Small-caps: A valuation tightrope walk

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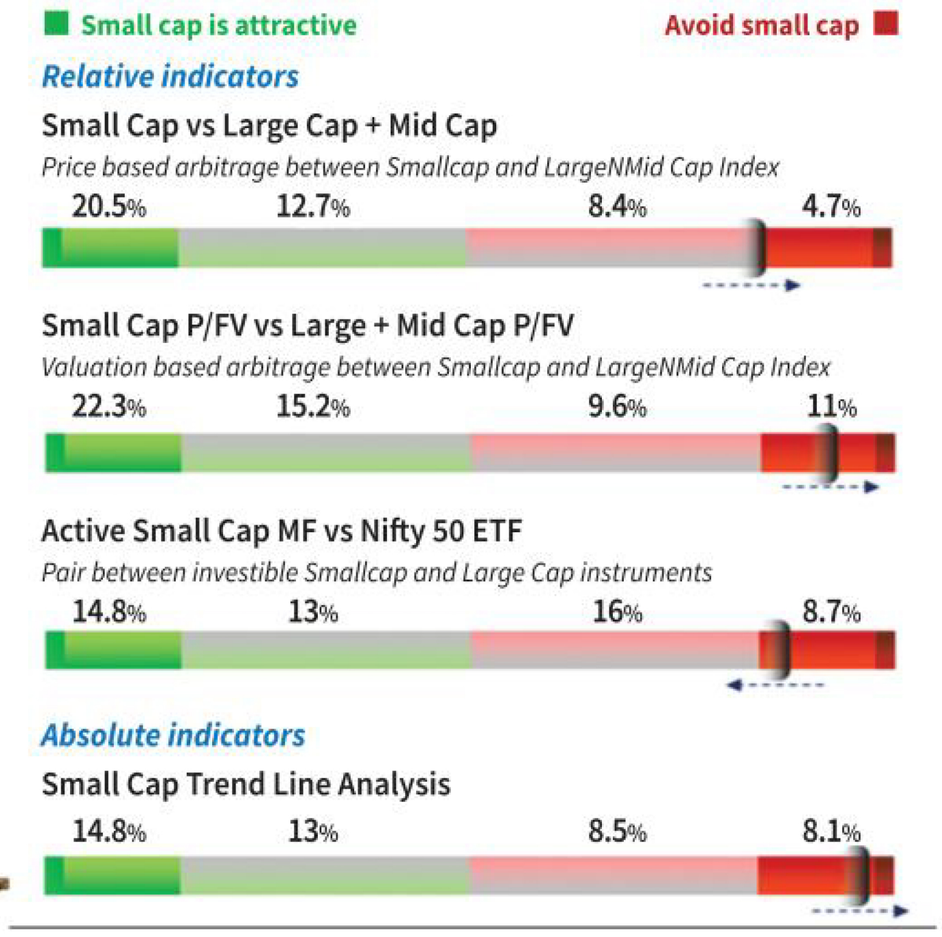
THEIR VIEW.
With current multiples at a historical high, returns may be lower

Position of market indicators in the small-cap space



Outperformance of small-cap over large-cap

	Relative indicators			Absolute indicator
Bands	Price-based arbitrage	Valuation-based arbitrage	Active Small Cap MF vs Nifty ETF	Trend line analysis
+1SD to +2SD	-5.2%	-2.7%	-2.4%	
Average to +1SD	-2.9%	-1.8%	3.5%	-5.4%
-1SD to Average	0.5%	2.9%	1.7%	-3.2%
-2SD to -1SD	5.2%	6.9%	-0.3%	-0.4%

Amogh Korde

Small-cap stocks, despite their higher volatility, have seen robust performance over the past few years. As a result, small-cap mutual funds, too, have gained popularity among investors. Data suggest that active small-cap fund managers have fared well against the small-cap index till 2018, with outperformance dwindling since then. However, interest in this space continues to remain strong.

Assets Under Management (AUMs) have increased by around 7x since March 2020 whereas AUMs of all equity schemes have grown by 4x.

From a valuation perspective, the Small-Cap P/E is currently trading above +2 Standard Deviation (SD), reaching a historical high. Does that mean you need to avoid small-cap space right now? We did a deep dive analysis on how small-cap returns have fared at different valuation levels relative to large-caps and mid-caps, and on absolute basis.

POTENTIAL FOR RETURNS

For the purpose of our analysis, we focused on four distinct indicators, three of which were based on a relative analysis and one was an absolute indicator. The indicators evaluated include:

1. Relative Indicators:

a. Price-based arbitrage between the small-cap and large and mid-cap index: The indicator compares price movement of small-cap space with that of large and mid-cap space combined.

b. Valuation-based arbitrage between the small-cap and large & mid-cap index: It compares valuation of small-cap space against large and mid-cap space.

c. Pair trade between investible small-cap and large-cap instruments: This indicator is similar to price-based indicator above, but instead of indices, we are using investible instruments i.e., active small-cap MFs and Nifty 50 ETF.

2. Absolute Indicator - Small-cap trendline analysis: This is a statistical indicator. Here, small-cap index is regressed with time.

The indicators in the accompanying table showcase the average forward 5-year historical CAGR of the small-cap index when the indicator was in the respective SD bands while the black vertical line indicates the current position of the indicator as against historical SD bands.

While both the relative and absolute indicators are in the 'avoid small-cap' zone, the 5-year CAGR potential varies. It is evident that when the indicators are in the green zones, i.e., below average, the potential for higher returns increases while the converse is true when indicators move to the red zone, i.e., above average.

However, it is important to highlight that even though long-term trend returns of the small-cap space average 11.5 per cent, the five-year forward returns within the -1 SD to -2 SD band are in the range of 14 per cent to 22 per cent.

This means that while investment in small-caps can, on an average yield 11.5 per cent returns (since 2004 Nifty Smallcap 100 CAGR returns of ~10% + dividend yield of ~1.5%), timing the entry in small-cap space can significantly enhance overall investor returns.

In addition to evaluating the absolute performance of the small-cap index on a standalone basis, it is also instructive to assess how the small-cap space has performed relative to the large-cap space in the same time periods.

OUTPERFORMANCE

The highlighted yellow bands in the accompanying table indicate the current position of the indicator as against historical SD bands. When evaluating relative outperformance, we observe that no consistent trend emerges. When the indicator is in the -2 SD to -1 SD band, both price-based arbitrage and valuation-based arbitrage indicate that small-caps outperform large-caps by a decent margin.

On the other hand, when we compare the active small-cap MF with the Nifty ETF, we observe that small-caps marginally underperform the large-caps when positioned in the same -2 SD to -1 SD band.

Interestingly, the highest outperformance of small-cap is reported when the active small-cap vs Nifty ETF indicator is in the average to +1 SD band. At the other extreme, i.e., the +1 SD to 2 SD band, both on a price-based arbitrage and valuation-based arbitrage, large-caps outperform small-caps.

Overall, our key takeaways from the analysis were,

i) Small-caps are currently expensive.

ii) Small-caps have the potential to generate good absolute returns over the long term and these returns can further be elevated by timing the entry and exit points.

iii) Small-caps tend to underperform large-caps when indicators are at the extremes of the red zone, i.e., at -2 SD level (currently, 2 out of 4 indicators are in that zone), leading to the conclusion that the small-cap space is currently expensive.

iv) While the active small cap fund manager(s) might manoeuvre the volatility better than the index (by stock selection, cash cushion, etc.), however it would still pay to keep one's eyes open to the risk of stretched valuations in the small-cap space.

The writer is Project Lead, Behavioural and Fund Analytics, Multi-Act