THE INDIA FORUM
A JOURNAL-MAGAZINE ON CONTEMPORARY ISSUES

December 19, 2023

Retail Investors in a Risky Dance with Small Cap Stocks

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Individual investors are entering the market like never before, investing heavily in small cap funds. These outlays, promoted by TV commentators and influencers, and facilitated by easy-to-use apps, can be a dangerous gamble. Small caps can fall as fast as they can rise, as they did during 2007-09.

The number of individual investors investing in Indian stocks has risen dramatically in the last couple of years. In late September, the National Stock Exchange (NSE) announced that the number of unique registered investors had crossed 80 million (counting unique permanent account numbers (PANs)). This count had crossed 50 million only in October 2021, implying a 60% jump in less than two years. So, three out of every eight investors currently in the stock market initiated the process to start investing in stocks in just the past two years.

Further, the jump to 80 million from 70 million unique registered investors took only around eight months. So, one out of every eight investors currently in the stock market initiated the process to start investing in stocks as recently as from January this year. This suggests that Indians have now taken to stock market investing like never before. In fact, the share of retail investors' ownership in the companies listed on the National Stock Exchange reached an all-time high of 7.62% as of September 2023.

'Small is beautiful'

Where are these new retail investors putting their money?

"Small is beautiful," wrote the economist EF Schumacher a few decades back. The Indian retail investor has discovered this during 2023 by investing in small cap stocks. (Stocks ranked 251st and beyond in terms of market capitalisation are termed "small caps".)

The BSE SmallCap Index – a broader representation of more than 950 small cap stocks in the Indian stock market – has grown by more than 54% from the end of March to 21 December. This, despite falling 3.4% on 20 December from a day earlier. In comparison the BSE Sensex – India's most popular stock market index which is made up of 30 large cap stocks – has rallied by a much lower 20% over the same period this year. (Large caps are stocks ranked in the top 100 as measured by market capitalisation.)

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So what explains this huge jump in small cap stocks? Typically, when any analysis is written of the Indian stock market, the money invested by the Foreign Institutional Investors (FIIs) is taken into account. FIIs have bought close to (net) Rs 1,73,916 crore or more than $21 billion worth of Indian stocks so far during 2023–24 (that is, from 1 April to 15 December).

It's worth remembering that FIIs normally invest in large cap stocks and mid cap stocks, which are stocks ranked in the top 250 in terms of market capitalisation. They also invest in small cap stocks but not with the same zeal, because it is difficult to buy or sell a substantial stake of small cap stocks without impacting the price of these stocks. Some news reports do suggest that the FII holding in select small cap stocks has gone up lately. nonetheless, that is not the only reason for prices going up.

A detailed breakdown of the share of retail ownership in different kinds of stocks (small, mid and large) is not publicly available on an aggregate basis. Nonetheless, looking at other data, it is safe to say that money brought in by retail investors has bumped up the prices of small cap stocks.

From April to November 2023, the net inflow into small cap mutual funds – which largely invest in small cap stocks – has been Rs 30,246 crore. This is a little under a third of the overall inflow into the equity mutual funds during the period, which stood at Rs 95,814 crore.

If we look at the data during the same period, over the last four years the net inflows into small cap mutual funds averaged less than 12% of the overall net inflow into equity mutual funds. From April to November 2022, they had averaged at around 14%.

Messages and danger signals

Retail investors invest in small cap mutual funds to indirectly invest in small cap stocks. Once the flow of money coming into small cap mutual funds goes up, the mutual funds need to use that money to buy small cap stocks. This extra inflow leads to a higher demand for small cap stocks, pushing up prices.

What does this tell us?

First, if retail investors are indirectly buying small cap stocks through mutual funds, it is safe to assume that they are buying small cap stocks directly as well. That's how broader trends typically tend to work.

Second, basic economics suggests that higher prices dampen demand. But in case of investment assets, the opposite is true. Higher prices lead to higher demand. This is what seems to have happened during the course of this year when it comes to small cap stocks.

Third, asset allocation or diversification or spreading your assets within an investment asset class seems to have gone for a toss. Take the case of large cap mutual funds, which largely invest in large cap stocks. These funds saw a net outflow of Rs 4,668 crore from April to November this year. So investors are chasing performance by investing more in small cap mutual funds. Also, they may be selling their investments in large cap funds to invest in the riskier small cap funds, thus disturbing their asset allocation. This is not the best way to go about things.

