INVESTING

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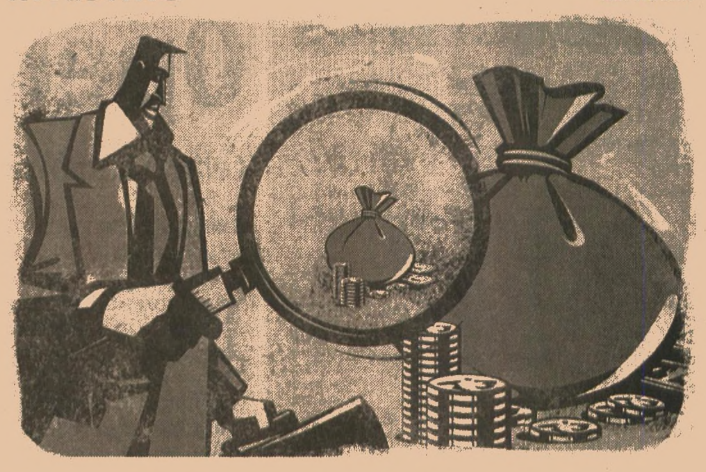

Stay away from mid, small caps

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Looking at the current levels, most experts are quite confident about equity markets' long-term prospects. From here on, most believe, the chances of markets inching up are very high. At worst, the Nifty could go down 100 points from the current level, they say.

In such situations (when the markets are near all-time low), traditionally, it is said that one should invest in mid and small-cap segments as these are high beta stocks that run up faster than the benchmark indices do. That is, if the Sensex, the BSE benchmark index, rises by one per cent, the mid-cap index could rise by 1.5-2 per cent. At the same time, a falling market could result in a sharper decline in these stocks.

Experts, however, warn against such perception. "The market today is much more complex than it used to be due to a number of global and domestic factors. Therefore, it is better not to look at stocks based on market capitalisation. It may not be right to assume that all midcap stocks will perform. Instead, invest based on individual stocks," says Jagannadham Thunuguntla, strategist and head of research at SMC Global Securities.

However, small and mid-cap stocks are not as well-researched as large-cap stocks. So, it is difficult to identify the right ones.

The Sensex lost over nine per cent in the past one year and the National Stock Exchange's Nifty 50 index lost over eight per cent (as on June 8, 2012). In the past three years, the benchmark indices gained slightly, over four per cent each. Compared to them, BSE's mid and small-cap indices lost 13.50 and 24 per cent, respectively, in the past year. In the three years ended June 8, these two indices gave over five and one per cent, respectively.

According to a recent report by economists Madan Sabnavis and Kavita Chacko of Care Ratings: "The larger companies tend to do better when conditions are adverse and the smaller ones, which are large numerically, are at a disadvantage in these times. Also, their profit indicators would be more vulnerable to economic changes compared to the larger ones."

The report highlights that for 2011-12, growth in sales was dominated by the top 100 companies due to their larger share in the sample. As a result, these companies pushed up overall growth of the sample. If these 31 companies are excluded, growth would have been 11.7 per cent in FY12 against 17.3 per cent in FY11. This will indicate a decline in growth against the increase witnessed presently. The higher growth in sales of the largest size group can also be attributed to the fact that a large proportion was in the petroleum-related sector, where higher prices and inelastic demand lifted growth in sales.

Growth in sales has also tended to increase with the size of companies. This means that smaller companies had bigger challenges in expanding their sales, especially when overall economic environment was beaten down. The companies in the lower size ranges (sales of less than ₹100 crore) witnessed an actual fall in sales. In fact, the smallest firms (sales of less than 10 crore) had had negative growth in sales all through this period, while those in the range of ₹10-50 crore had witnessed negative growth in three of four years. Clearly, there are problems with smaller companies, says the Care report.

So, while the existing investors of mid and small-caps must be sitting on huge losses, be cautious in treading the segment over the next one to one-and-a-half years. Typically, an exposure of 10-20 per cent of your portfolio in such schemes, or stocks, is advisable. First timers could start with large caps or index funds.

Quintessentially you should know your risk appetite, investment horizon before investing. But, keep the bias towards large cap in this market, says Viikaas M Sachdeva, chief executive officer of Edelweiss Asset Management.

"Valuations are unattractive both in case of large caps and the smaller ones. But, the large caps show the confidence to bounce back compared to mid and small-caps. Consider smaller firms once the sentiments are positive or when the markets have inch up some points making large caps look overvalued. Investment in large caps is valuation-driven, while in mid and small caps is driven by sentiments, Sachdeva adds.

There are two ways to invest in mid and small-caps. Either invest directly in stocks or take the mutual fund route. Value Research, a mutual fund rating agency, defines mid- and small-cap schemes as those that have more than 40 per cent exposure to mid and small-cap stocks. Schemes that have more than 40 per cent exposure in large-cap stocks are classified as large-cap funds.

RULES OF THE GAME

- Mid-and small-caps tend to outperform the benchmarks in a rising market; decline faster in a falling market
- Look at stocks a fund has been investing in; avoid funds that have stocks which have raised money too many times
- A number of mid-cap funds prefer to invest in large caps, to the extent that top five holdings are bigger stocks
- Based on your risk profile, choose a midcap with investing in large/midcaps
- A midcap scheme with less than 20 stocks is betting on few sectors and, hence, is riskier in nature
- Do not forget the historical performance (3-5 years) and yearly returns to check its performance in different cycles
- Funds with low corpus are better as it can enter and exit stocks at short notice