

Smallcap mutual funds dominate return charts in 5 & 10 years. What's driving the surge?

By Surbhi Khanna, Published on July 28, 2025



Smallcap mutual funds have topped the return charts in both five and ten years across all equity fund categories, including sectoral and thematic schemes. According to market experts, while smallcap funds and indices have delivered similar returns over the past five years, the category has significantly outperformed the index over a ten-year period and their relatively smaller size offers higher growth potential, making them appealing to investors willing to take on higher risk for potentially higher rewards.

“Over the last 5 years, both the Nifty Smallcap 100 Index and smallcap mutual funds have delivered approximately 33% returns. Whilst over 10 years, the smallcap mutual fund category has outperformed, delivering around 18% CAGR compared to the index's 14% CAGR,” Vishal Dhawan, CEO of Plan Ahead Wealth Advisors, a wealth management firm in Mumbai, shared with ETMutualFunds.

Small caps are often companies with the ability to grow earnings at a faster clip than more mature large caps and their relatively small size allows for higher growth potential, which can translate into significant returns for investors who are willing to embrace the risk moreover many small caps are closely tied to India's domestic consumption and manufacturing trends, which benefit from structural tailwinds, Dhawan mentioned as the reason for this surge in performance.

Since small caps tend to be more attractively valued than large caps during market corrections, they can offer better risk-reward for patient investors. However, their higher business and liquidity risks make them more suitable for those with a higher risk appetite and a long investment horizon, he added.

As on July 23, 2025 small cap funds have offered an average return of 32.48% in the last five years and an average return of 17.12% in the last 10 years. Around 21 small cap funds have completed five years of existence in the market out of which Quant Small Cap Fund offered the highest return of 41.36% and Aditya Birla Sun Life Small Cap Fund gave the lowest of 27.67% return.

Around 13 small cap funds have completed 10 years of existence in the market out of which Nippon India Small Cap Fund offered the highest return of 21.06% and Aditya Birla SL Small Cap Fund gave the lowest return of around 13.33%,

Considering the performance in the long term, Dhawan recommends trimming exposure in these funds and investors should revert to their target asset mix and lastly avoiding lumpsum investment and doing SIP/STP with a 10 year horizon would be a prudent approach.

According to the expert, while smallcap mutual funds have delivered strong long-term returns, current valuations are trading at a premium to historical averages which suggests that the risk-reward is less favourable at this stage.

Given the sharp rally in recent quarters, many investors may now be overexposed to smallcaps compared to their intended asset allocation to which Dhawan suggests this is a prudent time to review and rebalance portfolios, especially if smallcap weights have become excessive. Instead of increasing exposure further, investors should trim excess holdings and return to their target asset mix and avoid lump-sum investments in smallcaps at current levels; if you're investing with a 10-year horizon, consider SIP or STP routes for gradual allocation.

In June, small cap funds received an inflow of Rs 4,024 crore registering a growth of 25% on monthly basis from Rs 3,214 crore in May. On the other hand, another risky category to gain investors' interest was mid

cap fund which received an inflow of Rs 3,754 crore in June registering a growth of 34% on monthly basis from Rs 2,808 crore in May.

In the current calendar year so far till June 30, small cap funds received a total inflow of Rs 24,774 crore whereas mid cap funds received a total inflow of Rs 21,870 crore.

Investors are increasingly looking to tap into the faster-growing segments of the economy, as seen in their rising preference for mid-cap and small-cap funds and broad-based market gains, including a surge in the Nifty 50 index and even stronger rallies in the mid- and small-cap indices, helped reignite interest in equity investments, Dhawan stated.

So, have the mutual fund inflows into small cap funds contributed to recent outperformance? As a response, Dhawan firmly says yes, to an extent, recent small-cap rallies were primarily to retail and mutual fund inflows, which helped push valuations higher after prior underperformance.

"DII (including mutual funds and insurance companies) have been pumping steady flows into equity markets. With domestic flows (DII) now a structural force driven by SIPs and rising financialization, the impact of these flows on market segments like small caps has intensified," the expert said.

Looking at the recent performance of one month, the small cap funds were in the red zone though they lost marginally 0.10% whereas in the three months they gained nearly 11%.

According to Dhawan, small-cap indices and funds are currently trading at a premium to their long-term averages, raising concerns about near-term return potential and at present, earnings growth does not justify the stretched valuations, especially amid ongoing global macro uncertainties.

"Given their inherent volatility, small caps are highly sensitive to economic shocks and tend to correct sharply at the first sign of caution. In this context, it may be prudent to shift focus toward relatively lower-risk sectors," said Dhawan.

In the last five and 10 years, post small cap funds, the next in the return chart were sectoral and thematic funds. Are there any sectoral or thematic funds that can give similar returns?

As of now, the Banking and Financial Services sector looks attractive as it has underperformed due to concerns on divergence between credit and deposit growth, a lowering of the net interest margins, and asset quality and with the RBI initiating liquidity-supportive measures and the broader macroeconomic environment remaining conducive, the outlook for the sector appears strong.

"Importantly, the banking sector is currently trading at a discount to its historical valuations, offering an attractive entry point for investors seeking stability with growth potential. It is critical to invest with a 3-5 year investment horizon," he added.

Small cap schemes invest in very small companies or their stocks. That is why investing in small cap stocks is considered extremely risky. The small cap segment can be extremely volatile in the short term, but they have the potential to offer very high returns over a long period. Small cap schemes are recommended only to aggressive investors with a high-risk appetite and long investment horizon, say, around seven to 10 years. ET Mutual Funds do not recommend small cap schemes to new and inexperienced investors.