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MID- AND SMALL-CAP FUNDS

Younger sibling's moment in the sun

Many mid- and small-cap funds have outperformed large-cap funds over the one-year horizon. But understand the risks before you invest in them

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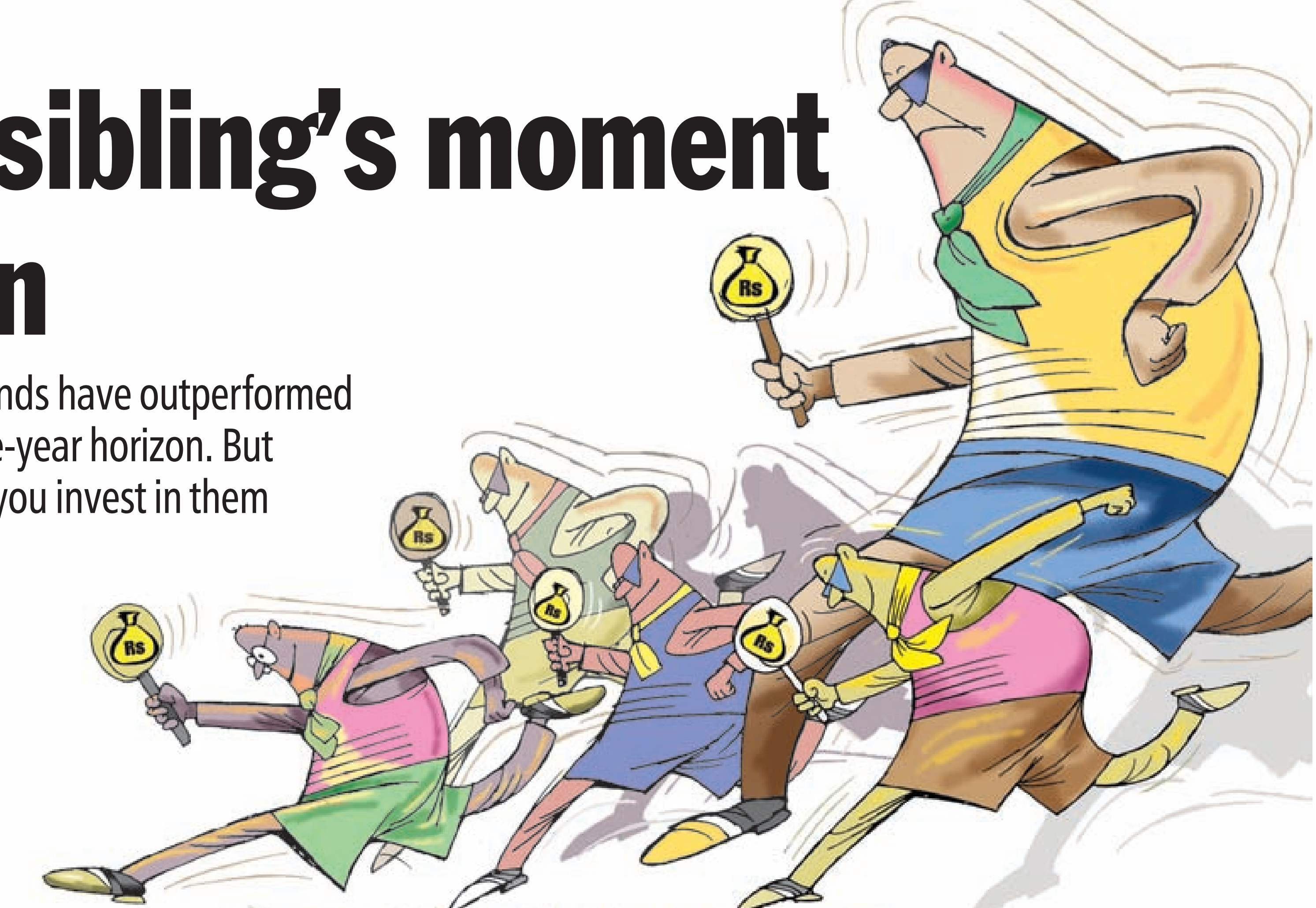

