



YOUR MONEY

PASSIVE INVESTING IN MID & SMALLCAP SEGMENT

Well suited for cost-sensitive investors seeking mkt returns

HIMALI PATEL

The new fund offer of Tata Nifty Midcap 150 Index Fund is open. A large number of fund houses already offer midcap and smallcap index funds and exchange-traded funds (ETFs) based on popular indices such as the Nifty Midcap 150 and the Nifty Smallcap 250. Investors must understand the pros and cons of investing in passive funds in the mid- and smallcap segment before taking the plunge.

Outperformance becoming harder

Historically, active mid- and smallcap funds have outperformed their benchmarks over the long term. However, this trend appears to be changing.

“The latest S&P Indices Versus Active (SPIVA) report for 2024 indicates a significant decline in the outperformance of mid- and smallcap funds compared to their respective indices. This indicates that generating alpha in these segments is becoming increasingly challenging,” says Vishal Dhawan, chief financial

planner, Plan Ahead Wealth Advisors.

In passive funds, investors need not constantly monitor the fund manager’s performance. “They do not have to worry about the fund underperforming relative to the market,” says Niranjan Avasthi, senior vice president, Edelweiss Mutual Fund. They can stay invested in the same fund for long and focus on their asset allocation.

“These funds enable new investors, those without an advisor, or those short on time and expertise to participate in

the market effortlessly,” says Arihant Bardia, chief investment officer and founder, Valtrust. Raghvendra Nath, managing director, Ladderup Asset Managers, highlights that key person risk is eliminated in these funds.

Chintan Haria, principal – investment strategy, ICICI Prudential Mutual Fund, points out that investors can earn market-equivalent returns at a low cost.

Passive funds stay true to their mandate. “When investors choose a midcap or a smallcap passive fund, 100 per cent of their investment is made in the chosen category,” says Arun Sundaresan, head – ETF, Nippon Life India Asset Management. Passive funds always maintain full exposure to the market, with no attempt to exit or take cash calls during downturns. “They do not try to time the market. This can work well over the longer term,” says Sundaresan.

Risk of higher tracking error

Liquidity in mid- and smallcap stocks is lower than in largecaps. “This can lead to higher tracking

error and tracking difference for passive funds in these segments, and impact the investor’s actual returns compared to the index,” says Avasthi. Haria says that smallcap indices often include illiquid stocks, leading to wider bid-ask spreads and pricing gaps in exchange-traded funds (ETFs). Mid- and smallcap segments are more volatile than largecap. During sharp corrections, these funds decline in line with their index and offer no downside protection.

“Without an active fund manager to course-correct or take cash calls, drawdowns can be deeper,” says Haria. Passive fund managers are bound to the index.

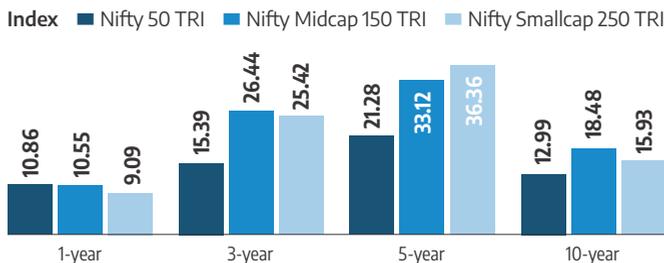
“Businesses that are not profitable may get purchased by these funds simply because they are part of the index,” says Dhawan. Bardia points out that these funds can at times include companies with poor fundamentals or governance.

Indices rebalance at set intervals. “The index may continue to hold stocks that are driving down the portfolio’s return. Active funds, where the fund manager actively tracks the performance of his portfolio stocks, can avoid this,” says Nath.

How to select an index fund

Haria suggests checking tracking error, expense ratio and assets under management (AUM). “High tracking error defeats the purpose of passive investing,” he says. In ETFs, trading volume is an important factor. “Higher the trading volume of an ETF, lower would be the impact cost of a transaction,” says Sundaresan.

Long horizon pays in mid & smallcap segment



Note: Above one-year returns are compound annualised

Source: Navigation RA