



YOUR MONEY

RECOVERY IN MID AND SMALLCAP FUNDS

Avoid full exit, book partial profit to restore allocation

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Midcap funds have risen 11 per cent, while smallcap funds are up 13.5 per cent on average over the past month. Experts believe the pain in these segments has not ended entirely, and hence investors must proceed cautiously.

Rebound following a prolonged correction

Investors should view the bounce back as a recovery from the sharp correction witnessed from late 2024. "The correction was triggered by expensive valuations and a weakening growth outlook caused by tightening fiscal and monetary policies," says Rupesh Patel, senior fund manager-equity investments, Nippon India Mutual Fund.

Investors also felt the correction in March this year may have been overdone. "The correction of more than 10 per cent in March was sharper than the likely 2-4 per cent impact on FY27 earnings if the war impact recedes soon," says Trideep Bhattacharya, president and chief investment officer-equities, Edelweiss Mutual Fund.

Valuations have come down. "Investors felt valuations have

reached re-entry levels," says Arvind Rao, founder of the personal finance advisory firm Arvind Rao and Associates.

Domestic consumption has not crashed completely. "Goods and services tax collections, credit growth, and corporate earnings in a few tracked sectors suggest that domestic consumption remains largely intact," says Rao.

Retail investors have not quit equities. "Systematic investment plan (SIP) inflows remained resilient despite the correction," says Rao.

Factors that could sustain recovery

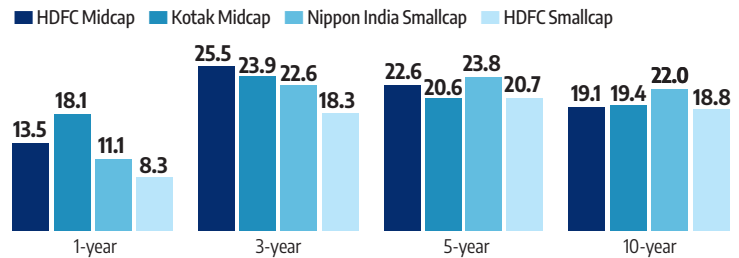
The rally's sustainability will depend on easing of geopolitical tensions. "Oil prices at around \$85 per barrel and a stable rupee could support inflation, earnings, and foreign flows," says Vishal Dhawan, founder and chief executive officer, Plan Ahead Wealth Advisors.

Earnings growth must catch up. "Earnings in the fourth quarter of FY26 and the first quarter of FY27 will be the real test for the rally," says Rao.

Continued inflows into domestic mutual funds can aid broader market liquidity.

Government spending on infra-

Wealth creators over long term Returns (%)



Note: AUM data as on March 31. Return data as on April 27. Returns for above 1-year periods are annualised. Returns are for direct plans. Two largest funds from each category (mid and smallcap) included
Source: Value Research

structure must continue. "Midcap and smallcap firms in sectors like roads, railways, defence, manufacturing, engineering, logistics, and components have been major beneficiaries of government capex," says Rao.

Risks to the recovery

Geopolitical uncertainty remains a key risk. "If a war-like scenario persists and oil prices remain above \$100, the bounce back could become unsustainable," says Bhattacharya.

Domestic inflation could become a concern, delaying RBI rate cuts, which would affect borrowing costs of smaller companies. "Prolonged geopolitical tensions could cloud the earnings growth outlook because of higher costs and disrupted supply chains," says Patel.

If earnings come under pressure, the re-rating could reverse. "Earnings downgrades could be triggered by weak demand, margin pressure, or both," says Dhawan.

These segments have given poor returns since the September 2024 peak. Further underperformance could hurt investor confidence.

"This would affect domestic flows, which have supported the markets," says Dhawan. Rao adds that a weak

monsoon could raise food prices and hurt consumption.

Valuations not frothy

Valuations have corrected. "The valuation froth has mostly worked itself out over the past 12-15 months," says Bhattacharya.

Rao adds that current midcap and smallcap valuations are closer to the historical average, but at the upper end. Since many pockets are still not cheap, any earnings downgrade could affect them.

Existing investors should rebalance

Existing investors should not exit after the rally if their goals are still far away. "Review your portfolio and rebalance based on your asset allocation," says Dhawan. Lump-sum investments should be avoided.

New investors should enter if they have the requisite risk appetite and investment horizon. "New investors should enter through SIPs or systematic transfer plans spread over 12-24 months," says Dhawan.

They should assess whether they have the risk tolerance to handle large drawdowns. Smallcap funds can correct as much as 30-35 per cent in adverse market conditions.