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**Concentration on Risky Small and Mid-Cap Mutual Funds: Disaster Follows**

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**Abstract**

It has always been a phenomenon that when market falls, investors in the stock market or market related mutual funds feel unhappy about their investments losing value. This will be more where investment products recommended carry a level of risk that is not appropriate to the risk profile of the investor. Asset allocation is supposed to be carried out in accordance with the risk profile of the investors. A well-diversified portfolio amongst debt and equity products in the proportion that matches the investor profile is the most appropriate approach.

However, in Indian conditions where Wealth Management Services as a profession is not fully recognized by all corners, the asset allocation is being done more in an ad hoc manner. And many of the Wealth Managers are not full-fledged professionals, for that matter.

The following case is an instance where the asset allocation has not been done in its conventional style, either deliberately or accidentally. Surely, non-conventional style cannot be considered absolutely out of place. The approach of this Wealth Manager, who can also be considered the second protagonist in the following case study, is to design the allocation in a heuristic manner after a detailed analysis of the historical returns from equity mutual funds. He also understands that his products are riskier. He bets on the long-term and matches the time horizon more than depending solely on the profile-based analysis and asset allocation.

*Key words: Diversification, Asset allocation, Smallcap and Midcap Funds, XIRR, CAGR, Heuristic, Long-term*

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## Introduction

Mr. Chenthil Kumar K was a Senior Executive in a Multinational company in Chennai till 2017, when he took voluntary retirement. He is now a consultant. He started investing in Mutual Funds ever since he met his new wealth manager and had been regularly investing in equity mutual funds, through SIPs and lump sum, since 2006. Over the period of time he started gaining confidence in mutual funds due to better returns on his investments and started investing more. Way ahead, in 2017, he went to the extent of liquidating his entire bank fixed deposits (FDs) to the tune of around Rs. 120 lakhs and invested in Mutual Funds, that too in small and mid-cap segments, as advised by his wealth manager. Fall in FD rates was also one of the reasons for the above switch. His family’s total Assets Under Management (AUM) stood at 1.78 cr. as on 12<sup>th</sup> January 2018, an Extended Internal Rate of Return (XIRR) of 28.03%. Overall unrealized profit on his investment was Rs. 47 lakhs. The entire investments were in small and mid-cap fund segment. His wealth manager suggested investing the whole amount in small and mid-cap segment and he had done so. Mr. Chenthil Kumar was quite happy about his investments till February 2018.

During February-March 2018 markets went for a toss and Nifty fell by around 10.46% (from a peak of 11121.1 to 9958.55). However, subsequently soon, by early July, the market completely retraced the loss and Nifty reached almost near the previous highs, which it had touched during February 2018. However, to his dismay Mr. Chenthil Kumar found that his portfolio value decreased to Rs. 1.55 crores as on 10<sup>th</sup> of July, 2018, washing away Rs. 23 lakhs of profit. He was deeply concerned about the fall and more worried that the market had already retraced the loss and reached near the previous peak, but his investment value was still showing a loss of 12.86% from the peak, profit fell down by 48.43% to Rs. 24 lakhs from Rs. 47 lakhs (Exhibit I).

Worried, he called up his wealth manager and aired his concern. He wanted to know why his portfolio was not bouncing back in tune with the market and questioned the strategy adopted by his wealth manager.

**Exhibit I – Portfolio Performance during Jan-July 2018**

			Value	Profit (Rs)	XIRR
<b>Invested Amount (Rs)</b>	1,30,47,199.48	<b>As on 14.01.18</b>	1,77,63,864.06	47,16,664.58	28.03%
		<b>As on 10.07.18</b>	1,54,79,619.28	24,32,419.80	12.06%
		<b>Diff in profit</b>		22,84,244.77	
		<b>% Loss in Value/Profit</b>	12.86%	48.43%	

Source: Author’s Representation

## Background Information

MF Equity funds invest in equity shares. Mid-cap funds and Small-cap funds invest in select stocks of mid and small-cap categories, which includes stocks ranked between 100-250 stocks in case of mid-cap funds and those except the largest 250 stocks in case of small-cap funds, by market capitalization. These funds are suitable for investors who are looking to invest money for at least 4-5 years and looking for very high returns. At the same time, these investors should also be ready for possibility of higher losses in their investments as the risk involved in these

segments is higher.

