

# The base effect has burnished small-cap funds' 3-yr numbers

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Small-cap funds have delivered a category average return of 30 per cent over the past three years. It is among the best-performing categories over this horizon. Over the past year, however, its returns have been muted.

## Base effect

A couple of factors have contributed to the category's stellar performance over three years.

"Sectors like chemicals, engineering, garments, etc have done well over this period and they belong mostly to the small-cap segment," says Samir Rachh, fund manager-equity, Nippon India Mutual Fund.

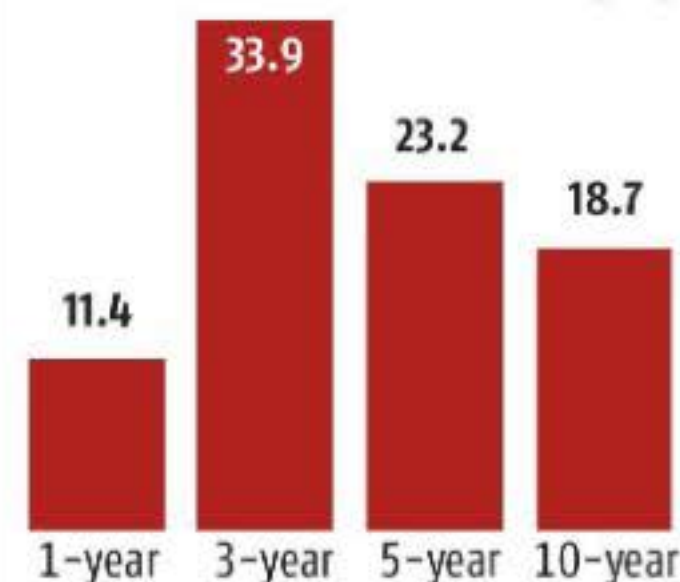
The base effect has also contributed. "Small-cap funds performed poorly in 2018 and 2019. Then these funds had two strong years in 2020 and 2021, which is why their returns appear very strong over a three-year period," says Kaustubh Belapurkar, director-manager research, Morningstar Investment Adviser.

## Long-term wealth generator

Most retail investors should have some allocation to these funds. "Small-cap funds have the potential to create wealth and generate sizeable alpha over the medium to long term, albeit with a higher risk-profile," says Yogesh Kalwani, head, investments, InCred Wealth.

Smaller companies are benefiting from the shift towards formalisation (from unorganised towards organised players), market share gains, and acceleration in the China-plus-one theme. Fund managers have greater opportunity to beat their benchmarks in this category. "Small-caps are under-researched

## SMALL-CAP FUNDS AVERAGE SIP RETURNS (%)



Note: Returns are for regular, growth funds;  
Source: Morningstar AWS

by large broking or research firms. They are also under-owned compared to other market segments. This provides fund managers the opportunity to add value over the long term through stock picking," says Kalwani. These funds have the potential to outperform large-cap funds in certain phases. "They do extremely well whenever there is an economic recovery, and also during the early part of a bull run," says Arun Kumar, head of research, Fundsindia.



## Enter with long-term horizon

Valuations are not in the bubble zone currently. "Valuations are not cheap, but they are not exorbitant either," says Rachh.

The Nifty Smallcap index is trading at a discount relative to the long-term average of the Nifty50. "Since 2011, the Nifty Smallcap P/E (price to earnings ratio), on an average, has stood at a multiple of 2.1 times the Nifty50 PE. But currently it is hovering at around 0.7x. Historically, whenever the relative valuation of small caps has been at 0.7x large caps, they have, on an average, delivered superior returns over a

holding period of above three years," says Kalwani.

## Beware high volatility

During bearish phases, these funds tend to crash more than large-cap funds. "High volatility and steep drawdowns are the two key risks in this category," says Belapurkar.

The time taken to recover from steep falls is usually longer than in large-cap funds. Kumar warns that since the category is not very liquid and the number of investment opportunities is limited, fund managers can find it difficult to deploy money if it comes in at a rapid pace. "Large and rapid inflows can affect performance," says Kumar.

## Limit exposure

Risk-averse investors, who don't like to see large drawdowns in their portfolios, should avoid this category. Given its high volatility, Kumar suggests limiting exposure to small-cap funds to 10-15 per cent of your equity portfolio and having at least a 7-10-year horizon. "Investing via the systematic investment plan (SIP) route will help to gain from high volatility," he says.

High redemption pressure can put these funds, especially the larger ones, in a spot. "Diversify across two-three funds from this category to deal with this issue," says Kumar. If a fund witnesses large inflows or large redemptions within a short period, consult your financial advisor on whether to stick around.

Finally, Quant Small-cap Fund has given a staggering return of 50.9 per cent, annualised, over the past three years. Before you rush to invest on the basis of past return, pay heed to a few points. "The fund's quantitative model needs to be tested across market cycles. Also, there is a question mark on whether the fund house's high-churn strategy can be pursued with a larger fund size," says Belapurkar.