INDIA'S NO.1 INVESTMENT MAGAZINE SINCE 1986

DALAL STREET INVESTMENT JOURNAL

DEMOCRATIZING WEALTH CREATION

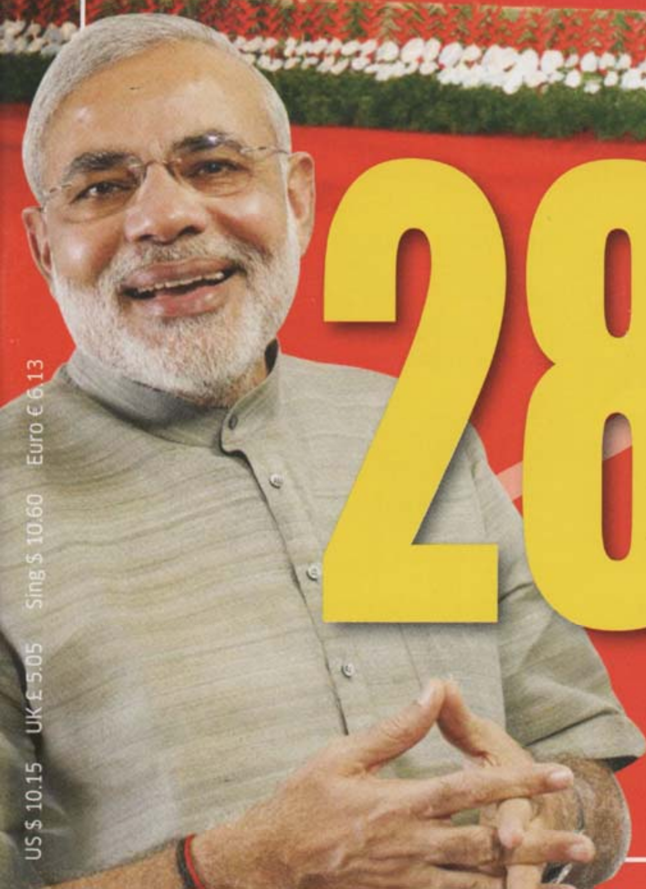
SUBSCRIBER COPY NOT FOR SALE

www.DSIJ.in ₹ 120

Editor's Keyboard

Dawn Of A New Era,

Minimum Government, Maximum Governance



AB KI BAAR 28 HAZAAR

ISSN 0974-6145

US $ 10.15 UK £ 5.05 Sing $ 10.60 Euro € 6.13

Vol. 29 No. 13
15 June 2014

The Retail Investor's Dilemma

T Srikanth Bhagavat
Managing Director, Hexagon Capital Advisors, www.hexagonwealth.com

T Srikanth Bhagavat
Managing Director, Hexagon Capital Advisors, www.hexagonwealth.com

I want to start investing in equity funds. Should I invest in large-cap or small & midcap funds?

- Jayprakash Sharma

You can invest in both types of funds and simultaneously benefit from the relative stability of large-cap stocks and the higher growth potential of small & midcap stocks.

Invest the bulk of your equity portfolio in large-cap diversified funds. These funds generally invest in "blue chip" stocks of well-established companies with strong financials and steady growth prospects and are generally more consistent than small and midcap funds.

Small and midcap funds generally invest in mid-sized companies in the early stages of their business cycles. Hence, these companies may have higher growth rates than large-cap companies which are already mature. Over time, small and midcap companies may eventually graduate to large-caps and benefit from "re-rating", which will generate higher returns for investors. For example, several leading Indian companies such as Infosys, TCS, Bharti Airtel and Dr Reddy's were once midcaps.

However, these high returns come at a price as small and midcap stocks are generally more volatile than their large-cap counterparts. The chart on the below illustrates this phenomenon. For example, in 2008, when global markets crashed, the

Nifty fell by 52 per cent while the CNX Midcap Index fell by 59 per cent.

Small and midcap stocks are less traded in the market, as large-cap stocks generally have a higher free-float component and are generally quite liquid as they are frequently traded. The volumes of small & midcaps in the market are lower than the volumes of large-caps. Because of these lower volumes, small & midcaps are more susceptible to price changes than large-caps.

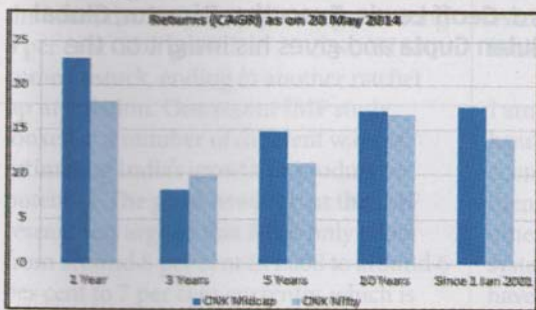
Furthermore, unlike blue chips, smaller companies are more susceptible to shocks in the business environment. This is because small and midcaps generally have a lower resource base and smaller balance sheets than mature large-caps. This characteristic also makes small and midcaps more vulnerable to business cycles. Small & midcap companies are usually the worst hit in a downturn as they also act as ancillaries to large-cap companies. Over the last few quarters, small & midcap stocks have suffered because of the weak economic environment and high interest rates. Hence, the growth prospects of mid-sized companies are not as predictable as those of large companies. This unpredictability is reflected in the stock behaviour.

