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Navigating The Market: Is Now The Right Time for **Mid & Small Cap Investments?**

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Equities are considered as vehicles of long-term wealth creation and it is generally advised that any investor looking to generate wealth over the long-term must have exposure to equities.

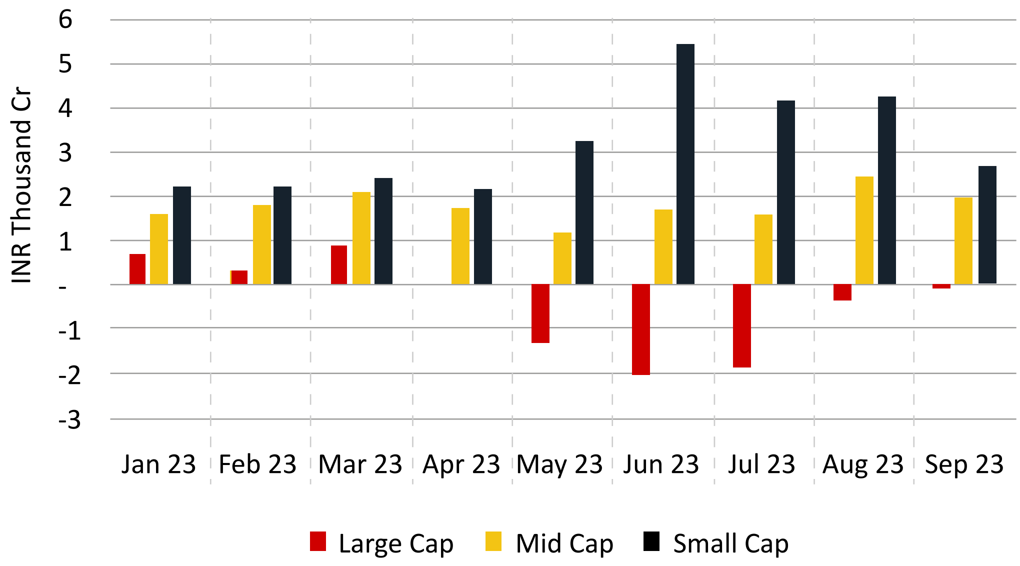
Within this broad asset class, historically, investors have gravitated towards mid & small-caps in their quest to generate superior returns. As a matter of fact, over the long term, Mid & Small Cap indices have delivered higher returns as compared to Large Cap index.

Table 1: Returns across the three market capitalisations

Period (CAGR)	NIFTY	NSE Mid-cap 100	NSE Small-cap 100
Jan 2004 - Sep 2023	12.9%	15.8%	14.6%
Peak to Today (Dec 07 - Sep 23)	7.7%	9.9%	5.1%
Trough to Trough [Global Financial Crisis (GFC) Bottom to Covid Bottom)	19.3%	25.8%	21.7%

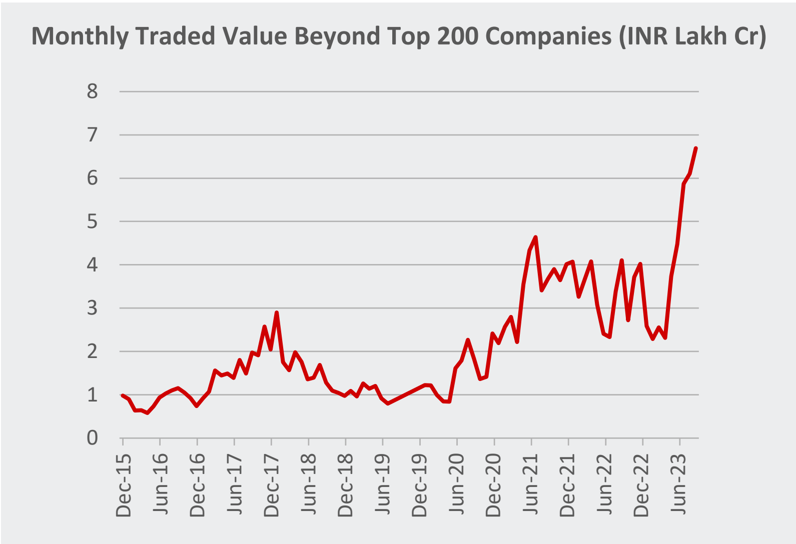
From the above table it is evident that both mid-and-small-caps have outperformed large caps during different market phases. Even if you look at the current market landscape, you will observe heightened interest in mid-cap and small-cap stocks. Mid-and-small-cap mutual funds are witnessing increasing inflows, while large-cap mutual funds have been witnessing outflows recently (Exhibit 1). The mid-and-small-cap space is also seeing increased liquidity as well (Exhibit 2). Both these indicators suggest increased interest in that segment of the market.

