mint
July 15, 2024

Devina Mehra warns investors on the risks of investing in smallcap stocks; here's why

Pranati Deva

Devina Mehra warns investors about the risks associated with smallcap stocks, emphasizing the historical pitfalls and importance of understanding volatility and risks.

Devina Mehra warns investors on the risks of investing in smallcap stocks

Smallcap stocks have been outperforming the Nifty index for a while now, witnessing robust demand by retail investors, multiple new highs and improvement in corporate earnings.

The Nifty Smallcap index has advanced over 25 percent in 2024 YTD as against a 13 percent rise in Nifty. Similarly in the last 1 year, the smallcap index surged 68 percent as against a 25.5 percent gain in Nifty and in the last 3 years, the smallcap index rallied 84 percent versus a 54 percent jump in the benchmark.

While the outperformance continues, most experts have advised investors to stay cautious and continue with a stock-specific approach.

Warning investors of the risks of investing in smallcap stocks, Devina Mehra, Founder and Chairperson of First Global, in her latest post to X (Twitter), highlighted critical insights and warnings regarding the performance and risks associated with smallcap stocks. Through a detailed analysis, Mehra outlined the historical pitfalls of investing in smallcaps, emphasising the importance of understanding their volatility and inherent risks.

https://tinyurl.com/a8huy4je


Devina Mehra
@devinamehra · Follow

Data that I've highlighted multiple times in various articles and interviews over the last several months. Worth a recap:

1. The Smallcap index fell nearly 80% in 2008-9, it fell nearly two-thirds in 2018/19

When something falls 2/3rds, it can triple and you will make zero... Show more

9:02 AM · Jul 15, 2024

263 Reply Copy link

Historical Declines

Mehra pointed out that the smallcap index experienced a near 80 percent drop in 2008-2009 and fell by almost two-thirds in 2018-2019. She emphasised that a significant fall of this magnitude can be misleading; even if the index triples afterward, investors might still see zero returns. This context is crucial when evaluating the recent 2-3 years' returns of small and microcap managers or smallcap funds.

Recovery Challenges

She further elaborated that an 80 percent fall followed by a 50 percent compound growth over the next three years still leaves investors down by about one-third of their initial investment. This stark reality underscores the difficulty of recovering losses in smallcaps.

Index Churn and Stock Survival

Mehra explained that while the 2008 high was theoretically breached in 2016, the composition of the index had changed dramatically. Many smallcap stocks that plummet do not recover and often disappear entirely. The smallcap index undergoes an 18-20 percent churn annually, leading to a completely new index every five years. To illustrate, she mentioned that around 4,000 companies trade on the Indian stock exchanges today, but the total number of listings over time is much higher, with some years witnessing over a thousand IPOs.

Ineffectiveness of Stop Losses

In large-cap stocks, stop losses can limit losses effectively, but this strategy often fails in smallcaps where liquidity issues prevail. During market downturns, smallcap stocks frequently hit a lower circuit, making it impossible to sell.

Hedging Limitations

Mehra also noted that hedging does not work well for smallcaps since the only liquid puts available are for the Nifty, which does not move in tandem with smallcap stocks.

Strategic Investment Approach

Sharing her investment strategy at First Global, Mehra mentioned that they typically hold 14-15 percent of their PMS portfolios in stocks with market caps between 1,000 and 5,000 crores. However, they have currently reduced this to about 7 percent to manage risk, despite potential short-term relative performance drawbacks.

The Difficulty of Wise Selection

She cautioned investors against the belief that they can consistently select smallcaps that will outperform. Historical data shows that in the 2008-2009 downturn, only 1 percent of smallcaps did not fall, and in 2018-2019, this number was just 8 percent. Mehra warned against the illusion that one's portfolio would exclusively consist of these rare performers.

Devina Mehra's detailed analysis and warnings serve as a crucial reminder of the risks associated with smallcap stocks. Her insights underscore the importance of thorough research, risk management, and realistic expectations when investing in this volatile segment. Investors are advised to heed her warnings and approach smallcap investments with caution, understanding the historical context and inherent risks involved.