How essential are midcap funds in wealth creation

Vivek Kudva
Managing Director-EMEA & India
Franklin Templeton Asset Management (India) Pvt.Ltd.

I was recently reading an article on mountaineering which stated that the Nepali government issues about 300-400 climbing permits each year to those aspiring to summit Mount Everest. In contrast, Denali in Alaska (North America's tallest mountain) had 1100 climbers in 2018, Mont Blanc in Europe had 25,000 climbers and Kilimanjaro (Africa's tallest) had 50,000 climbers. It is quite obvious why the numbers are lower for the Everest vis-à-vis the others. The Everest at 8848 meters is the tallest and riskiest to climb. In fact, the climb beyond 8000 meters is called the 'death zone'. In comparison, Denali (6190 m), Mont Blanc (4810 m) and Kilimanjaro (5895 m) are relatively easier and less risky to ascend which explains the larger numbers.

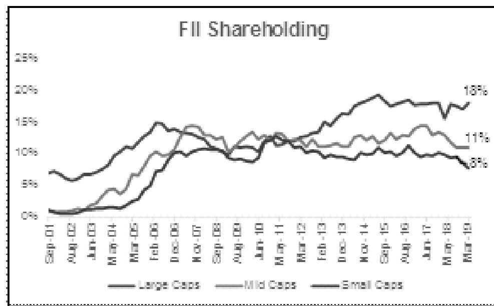
The investment world is no different. People crowd more towards low risk investments like plain vanilla assured returns products while crowds are lesser for market linked products like stocks and mutual funds owing to the relatively higher risk. However, the declining returns from traditional assured returns products, rising lifestyle inflation as well as the 'Mutual Funds Sahi Hai' campaign by AMFI (Association of Mutual Funds in India) has led to growing traction towards mutual funds in recent times. However, it is ironic that mutual funds have more takers for riskier equity products rather than for debt or hybrid products (mix of equity and debt) which carry relatively lower risk.

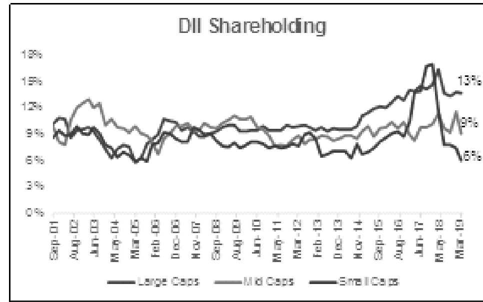
While all equity funds carry a market risk, there is a risk hierarchy within this category as well - Large cap equity funds are lower on the risk scale vis-à-vis midcap and then small cap funds where the risk is incrementally higher. The large cap category includes large, popular companies and comprises over 70% of India's listed market capitalization. According to SEBI (Securities and Exchange Board of India), the top 100 companies by market capitalisation are categorised as large cap companies, the next 150 are midcap companies and the rest are small cap companies. By definition, large cap funds need to invest atleast 80% of their corpus and midcap funds need to invest atleast 65% of their assets in the stocks corresponding to their market cap ranges.

Risk and return go hand in hand owing to which mid and small cap funds have a higher return potential vis-à-vis large cap funds. Let us look at the key traits of the underlying large and midcap stocks which contribute to their risk and return quotient. To begin with, large cap stocks are well researched and closely tracked with positive or negative news in such companies being well amplified in the offline and online media. Thus there is very little information asymmetry here which is why analysts can study the company from all dimensions and take well informed investment decisions. The stocks too are highly liquid and widely held owing to which they are less volatile meaning large volumes of buying or selling does not significantly impact prices. Being well established diversified companies, they are also more resilient to economic cycles and hence may fall relatively lesser when the markets are down. However, the drawback is that returns can also be commensurately lower in large cap funds.

