Small-cap funds can be rewarding over long term

But investors must be willing to tolerate bouts of high volatility

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PAYOFF COMES BY STAYING INVESTED FOR LONG TERM

Returns are for regular plans; above 1-year returns are annualised

Source: Morningstar AWS

The stock market has shown considerable strength in recent weeks, with the indices moving up swiftly. Year-to-date, however, small-cap funds have remained flat (0.9 per cent). Over longer periods of three, five and 10 years, however, small-cap funds have rewarded their investors handsomely. After the recent bout of volatility (between October 2021 and June 2022), one question on investors' minds today is whether this is a good time to enter small-cap funds.

"Small-cap funds are always a good investment for long-term investors who have the patience to live through the volatility associated with equity markets in general and small-caps in particular," says Harish Bihani, senior fund manager, ICICI Prudential Mutual Fund.

Small-cap funds are mandated to invest at least 65 per cent of their corpus in shares of companies with market caps less than that of the 250th largest company on the stock exchanges.

Potential for big gains

Not all small-cap companies are fragile investment bets. Some of them are emerging market leaders in their respective sectors. Some have strong management, good balance sheets, and a sustainable business model.

As India's manufacturing segment gathers steam and emerges as a growth driver, exposure to mid- and small-cap stocks in this segment could bring outperformance over broad market returns.

"There is huge potential for long-term wealth creation via small-cap funds in an evolving economy like India. This universe offers the potential to invest today in tomorrow's mid- and large-cap companies. One gets to participate in various fast-growing sectors and invest with great entrepreneurs in their evolutionary phase," says Ravi Kumar TV, founder, Gaining Ground Investment Services.

Since the small-cap universe is very large, and it's not tracked as extensively, there is a greater possibility of fund managers finding hidden gems.

Be aware of the risks

Small-cap funds make sense for investors with high tolerance for volatility. "The risks in this category are primarily associated with portfolio volatility, which is typically higher than in large caps during market extremes. The other generic risks are investments done in a small-cap fund at extreme valuations, which results in lower forward returns, or, in some cases, negative during an investor's holding period," says Bihani.

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During economic downturns, large-cap companies typically tend to be more resilient while small caps tend to be more susceptible. "Investors also run business continuity risk in small-cap stocks and funds," says Nitin Rao, chief executive officer (CEO), InCred Wealth.

Rao highlights that these stocks also have governance risk. Large-cap companies are subject to scrutiny, since they are tracked by many analysts and also by the media. Small caps are not tracked as widely. Hence, there is greater risk of corporate governance issues arising in them.

During market downturns, liquidity tends to dry up faster in this segment, making exit more difficult.

Invest for the long haul

One way you can counter the higher risk in this category is by having a longer time horizon. "Invest if you are comfortable with this category and have an investment horizon of beyond five years," says Rao.

Bihani agrees. "Past performance suggests that the rolling returns of small-cap funds in most long-term (five years or more) time frames remain healthy," he says.

Limit your exposure

Avoid investing more than 10-15 per cent of your money in small-cap funds. "While most advisors feel that only 10 per cent should be allocated to small-cap funds, the allocation can vary depending upon the investor's risk appetite. Invest regularly via the systematic investment plan (SIP) route," says Kumar.

Finally, pay attention to fund size. If it becomes too big (typically if asset under management goes beyond Rs 10,000 crore), the fund manager could find it difficult to generate alpha.

Finally, as Rao says: "Select a fund that has been consistent in generating alpha. Also take into consideration portfolio quality."