Mr. Chenthil Kumar used to be a Bank FD investor till he got introduced to his new Wealth Manager, who in turn introduced him to Equity Mutual Funds way back in 2006. Though he was in his late 30s, he was well placed financially. He was new to equity and related investments. The wealth manager found him to be slightly risk averse and hence put him in the moderately aggressive category and offered a diversified equity fund and a Systematic Investment Plan (SIP), with the following investments to start with.

SBI Magnum Contra – Growth - Lump sum Rs. 50000 invested on 03.04.2006  
SBI Magnum Tax Gain Scheme - Div. -SIP of Rs. 3000/- per month started on 07.04. 2006

The Wealth Manager collected the detailed information from Mr. Chenthil Kumar to plan his investments. All details were coded and analyzed.

Exhibit II summarizes the personal data collected by the wealth manager for profiling the investor in 2005.

**Exhibit II – Personal Data of Mr. Chenthil Kumar**

Name	Chenthil Kumar K
Date of Birth	27-04-1968
Occupation	Sr. Executive
Net take home	Rs. 1, 20,000/- pm

**Spouse:**

Name	Rejitha
Date of Birth	27-May-1971
Occupation	House wife

Assets	House worth Rs. 80, 00,000/-
Investments in FDs	Rs. 60,00,000/- @ 8.25%
Liabilities	Housing loan - Rs. 40, 00,000/-
Equated Monthly Instalment (EMI)	Rs. 35000/- pm.
Life Insurance	Nil

**Dependence:**

Mother	Aged 80
Children	son aged 7 and daughter aged 5

**Goals:**

Short term goals (1 – 2 years)	Nil
Medium term goals (3-5 years)	Nil
Long term goals	<ol style="list-style-type: none"> <li>1. 2015 – Rs. 45 lakhs – higher education for daughter</li> <li>2. 2017 – Rs. 20 lakhs - higher education for son</li> </ol>

Source: Author’s Representation

The wealth manager was of the opinion that he had the capacity to take more risk and was sure he should look into mutual fund equity schemes to optimize his returns. However, as he found

that the investor was new to equity related products and had a slightly low risk appetite, he decided to go slow on it. He was also not sure of his risk tolerance level.

As far as the goals were concerned, the wealth manager felt that he had enough of FDs to take care of these goals and need not plan separately.

Accordingly, Mr. Chenthil Kumar was introduced to mutual fund equity schemes with a small beginning. He also suggested to him a term plan for Rs. 50 lakhs, which he soon took up.

### **2006 - 2014**

Though he had a small beginning in 2006, his confidence in mutual funds started building up with the funds churning out good returns during 2000-2008. He started investing more and more during the period mostly through SIPs. The wealth manager through appropriate churning and restructuring tried to optimize his returns by taking him through a bit risky portfolio with mid-cap and theme based funds (Sundaram Select Mid-cap, Tata Infrastructure Fund, ICICI Prudential Infrastructure Fund, Reliance Equity Opportunities Funds etc.) which were the star performers during their prime periods (2005-2008). Mr. Chenthil Kumar came out of these funds at an appropriate time (2009-10) and invested into mid-cap fully at the behest of this wealth manager.

By 2010, his investments stood at Rs. 5 lakhs plus which slowly grew to Rs. 16 lakhs by 2014. Larger portion of his investments remained in small and mid-cap segment of mutual funds.

### **2015-17**

As his confidence grew, he started pumping in more and more money into mutual funds. During early 2017, he pulled out his entire FD investments to the tune of 120 lakhs to invest in mutual funds, that too in small and mid-cap fund. Fall in FD rates triggered this move. By early January 2018 (on 12th January, 2018) his investments showed an XIRR of 28.03%.

The Wealth Manager probably depended more on a heuristic approach while offering a fully concentrated portfolio of small and mid-cap funds. He created a balanced portfolio and did not offer debt funds, as he observed that debt funds had been generating only a return range almost equal to bank fixed deposits. Hence, he did not find any meaning in shifting the funds already in bank FDs, where the risk was nil, to debt funds where there was risk, though in a smaller magnitude. (Table-15 of Exhibit III- Select Corporate Bond Funds).

