Inflows into smallcaps, midcaps remain high

Vishal Dhawan, founder and chief executive officer of Plan Ahead Wealth Advisors, said this was likely a result of an increase in size of smallcap schemes, driven by sizable inflows through both systematic investment plans (SIPs) and lump sum routes. "While the stress levels are fine for now, the trend needs to be tracked," said Dhawan.

"Investors should consider this aspect but also look at other parameters like Sharpe ratio and information ratio when selecting funds," he added.

In early 2024, the Securities and Exchange Board of India (Sebi) had mandated that mutual funds release monthly stress test reports for their midcap and smallcap funds. This aimed to raise awareness about the risks in these segments amid heightened inflows and 'frothy' valuations in midcap and smallcap space.

During this period, several fund houses managing large smallcap funds imposed caps on inflows to maintain optimum liquidity. However, inflows into smallcap and midcap fund categories remain high, with 30-40 per cent of net investment account openings in active equity attributed to these segments. Strong inflows, along with mark-to-market gains, resulted in 41 per cent rise in smallcap funds' assets under management (AUM) in 2024 at ₹3.3 trillion. Midcap funds' AUM grew 42 per cent year-on-year to ₹4 trillion in December 2024. While strong inflows amid pricey valuations has been a concern in the midcap space as well, their liquidity position is better compared to smallcap funds. The 10 largest midcap funds require an average of 16 days to liquidate 50 per cent of their portfolios, against 15 days in February 2024.

Liquidity stress test is conducted by adopting a pro-rata basis of liquidation after removing the 20 per cent least liquid holdings. Also, mutual funds have to assume a 10 per cent participation volume and three times the volume for assessment.