Selection Dilemma! Large vs Mid & Small Caps

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"Mid-caps and Smalls caps have bounced back smartly!", screams economic news headlines. Of course they did, but so did large caps. Also, the bounce-back happened after a steep fall making us wonder as to what was the source of excitement. Though the virus outbreak started towards December-end, it was not until March that the full impact of its devastation rattled financial markets globally, including India. To be precise, March 23, 2020 marks as the date when markets hit a super low all over the world including India. The fall was quick and deep. But what surprised many is the speed with which the rebound happened leading to the headline scream referred above. It is a sort of a V-shaped journey where losses were not only recouped but even resulted into substantial gains in many cases. This is despite the fact that, in effect, all the three indices (large-cap, mid-cap and small-cap) are still under the water as of August 19, 2020.

This raises a deeper question: "Should we invest in mid-caps and small-caps at all?" The traditional argument is that the upside to investing in mid-caps and small-caps is way higher than in the large-caps. Let us not forget, today's Reliance Industries and Infosys were once a small-cap before they first turned into mid-caps and finally became large-caps. Fair enough. This is true if only we could spot a Reliance or Infosys well in advance when they were swimming in the small- and mid-cap space. Let us examine the stock universe from various angles and analyze the question.

Performance: While looking at the risk-adjusted performance of these asset classes, it is clearly evident that mid-caps and small-caps plot very poorly in the graph. In other words, when we invest in mid- and small-caps, we take more risk for less return (shouldn't it be otherwise?). While we may not be averse to taking higher risk (as this is clearly the bet), one should be compensated for this through higher returns. Otherwise, it defies the very logic of investments.

Size of the Universe: Polarization is a major issue not just with Indian stocks, but also with almost all markets. In the context of S&P500, there is a joke that it is comprised of two indices i.e., S&P5 and S&P495 where the former constitutes the majority. The same applies to Indian stocks as well.

In the total universe of 3,840 stocks under our study, we can see how lopsided this distribution is in terms of large, mid and small caps. While large caps account for 74% of the total market capitalization, they account for only 3% in the stock universe. Conversely, the small caps account for 93% of companies with a meager 10% share in m-cap. The skew is even more evident when we look at the average m-caps across these three segments. Stock picking within a pot of 100 or 200 stocks improves the odds to spot winners than looking at thousands of companies. While it is true that there are many hidden gems in the large universe of small caps, it could be a herculean task to analyze such a vast space in order to identify the gems among them.

Operational Metrics: Large caps tend to be dominating due to their size and hence command market leadership in their respective industries. Due to this reason, they command pricing power and enjoy better margins and cash flows. It is also due to this reason, they command higher valuation in terms of P/E and P/B. More importantly, they have better operational metrics like operating cash flows, free cash flows, better interest cover and better dividend yield, to name a few. Furthermore, in terms of metrics such as Return on Capital Employed (RoCE), Return on Equity (RoE), etc., too, large caps compare favorly with mid and small caps.

Drawdowns: This is normally an overlooked risk-metric that I place a lot of importance on. A drawdown is defined as the percentage fall from index peak to index trough and how long it took to recover from the bottom. The index peak for Nifty 50 happened on January 14, 2020 with the index hitting 12,362 before it fell to trough of 7,610 on March 23, 2020, implying a 38% fall. In terms of days, that is only 69 days. However, when we look at the same data for mid-caps and small-caps, the fall has been steeper and long-lasting (800 days). In other words, when mid-caps and small-caps go down, they stay there longer and one may have to wait it out to recover the capital.

Large Caps Dominate

	No. of Companies	Market Cap	Market Capitalization Average values
Large-Cap	100	1,12,45,632	1,12,456
Mid-Cap	150	23,48,066	15,654
Small-Cap	3,590	15,90,096	443
Total	**3,840**	**1,51,83,795**	**1,28,553**

Note: As per SEBI circular in 2017, top 100 companies are classified as Large-Cap; next 150 are classified as Mid-Cap and rest are all Small-Cap.

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Sector Representation: While financials dominate all the three segments, we can notice that large-caps are dominated by high margin industries like technology and consumer non-cyclicals, while mid-caps and small-caps suffer from low margin industries like basic materials, industrials, construction and chemicals. This resonates with our earlier observations about market leadership and pricing power. Also, the domination of top five sectors is noticeable in large-caps compared to small-caps which makes stock picking that much more easier for the large-cap segment.

Liquidity: Nearly 75% of total value traded is accounted for by large-caps with mid-caps accounting for 20%, while small-caps accounting for the rest 5%. The low liquidity can actually increase the cost of trading (through higher bid-ask spreads) and can be the reason why they plot inferior on the risk-return graph. Lack of liquidity will drive away large funds as it renders both buying and selling large quantities difficult. Derivatives support is also generally available only for liquid counters and hence hedging mid- and small-cap risk at stock- and index level is also rendered difficult.

What a Recovery!
Equities not only erased losses, but also delivered gains

	NIFTY50	MID-CAP100	SMALL-CAP100
31-12-2019	100	100	100
23-03-2020	62.54	64.26	57.80
19-08-2020	93.75	98.02	95.38
The Fall	–37%	–36%	–42%
The Recovery	50%	53%	65%
YTD (19-08-2020)	–6%	–2%	–5%

Source: Reuters

Way forward

I deliberately avoided a commentary on valuation metrics like price-to-earnings and price-to-book. This is due to the fact that presently with earnings suffering a steep fall and markets recovering faster than anticipated, an increase in the numerator (price) and a decrease in the denominator (earnings) will definitely result in steeper P/E. However, in due course this will be corrected either by a price fall (more likely) or an earnings catchup (less likely) or both. As this is a moving target, I chose not to flag this as a metric for evaluation.

Individual investors are better off taking no exposure to small-caps and mid-caps as per this research. Institutional investors and high net worth can consider active management of mid-caps, but they must realize that it may consume more research time. Mid-caps and small-caps can therefore lend themselves to more quantitative application which can minimize or avoid time-consuming human research.

Happy Investing! ■

Reference # 20M-2020-09-12-01