He even avoided hybrid funds, passive funds in the portfolio on two counts:

1. He was convinced that inclusion of such funds will only average out the overall returns. In a comparatively better period also the returns were around 10.62% to 18.28% in Hybrid Aggressive funds, mostly negative returns in bad patch (Table 16 & 17 of Exhibit III), 11.12% to 12.03% from Hybrid Conservative funds (Table 18 of Exhibit III) over 5-year period and in case of index funds, it varied from 14.61% to 18.26% over 5-year period (Table 11 and 13 of Exhibit III).
2. Risk level in these types of Hybrid Funds was also high. During a bad patch (2008-09) the returns from hybrid funds were negative for two year and three-year periods as is evident from Table 16 of Exhibit III. Hence there was no logic in investing in Hybrid funds or index funds.
3. Compared to the above, small-cap funds had generated better returns as against much lower returns from index funds during the time under study. Mid-cap funds have had also beaten the index decisively (Tables 1, 3, 5, 7 & 9 of Exhibit III)

### **2018 – The melt down**

Now, with the recent shake up, and resultant erosion in his portfolio value, Mr. Chenthil Kumar had almost lost the confidence in the market and his wealth manager. His worries aggravated when he observed that the market had almost come back to the previous high, when he had a return of 28%. This market meltdown had brought down the CAGR to around 2.47%. The wealth manager was in a difficult corner and had to convince him and bring back his confidence by realistic facts as follows:

#### **Market during Feb – July 18**

1. Market started drifting due to an investor unfriendly budget which imposed restricted capital gain tax on mutual funds and equity investments.
2. This was followed by high petroleum prices and consequent fall in rupee
3. International trade war.

#### **Outcome**

The Wealth Managers tried his best to convince Mr. Chenthil Kumar with historic returns and reason out that he may have patience as he was a long-term investor. The Wealth Manager was able to convince him and buy some time.

#### **The other side of the story**

Wealth Manger remains confident- The well experienced wealth manager with over 35 years of exposure to the industry is quite confident of returns from small and mid-cap funds in the long term. Being a long-term investor, the wealth manager tried to convince Mr. Chenthil Kumar with the historical performances as he had been witnessing in the small-cap segment (Exhibit III).

**Exhibit III: Historic performance (CAGR %) of Select Small and Mid-cap Mutual Funds Compared with Nifty 50 at Various Periods Selected at Random**

Table 1 - Mid & Small-Cap Funds as on 05.11.14	CAGR %			
	1yr	2yr	3yr	5yr
Mutual Fund Scheme				
Franklin (I) Smaller Cos (G)	101.6	50.2	45.9	24
Birla SL Pure Value Fund (G)	104.1	46.2	38.2	22.1
Tata Mid-cap Growth Fund (G)	96.4	44.4	37.2	20.5
SBI Magnum Mid-cap Fund (G)	76.3	42.8	40.1	19.3

Source – MONEY CONTROL.COM

**Table 2 - NIFTY 50 - as on 05.11.14**

	1yr	2yr	3yr	5yr
NIFTY 50	33.35%	20.90%	16.42%	11.84%

Based on Nifty closing values downloaded from nseindia.com

**Table 3 - Mid & Small-cap Funds as on 02.05.16**

Mutual Fund Scheme	CAGR %			
	1yr	2yr	3yr	5yr
Reliance Small Cap Fund (G)	5.7	25.1	38.1	21.6
Franklin (I) Smaller Cos (G)	5.6	25.9	34	23.9
SBI Magnum Mid-cap Fund (G)	4.8	26.6	32.7	23.4
Birla Sun Life MNC Fund (G)	-0.9	31.2	30.6	22.6
ICICI Pru. Exp & Other Services (G)	-3.6	22.8	30.1	21.3
Tata Mid-cap Growth Fund (G)	-6.6	20	27.3	18.3