Midcap funds, on the other hand include smaller companies, which are not as widely held or researched. They are also relatively less liquid often with lower trading volumes owing to which price fluctuations are higher than in large caps. While their smaller size adds nimbleness and makes them more responsive to opportunities, at the same time, it also makes them more susceptible to a downturn in the business cycle. Thus midcap funds may be relatively riskier but the return potential is certainly higher.

Let's look at some numbers to back these claims. The chart below shows that large caps are more widely held than midcaps among institutional investors. FPIs (Foreign Portfolio Investors) hold 18% in large-cap companies vis-à-vis 11% in midcaps. On the other hand, DIIs (Domestic Institutional Investors) own 13% in large caps vis-à-vis 9% in midcaps.





Source: Capitaline, as on 17 May '19.

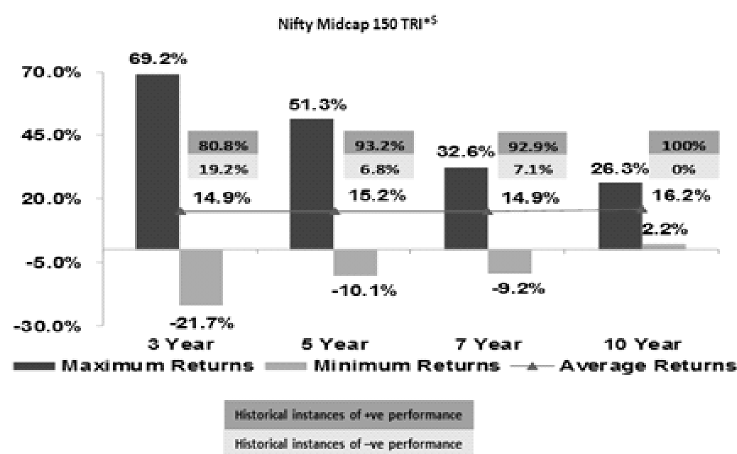
Regarding coverage of a stock by brokerages, 31 analysts on an average track the top 100 large cap stocks while only 15 analysts track Nifty Midcap 150 stocks (Source – IIFL report, April 2019). This has led to select fund managers spotting several multi-bagger midcap opportunities early and gaining handsomely when true price discovery took place especially when these midcaps matured to become large cap stocks.

Having said that, the proof of the pudding is always when you eat it. The graph below shows the 5-year performance of the large cap and the midcap index. There are two observations here – 1. Midcaps have outperformed large-caps by 5% (17% annualized returns of the large cap index & 12% of the midcap index) and 2. Midcaps have displayed higher volatility as seen by the various boxes which indicate that the ups and downs are taller / deeper for midcaps than large-caps.

Outperformance of midcaps is also seen in the point to point and SIP performance for 5, 10, 15 and 20 years as of end May 2019 (see below table). Midcap funds outperformed large cap funds across timeframes and the alpha was in the 2-4% range on an annualized basis. Please note that these are category average returns and better performing funds may provide a higher differential.

Another number to look at is the upside and the downside during 2014, 2017 and 2018. Midcap funds saw a 28% higher upside vis-à-vis large-cap funds in 2014 and 12% in 2017. However, midcap funds also fell more than large cap funds during the 2018 carnage wherein the returns differential was almost negative 10%.

Thus downside volatility is the key risk associated with midcap funds. So how does one manage this risk? The best way to manage this volatility is to invest systematically, and across longer timeframes. The graph below shows the rolling performance of the Nifty Midcap 150 index over 3, 5, 7 and 10 year timeframes observed over the past 25 years from 1993 to 2019. The bars indicate maximum and minimum returns across these periods. While there are negative periods during 3, 5 and 7 year timeframes, there are no negative periods over any 10-year timeframe since 1993. Thus it is historically proven that longer investment periods help to ride out volatility. You will also observe that negative returns are higher over shorter timeframes and taper off as the holding period increases.



