical evidence.



by Sanket Dhanorkar

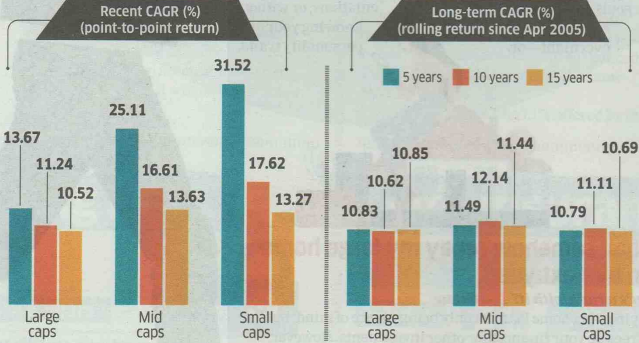
Small-cap funds have enjoyed a record run in the past five years. The category has fetched 31% annualised returns, compared to 16% from large-cap funds. Investors continue to bet heavily on this space. Since 2019-20, the total inflow in small-cap funds has crossed ₹1 lakh crore. Assets under management have grown nearly seven times. Folios in small-cap funds have now grown from 50 lakh to 2.35 crore, far higher than any other category, barring thematic funds. Clearly, investors are betting on this space to continue delivering outsized returns.

A well-woven narrative is shaping this gold rush for small-cap funds. India is expected to continue growing at a faster clip than most other nations. Newer, emerging sectors and businesses will be at the forefront of this growth. It is argued that these unique opportunities are mostly available in the small-cap space. The longer runway for growth for these businesses provides opportunity for outsized returns. Besides, this space provides a much larger playground for investible ideas, unlike the large- and mid-cap segments. It is also not covered extensively by analysts, suggesting mispricing in undiscovered stocks.

The argument that small caps are a risky proposition, owing to their vulnerability to business cycles, no longer has any currency. Today's small caps, it is argued, are no longer the ugly ducklings of the past. According to data from Ventura Securities, the market cap of the stock ranked 251st—qualifying as the biggest small cap—in December 2019, has surged 4x, from ₹8,000 crore to over ₹34,000 crore today. Similarly, the tiniest small cap,

Recent outperformance of small caps clouds past hiccups

Empirical evidence indicates small caps can underperform over longer periods.



Compiled by ETIG Database. Data as on 27 Dec 2024.

or 500th ranked company's market value has surged 6x, from ₹2,000 crore to nearly ₹12,000 crore. In December 2019, the 500th company's current market cap would have fetched it the tag of a mid-cap stock.

To be sure, the narrative has been backed by performance in the past five years. The earnings growth in small caps (21% CAGR) has far outpaced large caps (15%) and mid caps (14%). The small-cap space has also yielded the most number of multi-baggers during this period. It is, therefore, being suggested that small caps as an asset class is the ideal investment for building serious long-term wealth.

However, this narrative is at odds with empirical evidence. Historically, over longer time frames, small-cap returns have typically converged with those of large and mid caps. In fact, rolling returns data suggests that over five-, 10- and 15-year time frames since April 2005, the BSE Sensex has outper-

formed the BSE Smallcap index 63%, 53% and 61% of the times, respectively. Recent market returns have masked this history, with small caps outpacing comfortably. However, mean reversion is an irrefutable truth in the stock market, and should play out eventually, experts insist. "The recent past has reinforced the belief that small caps tend to outperform. A lot of variables must line up favourably for small caps to continue delivering. Narratives and perceptions can change easily for this highly cyclical market segment," remarks Nirav Karkera, Head of Research at Fisdor. "It is important to remember that while small caps work over time, they don't work all the time. The underperformance phases or declines are very sharp versus the large caps," observes Arun Kumar, Head, Research, FundsIndia.

This demands that investors proceed with caution in small caps and not blindly follow

narratives. Besides, investors in small-cap funds should be careful in their picks for this space. Your experience might differ vastly from another fund in the same basket. There is wide divergence in the way small-cap funds are managed. As per Sebi, small-cap funds need to allocate at least 65% of the corpus in small-cap stocks, and the rest can be deployed in any other market-cap segment. Some small-cap funds are true-to-label, placing nearly all bets in their primary universe. DSP Small Cap and SBI Small Cap have more than 95% exposure to small caps. Others take big positions in large or mid caps. Edelweiss Small Cap, Invesco India Small Cap and HSBC Small Cap are among funds that have more than 20% exposure in mid caps, apart from their small-cap bias.

Even within small caps, many funds invest large sums beyond the top 500 stocks in market cap, even as a few stay mostly within that boundary. LIC Small Cap, DSP Small Cap, Tata Small Cap, Motilal Oswal Small Cap and Bandhan Small Cap all have significant exposure (more than 50%) beyond the top 500 stocks by market cap. Meanwhile, Baroda BNP Paribas Small Cap, Canara Robeco Small Cap and HSBC Small Cap have currently parked less than 25% in this universe. Apart from this, some funds take cash calls and even stop flows in specific market phases. ICICI Prudential Small Cap is currently sitting on 15% in cash equivalents. SBI Small Cap and Tata Small Cap have nearly 10% in cash.

With differing approaches, return outcomes also vary. The best performing small-cap fund has yielded 47% over the past five years, while the worst performing fund has fetched 25%. So, make sure you pick wisely as you navigate this promising, yet tricky, terrain, and limit your small-cap exposure to 20% of the portfolio.



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