Source – MONEY CONTROL.COM

**Table 4 - NIFTY 50 - as on 02.05.16**

	1yr	2yr	3yr	5yr
NIFTY 50	-6.31%	7.98%	9.17%	6.49%

Based on Nifty closing values downloaded from nseindia.com

**Table 5 – Mid & Small-cap Funds - as on 31.07.17**

Mutual Fund Scheme	CAGR %			
	1yr	2yr	3yr	5yr
Reliance Small-cap Fund (G)	38.4	22.4	27.4	33.1
L&T Emerging Businesses Fund-RP (G)	43.2	26.9	27.8	N A
L&T Mid-cap Fund (G)	36.9	20.6	27	29.3
Birla SL Small and Mid-cap Fund (G)	29	22.4	26.3	27.4
Franklin (I) Smaller Cos (G)	20.6	17.4	23.4	31.8

Source – MONEY CONTROL.COM

**Table 6 - NIFTY 50 - as on 31.07.17**

	1yr	2yr	3yr	5yr
NIFTY 50	10.21%	5.63%	7.23%	12.73%

Based on Nifty closing values downloaded from nseindia.com

**Table 7 – Mid & Small Cap Funds - as on 29.12.17**

Mutual Fund Scheme	CAGR %			
	1yr	2yr	3yr	5yr
ABSL Small and Mid-cap Fund (G)	58.6	31.5	25.5	27.7
Franklin (I) Smaller Cos (G)	45	25.9	21.2	30
Reliance Small-cap Fund (G)	65.4	31.2	26.5	34.4
L&T Emerging Businesses Fund-RP (G)	67.7	35.5	28.3	N A

Source – MONEY CONTROL.COM

**Table 8 - NIFTY 50 - as on 29.12.17**

	1yr	2yr	3yr	5yr
NIFTY 50	29.95%	15.24%	8.49%	12.25%

Based on Nifty closing values downloaded from nseindia.com

**Table 9 – Small Cap Funds - as on 20.07.18**

Mutual Fund Scheme	1yr	2yr	3yr	5yr
L&T Emerging Businesses Fund-RP (G)	2.71%	23.01%	19.55%	N/A
Reliance Small-cap Fund (G)	1.40%	19.31%	15.59%	33.60%
HDFC Small-cap Fund - Direct (G)	11.40%	21.57%	16.90%	N/A
ABSL Small-cap Fund - D (G)	-4.50%	13.22%	13.14%	24.65%
SBI Small-cap Fund (G)	8.50%	19.34%	15.18%	N/A

Source – MONEY CONTROL.COM

**Table 10 - Nifty 50 - as on 20.07.18**

Nifty Returns	1yr	2yr	3yr	5yr
NIFTY 50	28.54%	13.37%	8.57%	12.80%

Based on Nifty 50 closing values downloaded from nseindia.com

**Table 11-Performance (CAGR) of Select Index Funds (Passive) AS ON 29.08.16**

Index Funds – Passive	CAGR			
Mutual Fund Scheme - 29.08.18	1yr	2yr	3yr	5yr
ICICI Prudential Sensex ETF	22.82%	18.90%	15.03%	14.61%
Kotak Sensex ETF/Index Funds	22.99%	17.43%	14.01%	15.89%
SBI - ETF SENSEX Index Funds	21.17%	17.35%	14.01%	16.60%
Nippon India ETF Nifty 100	16.99%	16.96%	14.30%	18.00%
Aditya Birla Sun Life Nifty ETF	19.33%	17.81%	15.00%	17.56%

Based on NAVs downloaded from AMFIINDIA.Com

**Table 12 - Performance (CAGR) of Select Small Cap Funds as on 29.08.18**

Mutual Fund Scheme	1yr	2yr	3yr	CAGR 5yr
Franklin India Smaller Companies Fund-Growth	5.99%	11.43%	15.03%	31.51%
Nippon India Small-cap Fund – Growth- Growth	15.20%	24.15%	21.55%	38.72%
Aditya Birla Sun Life Small Cap Fund – GROWTH	4.07%	13.60%	16.65%	29.28%
Sundaram Small-cap Fund-Regular Growth	-5.30%	7.76%	9.34%	29.27%