Illustration:SUDIPTO SHARMA

TODAY if you look up the one-year returns from diversified equity funds, of the top 10 funds in this category seven are mid- and small-cap funds. These seven funds have generated returns ranging from 107.20-140.91 per cent over the last one year, handsomely beating the one-year category average returns for diversified equity funds, which is 85.28 per cent. Similarly, the BSE mid-cap and the BSE small-cap index have outperformed their bigger brethren, the Sensex, over the last one year: while the Sensex has yielded a return of about 74 per cent, the mid-cap index has yielded 106 per cent, and the small cap index, 117 per cent.

At first glance, these numbers create a compelling case for investing in mid- and small-cap funds. But before one ventures forth, one needs to probe further.

Why the out-performance

Explaining why the mid- and the small-cap index have outperformed the Sensex over the last one year, Mumbai-based financial planner Vishal Dhawan says that these indexes had also fallen much more from the peak of 2008. From January 8, 2008 to March 9, 2009 (last year's peak to this year's trough), the Sensex fell by 61 per cent while the mid-cap and the small-cap index fell by 74 per cent and 79 per cent respectively. Similarly, if you look at data from January 8, 2008 (peak) to December 15, 2009 (current data), the returns are (-) 19 per cent from the Sensex, (-) 35 per cent from the mid-cap index, and (-) 42 per cent from the small-cap index. "While returns have been better over the last 12 months or since the pullback in March 2009, overall the Sensex investor has been better off than the investor in mid-cap or small-cap indices since peak levels," says Dhawan. He further adds: "Since the fall was much higher for mid-caps and small-caps, the valuation advantage that they presented was also greater than for large-caps."

Explaining this whole phenomenon of a bigger fall and a bigger bounce back, Dhawan says: "During periods of risk aversion money moves to the stocks of the largest businesses as they offer economies of scale, access to capital, market leadership, and higher stock market liquidity. Then as risk aversion reduces money starts flowing into higher-growth businesses, which however come with incremental risk."

The promise of mid- and small-caps

The primary reason why you should invest in mid- and small-cap stocks is that you want exposure to a group of stocks that are rising stars. According to Pune-based financial planner Veer Sardesai, "The mid- and small-cap space consists of stocks that represent new ideas and promise rapid growth. If they are still undiscovered by the market at large, the fund manager can buy them at a discount and profit from the rapid growth in their earnings." Adds Dhawan: "As India gets more researched by both foreign and domestic investors, mid-caps and small-caps could outperform."

The risks

These stocks also carry greater risk than large-caps. "Many mid- and small-cap companies run into problems because of their inability to fund expansion, over-expansion, and inexperienced management. There is a fair degree of mortality among them," says Sardesai.

Further, says Sardesai, there's the risk due to the fact that in India, mid- and small-cap stocks do not have the liquidity that large-cap stocks enjoy. When markets crash, these stocks become illiquid, i.e., finding buyers for them becomes difficult. For this reason in a downturn they suffer a higher erosion in market value than large-cap stocks.

Who should invest?

Mid-and small-cap funds are not for conservative investors who are trying to build a corpus for retirement. Such investors would do well to stick to large-cap or at best multi-cap diversified equity funds. "Those investing in mid- and small-cap funds should be willing to court extra risk in the quest for extra returns," says Sardesai. Such investors, he warns, should be fully aware that the value of their fund would erode deeply in a downturn. If they can stomach the massive volatility and hold on to these funds, there is the possibility that on the upside these funds could give them better returns than large-cap funds.

How much?

Given the volatility in returns, investors should have only a limited exposure to these funds. Sardesai suggests capping your exposure at 20 per cent.