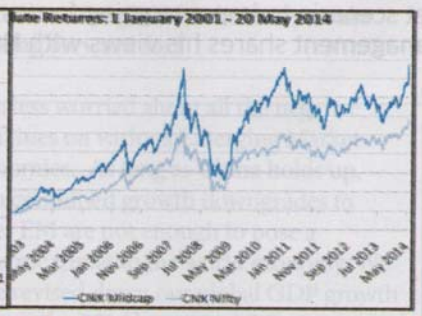
Currently, small & midcap stocks are trading at relatively more attractive valuations than large-cap stocks as shown in the table.

	CNX Midcap	CNX Nifty
Index Value on 20 May 2014	10,003	7,276
P/E on 20 May 2014	16.64x	20.21x
10 Year Average P/E	16.31x	18.70x
Index Value at Nov. 2010 Peak	9,783	6,312
P/E at November 2010 Peak	23.28x	25.59x

The price-earnings ratios (P/Es) of both indices are relatively more attractive than they were at the last peak in November 2010, but the CNX Midcap Index only surpassed its previous record high on 19th May, 2014. In contrast, the Nifty crossed its 2010 peak six months ago, in November 2013.

Small and midcap stocks may generate higher returns when India's economy recovers. A stable government may provide a good environment for small and midcap stocks to rally. These stocks tend to outperform large-caps in the upswings of the economic cycle. Furthermore, small and midcap stocks usually generate higher returns than large-caps over a long period of time. This is shown in the charts and the table below.





Analysis of Rolling Returns: January 2001 - December 2013						
	1-Year Rolling Return		3-Year Rolling Return		5-Year Rolling Return	
	CNX Midcap	CNX Nifty	CNX Midcap	CNX Nifty	CNX Midcap	CNX Nifty
No of Periods	13	13	11	11	9	9
Periods of Negative Returns	4	3	3	1	1	1
Average Return (per cent)	27.7	19.5	100.6	65.4	229.4	145.7
Minimum Return (per cent)	-59.4	-51.8	-8.9	-0.1	-7.6	-3.8
Maximum Return (per cent)	138.3	75.8	302.1	195.1	817.7	461.4

Consequently, you can invest a small portion of your equity portfolio in small and midcap funds if you have an investment horizon of at least 5 years and can tolerate short-term volatility. You can follow a "core and satellite" approach. You can invest the majority of your equity portfolio in large-cap funds (the "core") and invest a small portion in small and midcap funds (the "satellite"). The funds shown in the table below are amongst the best performers in their respective categories and have generated high risk-adjusted returns.

Scheme Performance as on 20 May 2014						
Scheme Name	Absolute Returns			CAGR		
	1 Month	3 Months	6 Months	1 Year	3 Years	5 Years
Large Cap Funds						
Axis Equity Fund(G)	10.10	23.21	21.90	23.77	15.17	-
Birla SL Frontline Equity Fund(G)	9.40	22.80	23.34	25.61	14.51	16.51
HDFC Top 200 Fund(G)	13.34	31.68	31.49	28.03	12.72	17.00
ICICI Pru Focused Blue Chip(G)	9.24	20.06	20.85	25.25	13.96	18.3
CNX Nifty	7.32	19.44	18.82	18.17	9.86	11.24
Small and Mid Cap Funds						
Franklin India Prima Fund(G)	11.72	29.60	34.69	38.34	18.75	22.06
HDFC Midcap Opportunities Fund(G)	10.11	25.43	37.17	40.89	18.62	25.58
ICICI Pru Value Discovery Fund(G)	14.33	33.22	39.07	45.88	18.58	26.85
IDFC Premier Equity Fund-Reg(G)	6.04	19.06	26.22	27.44	16.14	22.25
CNX Midcap	13.24	31.55	32.13	23.03	8.30	14.77

Your allocation to small and midcap funds should be ideally determined by your risk profile, a financial advisor can help you assess this. This core and satellite approach will ensure that the bulk of your equity investments are invested in relatively stable large-cap funds. You may be able to enhance your returns by investing a small portion of your corpus in small and midcap funds.

Note: The price-earnings ratios are from NSE's website.

You can invest a small portion of your equity portfolio in small and midcap funds if you have an investment horizon of at least 5 years and can tolerate short-term volatility. You can follow a "core and satellite" approach. You can invest the majority of your equity portfolio in large-cap funds (the "core") and invest a small portion in small and midcap funds (the "satellite").

Disclaimer: Past performance does not guarantee future returns. The mutual funds which have been mentioned are indicative of historical performance only. Please consult your financial advisor before investing in mutual funds.