Past performance may or may not be sustained in future. Period – 1.12.1993 to 30.04.2019 for Nifty Midcap 150 TRI and Nifty 50 TRI; The benchmark Index is adjusted for the period December 1, 1993 to May 20, 2013 with Nifty 500 and for the period May 20, 2013 to Jun 4, 2018 with the performance of Nifty Midcap 100. Dividends assumed to be reinvested and Bonus is adjusted. Returns greater than 1 year period are compounded annualized.

*Benchmark. **Additional Benchmark

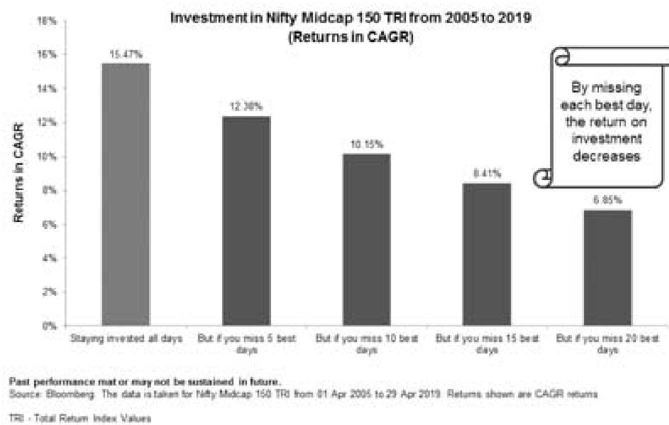
Note: The above table shows the performance on a daily rolling basis to compute returns for respective periods (3,5,7 and 10 years)

As TRI data is not available since inception of the scheme, benchmark performance is calculated using composite of ($ Nifty 500 PRI values from to 01.12.1993 to 26.11.1998, Nifty 500 TRI values from 26.11.1998 to May 20, 2013, Nifty Midcap 100 TRI values from May 20, 2013 to June 4, 2018 and Nifty Midcap 150 TRI values since June 4, 2018,^ Nifty 50 PRI values from 01.12.1993 to 30.06.1999 and TRI values since 30.06.1999)

TRI – Total Return Index

The second is liquidity risk. Midcap stocks typically have lower liquidity vis-à-vis large cap stocks and this could impact the fund during periods of higher redemptions when liquid stocks could be sold first. To mitigate this risk, one must ensure that the fund is adequately diversified and there is no large concentrated holding in any individual stock.

The third is the risk of timing the market. We observe that investors like to invest in good times and are fearful and stay away in bad times. Not staying invested across longer time frames derails wealth creation. Here’s proof ! The below graph indicates the decline in returns if one tries to time the market and misses just a few of the best days in the market. If the full period returns from 2005 to 2019 by staying invested in the Nifty Midcap 150 TRI index are 15% annualised, they will drop to 10% if one misses the 10 best days and further drop to 7% if one misses the best 20 days. In timing the market, one may not just miss the bad days but also some of the good days. Hence staying invested across time frames is the key to wealth creation.



While midcaps have the potential to provide higher returns, the bigger challenge is investor behavior in a down cycle. A practical wealth creation strategy for the common investor is a core and satellite portfolio. The 'core' includes large-cap funds which offer close to market returns and the 'satellite' includes midcap funds which provide the alpha. This not only gives investors the best of both worlds, it also helps cushion the downside. This is provided one has an investment horizon of over 5 years and follows the SIP route. You may choose the proportion of midcap funds basis your risk appetite. However, it is important to re-balance your portfolio regularly by buying more midcap funds when their proportion falls below the original level and selling them when the proportion rises.

To conclude, midcap funds are an essential ingredient in the wealth creation journey owing to their higher return potential. Investors can tackle their relatively higher volatility by investing consistently over longer time frames as well as in a staggered manner via SIPs. A portfolio that includes midcap funds may not only help to beat lifestyle inflation but also has the potential to help investors reach their goals relatively faster. It is famously said **"If you are not willing to risk the unusual, you will have to settle for the ordinary."** Midcap fund investing can help you rise above the ordinary in the wealth creation journey!