Exhibit 1: Strong flows in mid and small-cap mutual funds



Source: AMFI Data

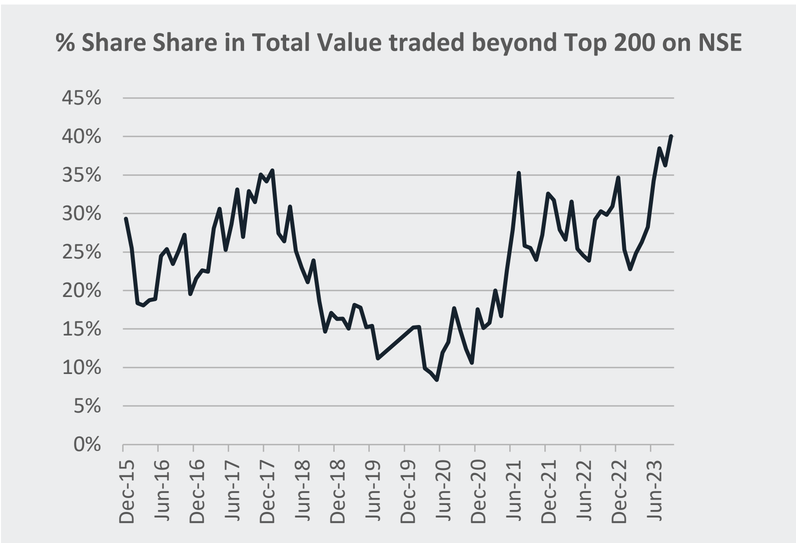
Exhibit 2: Increased liquidity in the mid and small-cap segment of the market



Source: NSE

Note: This chart shows the data of monthly value of shares traded for all companies listed on the NSE excluding the Top 200 companies.

Exhibit 3: Percentage contribuon of volume on NSE coming from companies beyond the top 200 market-cap companies



Source: NSE

Note: This chart shows the % contribution of volume on NSE coming from companies beyond the top 200 Mcap companies.

The curious case of volatility

With this evidence, the inevitable question would be, "This segment of the market has such great potential to generate returns, then why invest anywhere else?

The simple answer to the above question is 'risk'. Volatility and drawdowns are two data points that could be considered to evaluate risk. Volatility refers to the variability in the returns while drawdowns measure the maximum loss from the immediate peak.

Table 2: Volatility and drawdowns across the three market capitalisations

Jan 04 - Sep 23	NIFTY	NSE Mid-cap 100	NSE Small-cap 100
Volatility (Std Deviation)	22%	26%	30%

Drawdown	NIFTY	NSE Mid-cap 100	NSE Small-cap 100
Global Financial Crisis	-55%	-65%	-75%
Covid	-29%	-45%	-60%

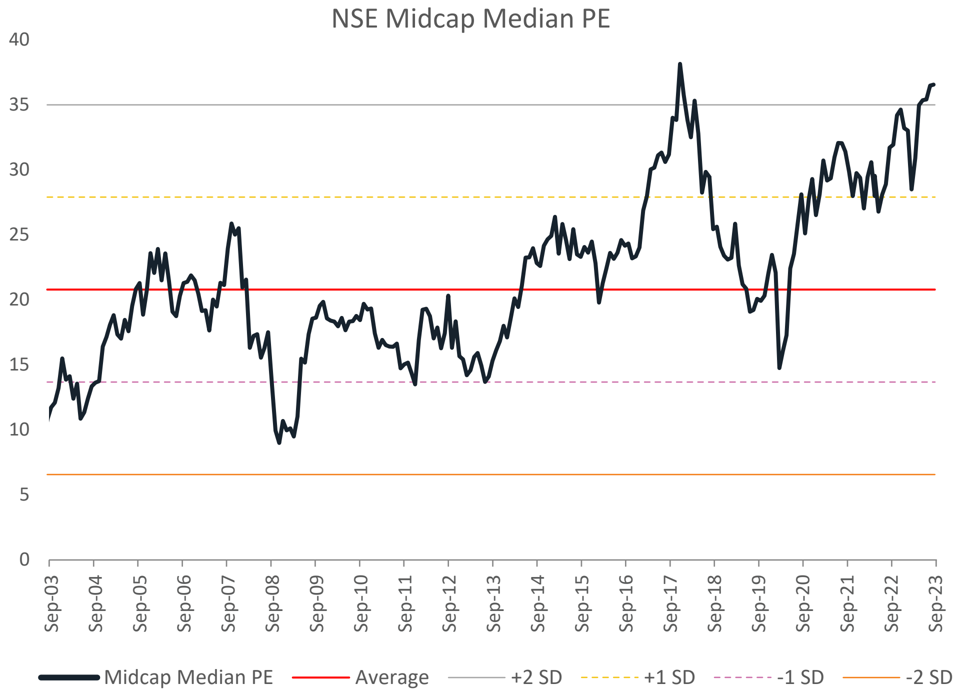
Due to higher levels of volatility and sharper drawdowns, mid-cap and small-cap stocks are considered riskier than large-cap stocks. As highlighted in the tables above, over the last 19 years, large-cap standard deviation, represented by Nifty, was 22% which was lower than mid-cap and small-cap standard deviation of 26% and 30%, respectively. Further, during times of crises, like Global Financial Crisis or Covid, large-caps have seen lower drawdowns compared to mid-and-small-caps.

