

## The Smallcap Euphoria: What to expect

*The smallcap index is up 41.7 percent since the March end, against the Nifty's 17 percent and NSE 500's 21.5 percent gains*

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Earlier this month I wrote a piece "[What do past stock market returns tell us about the future?](#)" that looked at the long-term return patterns of the Sensex and the Nifty, the indices with stocks in the large market capitalisation universe. But the flavour of this season has been the small and midcap space.

The bulk of the mutual fund inflows have also been here. In fact, there has been a net outflow from the largecap mutual fund space in the last few months even as smallcase scheme subscriptions have zoomed.

This is the space where new fund and PMS schemes are being launched. I have been getting messages and DMs, seeking recommendations for buying small and midcap stocks. From social media, it appears that not just the formal financial advisors but even the AMC (asset management company) service personnel have been pushing smallcap schemes.

**Also Read:** [The crystal ball for the US economy: How do things look now?](#)

What does the history show here?

One, it shows that the market participants have either never known or have forgotten history. Perhaps not surprising, given the number of new participants who have come in both as stock market and mutual fund investors.

### **Looking back: How brutal have the bear markets in smallcaps been?**

The NSE Smallcap index fell 78 percent from its January 2008 peak over the subsequent 14 months.

It crossed its high only in July 2016, after more than 8 years!

And even the smallcap bull run of 2016-17 didn't last long. There was another 65 percent fall from the January 2018 high over 14 months. The level was crossed again only three and a half years later.

# SMALL-CAP INDEX BIGGEST DRAWDOWNS

## NSE SmallCap 100

Max Drawdown	-77.50%
Longest DD Days	3124
Volatility (ann.)	24.10% (till March 2020)

Sr No.	Start	Valley	End	Days	Max Drawdown (%)
1	08-Jan-08	09-Mar-09	28-Jul-16	3124	-77.5
2	16-Jan-18	24-Mar-20	07-Jun-21	1238	-65.1
3	11-May-06	14-Jun-06	10-Nov-06	183	-34.7
4	18-Jan-22	20-Jun-22	21-Aug-23	580	-33.4
5	05-Jan-04	17-May-04	21-Sep-04	260	-29.3

Source: Bloomberg, First Global Research



## Yes, but my stocks will do much better

The response to this data from a number of investors/ intermediaries is along the lines of: Yes, the index may have fallen, but I am choosing my stocks very carefully and no matter what happens to the index, my stocks will do well.

Let's examine this as well.

In the 2008 to 2009 crash, how many smallcap stocks did not go down? A grand total of 1 percent!

What are the odds that not only would you have held these stocks but that these would have comprised the majority of your portfolio?

In fact, 90 percent of smallcaps were down more than 50 percent in this period.

How about the 2018-20 smallcap collapse?

78 percent of the stocks down more than 50 percent.

Only 8 percent were up in that period.

To put it as politely as I can: It is plain foolish to ignore base rates and averages and assume that you will be the exception to the rule and do brilliantly well even as everything collapses around you!

# SMALL CAP FALL COMPOSITION

Start	End	Small cap Index Drawdown (%)	% of Stocks down more than 70%	% of Stocks down more than 50%	% of Stocks down more than 40%	% of Stocks up for the period
08-01-2008	09-03-2009	-78%	72%	90%	93%	1%
10-11-2010	06-08-2013	-44%	38%	58%	67%	15%
16-01-2018	24-03-2020	-65%	55%	78%	82%	8%

Universe considered for above analysis is 1500 stocks between market cap rank of 250-1750 at the beginning of fall.

Source: Bloomberg, First Global Research



## Did smallcaps ever recover at all?

And this is still not the worst part.

We said that the smallcap index took more than eight years in 2016 to come back to its 2008 levels.

The real sting?

The smallcap index changes 18-20 percent of its constituents every year in most years. Yup, the churn is as high as that. So in about five to six years, the index changes almost completely. It is, to all intents and purposes, an altogether new index.

Therefore, even after eight years the smallcap stocks that made the highs in 2008 never recovered; many just vanished from the face of the earth or became penny stocks.

Even if you had been "patient" enough to hold them for eight years, you would not have recovered your money.

Sobering thought, isn't it?

## The Liquidity question

Up till now, we have been talking about the price movements in smallcap stocks. However, the truth is that these are stocks where there is ample liquidity when they are on their way up but when they start to crack, not only does the price go down you often have no exit at all. Liquidity dries up and many hit the downward price circuit days in a row, leaving you trapped.

Also Read: [Rakesh Jhunjhunwala on your mind? What it takes to be the next Big Bull on D-Street](#)

## How to play this?

These are the brutal truths that most investors scrambling on to the smallcap bandwagon do not know or appreciate.

This is always a risky end of the market and must be played extremely carefully. FOMO (Fear of Missing Out) isn't the right reason to get on the train which already left the station long ago.

Plus, much of the data that is talked about to prove that smallcaps give outsized returns is also not accurate because it is not survivorship bias-free.

In the US, where mutual funds have a much longer history, some studies have shown that smallcap funds outperform the general mutual fund universe.

However, once the data was adjusted for mutual fund schemes that had closed or had to be merged due to non-performance, smallcap schemes had actually not outperformed at all even on a return basis - let alone on risk-adjusted returns.

Investing is a loser's game (Google *The Loser's Game* by Charles D Ellis) where you must ensure that you do not have big losses on your capital, in order to have any hope of winning the investment game.

As a general rule: never have more than about 20 percent of your portfolio in small caps. That is the discipline we, at First Global, maintain in both our PMS schemes and our Smallcase, FG-HUM.

Even more caution is advised when small caps have already run up, as is the case currently. The small-cap index is up 41.7 percent since the March end as against 17 percent for the Nifty and 21.5 percent for even the NSE 500. It is time to be cautious rather than adventurous.

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