



Mid-, small-caps shine, but caution is in order

BY NITI KIRAN

Are you looking for an investment theme? For what it's worth, the mid-cap and small-cap space might offer a good opportunity. For now, mutual fund investors seem to be finding comfort in this space, which has contributed about half of all new folio additions in recent months, according to the latest data from the Association of Mutual Funds in India (Amfi).

This year so far, while the Sensex has gained nearly 7%, the BSE MidCap index has managed just 2.5% returns and the BSE SmallCap index declined nearly 1%. However, in the last six months, which were full of uncertainty, the story changes. The gains in this period have been 16%, 17.3% and 16.2%, respectively.

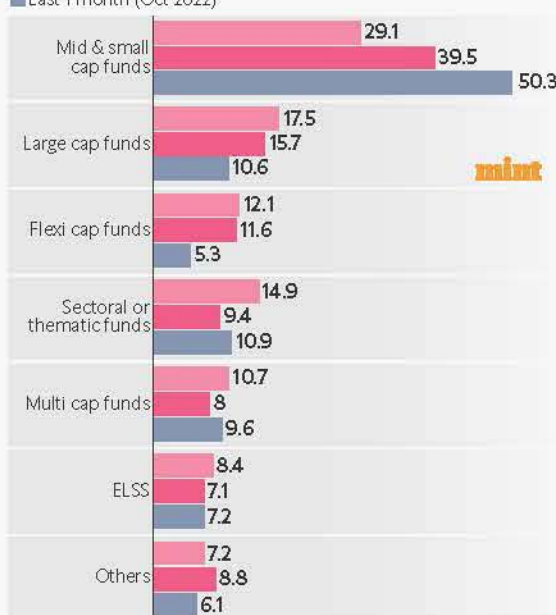
In nine of the past 17 years, the mid-cap index has outdone the Sensex. The small-cap index has done so eight times. Bad years tend to be followed by years of outsized returns for mid-caps and small-caps, even greater than the Sensex. During the financial crisis, the mid-caps and small-caps first lagged, but bounced back in 2009 with unmatched gains. The trend saw a repeat in 2011. The years 2018 and 2019 were an exception to the trend.

In terms of delivering long-term returns for investors, mid-caps and small-caps have managed returns comparable with the Sensex. The median 10-year rolling return since 2015 has been 9.6% per year for the Sensex and 9.9% and 7.8% for the mid-cap and small-cap indices, respectively.

With growing risk appetite, mid- and small-cap funds are turning investors' favourites

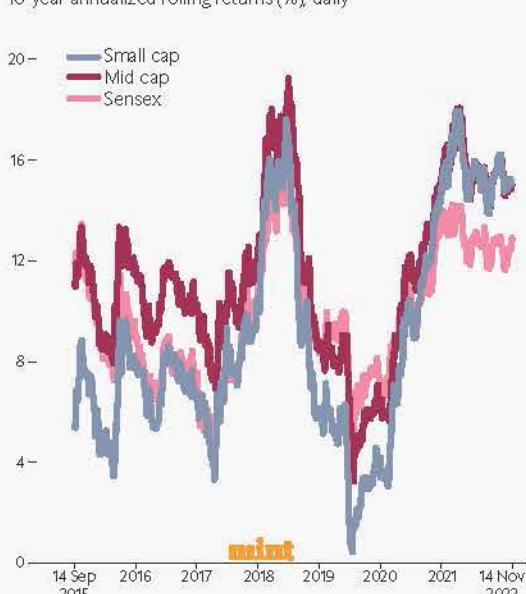
Share (%) of equity fund categories in new folio additions in...

■ Last 1 year (Nov 2021-Oct 2022) ■ Last 6 months (May-Oct 2022)
■ Last 1 month (Oct 2022)



Long-term investment in mid- and small-cap stocks has been rewarding

10-year annualized rolling returns (%), daily



Beating Benchmarks

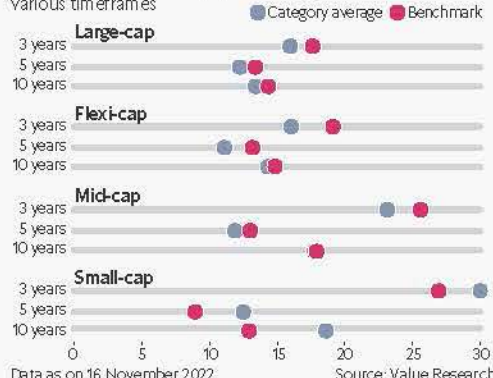
EQUITY MUTUAL funds that primarily invest in mid- and small-sized companies have also made merry. On average, small-cap funds have beaten their benchmark over the last three-, five-, and 10-year timeframes. Mid-cap funds have performed on a par with their benchmark over the last 10 years.

"On an absolute, as well as risk-adjusted basis, mid-caps as a category have delivered far superior returns compared to large-caps," said Sachin Relekar, senior fund manager at IDFC Asset Management Company. Almost one-third of the large-cap funds have outperformed their benchmark over the last five years, but for mid- and small-cap funds, this share is 44% and 80%.

This is probably driving investors in droves towards mid- and small-cap schemes. "Long-term drivers for return generation, such as earnings growth and business profitability, broadly remain intact, particularly for mid- and small-cap companies," Relekar said.

Small-cap schemes have generated benchmark-beating returns

Returns (%) of various equity fund categories over various timeframes



Valuations of both mid and small cap indices have corrected sharply

Index trailing price-to-earnings ratio (times)



Attractive Valuations

THE SEGMENT also looks attractive in terms of valuations, which have corrected sharply from their peaks. The price-to-earnings (PE) ratio of the small-cap index is lower than that of the Sensex, while the mid-cap one is almost on par. This could be appealing for investors looking for bargain buys.

Historically, when mid-cap valuations have been on par with large-caps, mid-caps tend to deliver higher returns over the next one-, three-, and five-year holding periods," said Yogesh Kalwani, head of investments, InCred Wealth.

Experts see ample opportunities for investors, though only a third of mid- and small-sized stocks are trading below their five-year median PE ratio. "These segments are relatively under-researched and thus offer a larger universe to select from," Kalwani said. Mid-caps and small-caps also saw buying interest from domestic mutual funds and foreign institutional investors in the September quarter, as they saw a marginal increase in stakes.

Investment Strategy

THE PRICES of some of these stocks have corrected sharply this year. As many as 34.3% mid-cap and 48% small-cap stocks are down by 25% or more since their 52-week highs. That offers an attractive entry point, but that alone should not drive investment decisions, experts said.

There are underlying risks with regard to such stocks. Extreme volatility in equities leads to sharp drawdowns in this segment. Moreover, mid- and small-cap stocks are less liquid than large-cap counterparts. "Hence, investors should have measured allocation to this segment that is in line with their risk-taking ability or asset allocation," Kalwani said. The stock-picking strategy should be from a long-term perspective. "The long-term allocation provides opportunities to tide over the volatility and take advantage of reasonable valuation as well," Relekar said.

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Price corrections offer an attractive entry point, but tread with caution

Share of stocks (%) trading below 52-week high



Source: Capitaline; Mint analysis

PARAS JAIN/MINT

PEANUTS by Charles M. Schulz