The biggest challenge for an investor is to stay disciplined during times of crises and volatility. If the investor is shaken by the volatility or drawdown and decides to exit at the wrong time, he/she could convert a mark-to-market loss into a permanent loss of capital. And, since mid-and-small-caps can exhibit significant volatility and sharp drawdowns, the investor should not only focus on the potential for higher returns but also consider the risk and his/her ability to digest the same.

Evaluating Reward vs Risk

And what if the higher return potential is doubtful? Would the risk be worth taking, if prospective returns are not attractive? While timing the market is difficult, it does have implications on returns. Generally, higher valuations lead to lower prospective returns. The below two charts showcase the valuation, as captured by median PE of constituents of NSE mid-cap index and the NSE small-cap index. In the case of the mid-cap and small cap indices, it has been observed that entry points below longer term average have given significantly higher returns compared to entry points above the average.

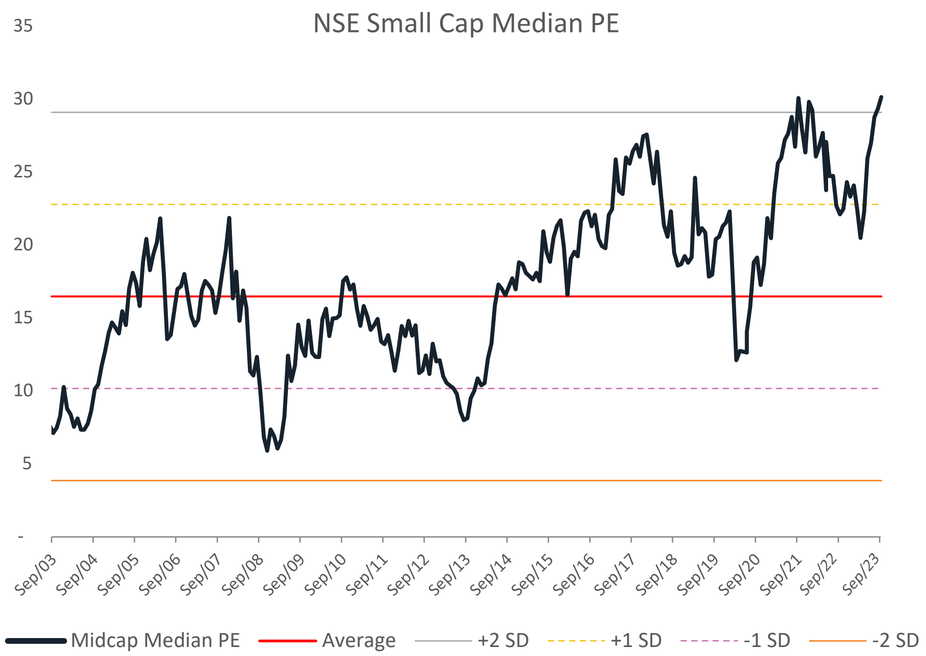
Exhibit 4: NSE mid-cap median PE



Average CAGR with in each Band
3 Year +2.8% 5 Year +10.8%
3 Year +12.1% 5 Year +8.7%
3 Year +16.3% 5 Year +14.4%
3 Year +43.8% 5 Year +31.3%

Note: The table adjoining the chart represents the average returns over the next three and five years for investments made in the NSE Midcap index within specific standard deviation ranges shown in the chart.

Exhibit 5: NSE small-cap median PE



Average CAGR with in each Band
3 Year -6.4% 5 Year +3.4%
3 Year +7.0% 5 Year +4.8%
3 Year +14.4% 5 Year +11.6%
3 Year +38.8% 5 Year +17.9%

Note: The table adjoining the chart represents the average returns over the next three and five years for investments made in the NSE Smallcap index within specific standard deviation ranges shown in the chart.

If historical relation between valuation and prospective returns hold, current valuations could lead to low single digit (or even negative) 3 year and 5 year prospective return. Thus, investors must assess whether they would be comfortable with the risk-return profile in this section of the market at the current time.

Conclusion

Mid-and-small caps can have the potential to generate high returns over the long-run and perform better than large-caps. Correspondingly, they also tend to be riskier than large-cap stocks. For investors looking to harness the benefits of mid-and-small cap stocks it becomes imperative to focus on valuation to evaluate reward vs risk.

A host of factors, including

1. Strong fund flows
2. Increasing liquidity
3. Over-valuation

are indicating that the mid & small-cap segments are currently in overheated territory.

Thus, as you consider your allocation to mid-and-small-cap stocks, do tread further with a hint of caution.

Disclosure and Disclaimer

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