Mid Caps and Small Caps

Not for the Faint Hearted!

While mid caps can provide better risk-adjusted returns than large caps in the long-run, it is certainly not without risks. Chief among them would be the issue of corporate governance (rather lack of it), where most of the mid caps and small caps, being owner-driven can give corporate governance a go-by in their quest to post profits and grab market share.

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While Nifty 50 (a good proxy for large cap) gained 3.2% in 2018, Nifty Mid cap 100 was down 15% and Nifty Small cap 100 was down 29%. The poor run of mid- and small-cap continues well into 2019 with the two being already down 10% and 12% respectively. While this presents a scary picture, the long-term performance is not bad at all. A dollar invested in Nifty 50 in 2009 is now worth \$3.6 (February 2019) while the same for Nifty Mid cap 100 is now worth \$4.3. While there is upside to be reaped in the long-term, year-to-year volatility can produce ulcers for lay investors.

All major multi-baggers of today started their life as small cap once upon a time akin to a kid! Extraordinary returns in stock market is possible only if we can identify small caps or mid caps that can go on to become large caps producing outsized returns. Sounds like a fairy tale, but fishing the mid- and small-cap pond can be treacherous. To understand why, just look at the distribution of stocks on the National Stock Exchange (NSE), as of February 2019.

From a market capitalization point of view, large caps account for 67% but has only 4% of number of companies. On the other extreme, small caps account

Mid Caps – The Great Churn	
Category	**No. of Companies Joining/Leaving the Index, 2018**
Nifty 50	4
Nifty Midcap 50	15
Nifty Midcap 100	62

Caps' Play: 'Small' (Cap) Is Large!		
Category	**Total Market Cap (US$ bn)**	**Number of Companies**
Large Cap	1,284	73
Mid Cap	442	197
Small Cap	202	1,634
Total	**1,928**	**1,904**

Note: Large cap defined as greater than $5 bn, Mid cap between $5 bn and $1 bn and Small cap less than $1 bn.

only for 10% of market cap but account for 86% of the total number of companies. It is the twin factors of extremely large universe coupled with small size that makes stock identification a difficult game within the small caps category.

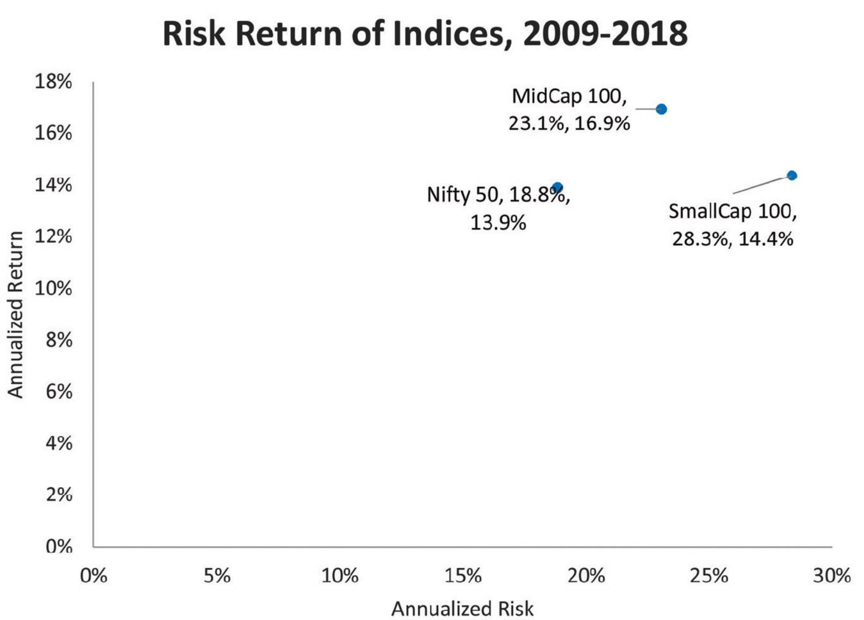
If one is not keen on stock picking, index investing can be an option especially through Exchange Traded Funds (ETFs). However, a look at the performance during the last 10 years indicates several things. While there is clear risk premium observed between Nifty 50 and Mid cap 100, there is no such premium observed with small caps. In other words, the small cap index produced lower returns compared to mid caps, but also entailed higher risk! Also, ETF investing should take into account the index rotation aspect. For e.g., stock exchanges that maintain these indices frequently include and exclude companies from the index, based on liquidity, profitability, and other criteria. Please note the huge churn that Nifty Mid cap100 experienced as compared to Nifty 50.

While mid caps can provide better risk-adjusted returns than large caps in the long-run, it is certainly not without risks. Chief among them would be the issue of corporate governance (rather lack of it), where most of the mid caps and small caps, being owner-driven can give corporate governance a go-by in their quest to post profits and grab market share. Also, given the low levels of institutional investments in mid caps and small caps (especially by foreign investors), there may not be any real pressure towards better adoption of good corporate governance. Hence, stock-picking based purely on published financial statements can be treacherous. A related issue to poor corporate governance is the lack of transparency. A majority of the mid caps and small caps may not have an active investor relations department that can provide investors with credible information about their companies' future plans. Also, the research coverage tends to be sparse in this area leading to poor transparency. The mid caps and small caps also experience heightened volatility compared to large caps. High levels of volatility can cause sleepless nights to investors though it could also offer good investment opportunities.

So, what should be the investment strategy? It depends on whether you are a professional investor or a layman. For professional investors, the obvious road is stock picking backed by arduous research. Here I would suggest to fish in the midcap pond which is much smaller with 197 stocks compared to small cap pond that has 1,634 stocks. Also, the risk-adjusted performances of Mid caps are better than those of small caps. The risk of poor corporate governance, transparency, and liquidity reduces as companies graduate from small cap to mid cap. Hence, picking stocks from the mid cap pool can increase the winning odds tremendously. For the lay investor, the best bet would be ETFs, especially the Mid cap 100, preferably through the SIP route to avoid market timing issues.

To conclude, I would say, while the mid caps and small caps are not for the faint hearted, they (the ones with solid fundamentals) certainly are the passport for a patient investor to grab a multi bagger early on, as compared to the large caps which may suffer purely under their own weight!

Happy Investing! ■



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