Dhawan suggests that conservative investors should have a 10 per cent exposure, ideally through a broad-based index fund such as Benchmark's S&P CNX 500 Index Fund. Aggressive investors could go as high as 50 per cent in their exposure to mid- and small-cap funds. He however suggests that investors should initially get their mid-cap exposure through a fund that has a mid-cap orientation but has a high average market cap. (He is referring to a fund such as Reliance Growth which has a 65 per cent mid- and small-cap exposure and a 35 per cent exposure to giant- and large-cap stocks.) "Once an investor has been through at least one stock market downcycle, he can look at the lower average market cap mid-cap funds as by then he will understand the risks of these funds well," he says.

Only a few good funds

While in theory it is a good idea to have a limited exposure to mid- and small-cap funds, finding the right fund is not easy, primarily because the long-term track record of the majority of these funds is quite indifferent. Of the 25 mid- and small-cap funds that we looked at, only eight had a five-year track record. Of these only two had managed to beat their category average return over this period. And barely eight funds have managed to beat the category average returns over the three-year horizon.

Another cause for concern is that the fund managers at these funds have been at the helm for a very short while: of the 25 funds we studied the fund managers at 19 have been with their funds for less than two-and-a-half years. "If the fund manager has been at the helm for a short while, that is definitely a cause for concern as he is the one who makes the key decisions. Hence it might be desirable to invest in this space through an index fund," says Sardesai.

The right ones

Based on his evaluation, Sardesai suggests that one could invest in Sundaram Select Midcap Fund. "It has a five-year track record, a reasonable-sized corpus and the management is also reputed," he says.

Dhawan likes the IDFC Premier Equity Fund as it controls inflows to ensure that fund size doesn't get over-bloated. Another option he likes is Birla Sun Life Midcap.

If you wish to go for an index fund that gives you exposure to the mid- and small-cap space, invest in the Benchmark S&P CNX 500 Index Fund, which has an 80 per cent large-cap exposure and a 20 per cent mid- and small-cap exposure. Financial planners don't much like Benchmark's Junior Nifty Fund (an ETF) as they believe that index is skewed towards financial sector stocks.

Mid- and small-cap funds come into the limelight during every bull run. A large number of investors invest in these funds because they have outperformed large-cap funds. Then when the bear market comes these investors get badly hit as they did not understand the risks of these funds in the first place. Hence have the largest portion of your equity investments in large- or multi-cap diversified equity funds and have only a limited exposure to mid- and small-cap funds. Even though the volatility of these funds is hard to stomach, they could provide a kicker to your portfolio returns if held across cycles. ◆

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OUTPERFORMERS OVER THE 3-YEAR HORIZON

FUND NAME	1-YR RETURN	3-YR RETURN	5-YR RETURN	LAUNCH DATE	AUM (RS CR)	FUND MANAGER	PRESENT SINCE
IDFC Premier Equity Plan A	105.39	26.47	NA	Sep-05	1,098.76	Kenneth Andrade	Feb-07
Sundaram BNP Paribas SMILE	125.37	19.82	NA	Jan-05	447.51	S Krishna Kumar	Feb-06
Birla Sun Life Midcap Plan A	121.15	17.68	27.88	Oct-02	1,001.42	Sanjay Chawla	Sep-07
Sahara Midcap	107.50	14.57	NA	Dec-04	9.32	A N Sridhar	Feb-07
Sundaram BNP Select Midcap	120.29	13.79	31.16	Jul-02	1,780.76	Satish Ramanathan	Sep-07
DSPBR Small & Mid-cap	120.95	11.01	NA	Oct-06	691.69	A. Maheshwari + A. Shah	Apr-08
DBS Chola Midcap	116.67	10.76	21.94	Jul-04	22.75	Anant Deep Katare	Oct-07
ING C.U.B. (small cap)	116.95	10.05	NA	Aug-06	41.49	Manish Bhandari	Aug-07
Category average	85.28	9.47	22.68				

Source: Value Research