Note On the basis of NAVs downloaded from AMFIINDIA.COM

**Table 13 – Performance (CAGR) – Index Funds (Passive) as on 29.08.18**

	1yr	2yr	3yr	5yr
ICICI Prudential Sensex ETF	22.82%	18.90%	14.87%	14.86%
Kotak Sensex ETF/Index Funds/ETFs	22.99%	17.43%	13.85%	16.17%
SBI - ETF SENSEX Index Funds/ETFs	21.17%	17.35%	13.85%	16.88%
Nippon India ETF Nifty 100	16.99%	16.96%	14.14%	18.26%
Aditya Birla Sun Life Nifty ETF	19.33%	17.81%	14.85%	17.84%

Note: On the basis of Nifty closing values downloaded from NSEINDIA.COM

**Table 14 – Performance (CAGR) - NIFTY 50 as on 29.08.18**

	1yr	2yr	3yr	5yr
NIFTY 50	19.35%	16.55%	13.47%	16.67%

**Table 15 -Performance (CAGR) of Select Corporate Bond Funds as on 29.08.18**

Mutual Fund Scheme - 29.08.18	1yr	2yr	3yr	5yr
Aditya Birla Sun Life Corporate Bond Fund – Growth	4.93%	6.73%	7.78%	8.98%
Franklin India Corporate Debt Fund – Growth	5.49%	7.62%	7.70%	9.42%
HDFC Corporate Bond Fund – Growth	4.59%	6.71%	7.88%	9.25%
Nippon India Prime Debt Fund – Growth	5.98%	6.88%	7.59%	8.53%
Sundaram Corporate Bond Fund – Growth	1.79%	5.18%	7.01%	9.47%
L&T Triple Ace Bond Fund – Growth	2.36%	3.50%	5.77%	6.97%

Note: On the basis of Nifty closing values downloaded from NSEINDIA.COM

**Table 16 -Performance (CAGR) of Select Hybrid Aggressive Funds – Bad Patch (2009)  
Hybrid Aggressive as on 01.04.09**

Mutual Fund Scheme	1yr	2yr	3yr	5yr
DSP Equity & Bond Fund – Growth	-22.45%	-0.19%	1.34%	N A
HDFC Hybrid Equity Fund – Growth	-38.10%	-15.14%	-11.08%	NA
ICICI Prudential Equity & Debt Fund – Growth	-28.49%	-9.77%	-5.29%	N A
Principal Hybrid Equity Fund – Growth	-28.85%	-5.72%	-5.81%	N A
SBI Equity Hybrid Fund - Regular Plan – Growth	-28.02%	-6.08%	-3.23%	N A

*Note: On the basis of NAVs downloaded from AMFIINDIA.COM*

**Table 17 -Performance (CAGR) of Select Hybrid Aggressive Funds – Better period  
(2016) Hybrid Aggressive**

Mutual Fund Scheme - 29.08.16	1yr	2yr	3yr	5yr
DSP Equity & Bond Fund –Growth	12.99%	15.47%	25.41%	14.50%
HDFC Hybrid Equity Fund – Growth	4.53%	4.33%	25.55%	10.62%
ICICI Prudential Equity & Debt Fund – Growth	14.52%	13.02%	25.67%	18.03%
Principal Hybrid Equity Fund – Growth	15.02%	11.03%	22.72%	15.49%
SBI Equity Hybrid Fund –Growth	9.84%	12.91%	25.01%	18.28%
L&T Hybrid Equity Fund – Growth	38.28%	28.20%	36.04%	#N/A

*Note: On the basis of NAVs downloaded from AMFIINDIA.COM*

**Table 18 - Performance (CAGR) of Select Hybrid Conservative Funds – Better period  
(2016) Hybrid Conservative**

Mutual Fund Scheme - 28.08.16	1yr	2yr	3yr	5yr
Franklin India Debt Hybrid Fund – Growth	10.80%	12.26%	14.89%	11.56%
ICICI Prudential Regular Savings Fund – Growth	11.32%	12.26%	15.92%	12.03%
IDFC Regular Savings Fund - Regular – Growth	9.37%	10.80%	13.20%	11.15%
Kotak Debt Hybrid – Growth	12.93%	11.87%	15.13%	11.14%
SBI Debt Hybrid Fund – Growth	12.31%	12.91%	13.91%	11.12%

*Note: On the basis of NAVs downloaded from AMFIINDIA.CO*