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Fourth, over the last few years, with the advent of apps with easy to use interfaces that can be installed on mobile phones, investing in stocks and mutual funds has become easier. This also explains why retail investors are punting big time on derivatives.

A recent Reuters news report pointed out that in India, "The ratio of the notional value of derivatives to cash trading is the highest in the world." The financial influencers selling courses also seem to be nudging retail investors take a punt on trading derivatives in particular options, by telling them that it is easy to do so, when it isn't.

Fifth, some TV channels have been driving the narrative of a battle between small retail investors and large foreign investors and how it's the small investor who is winning this time around. Stories sell better than data/numbers and logic. And this is a story that many retail investors seem to have lapped up, given that it makes them feel good and adds a nationalistic fervour to their investing.

Nonetheless, as far as TV channels are concerned, it is important to remember a small anecdote that Morgan Housel recounts in his new book *Same As Ever*: "Years ago Jon Stewart [a TV host among other things] interviewed investor and CNBC host Jim Cramer. When pressed on CNBC content that ranged from contradictory to inane, Cramer said, 'Look, we've got seventeen hours of live TV a day to do.' Stewart responded, 'Maybe you can cut down on that.' He's right. But if you're in the TV business, you can't."

There are time slots that need to be filled up and for that stories are stories are needed, like the one in India about the battle between the small retail investor and large foreign investor.

> It is worth remembering that small cap stocks can fall faster than they rise. The BSE SmallCap Index had stood at 7,004 points as on 2 January 2007. It more or less doubled to 13,975 points by 7 January 2008, and then fell by 80% to 2,867 points by March 9, 2009.

Of course, TV channels are not the only ones cashing in on the small cap mania, many financial influencers have also gate-crashed this party, by telling retail investors what they want to hear – that prices will only keep going up. In fact, financial influencers also constantly need to keep coming up with content in order to keep their followers engaged.

Sixth, stock market investors have a very short term memory and that's worsened in the Indian case because many retail investors are newbies in the stock market and the short period they have been there, they have only seen the stock market go up. And like most human beings, they are working on the assumption that tomorrow will be like today, which it will be, until it won't.

In fact, it is worth remembering that small cap stocks can fall faster than they rise. The BSE SmallCap Index had stood at 7,004 points as on 2 January 2007. It more or less doubled to 13,975 points by 7 January 2008, and then fell by 80% to 2,867 points by March 9, 2009. Now, anyone who knows some basic maths can tell you that a 80% fall wipes off a 400% gain. Also, the high of 13,975 points reached in January 2008 was crossed again only on 16 March 2017, more than nine years later. Dear reader, chances are you probably did not know that, now you do.

Seventh, in the ideal theoretical world, the stock price of a company at any point of time should be around the discounted current value of its possible future earnings. But then that's not how the world works. As Housel writes: "Every investment price, every market valuation, is just a number from today multiplied by a story about tomorrow […] The stories are often bizarre reflections of people's hopes, dreams, fears, insecurities, and tribal affiliations. And they're getting more bizarre as social media amplifies the most emotionally appealing views."

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As long as a stock's price is driven partly by the prospect of its future earnings and partly by story-telling, things are good. But when the story-telling totally takes over, as it currently seems to have, there is a problem. In fact, we have been there for a few months now. (See my earlier analysis in Mint in August 2023 and September 2023 of this trend.) On 11 September, Kotak Institutional Equities, a stock brokerage, came out with a damning report on small-cap stocks . It said that there had been no meaningful change in the fundamentals of most such companies. "In fact, they have worsened in many cases," it added. Irrational exuberance amongst investors seems to be driving the current rally. And, what history tells us is that irrational exuberance of the investing kind rarely ends well.

Other similar warnings have been made. Nilesh Shah, Managing Director at Kotak Mahindra Asset Management, tweeted and quoted Captain Kirk of the Star Trek series, to say that valuations seem to be boldly going "where no man has gone before."

Conclusions

To conclude, it's not always easy to exactly explain why the stock market has behaved the way it has. So, why did the fascination with small cap stocks start in the first place? Why did the initial flurry of money into such stocks start to come in only this year? Did stock brokerages start recommending such stocks once enough and more money had gone into large cap stocks and midcap stocks, or did retail investors start investing in small cap stocks on their own? Or was it a bit of both? Why were these stocks not so hot last year? All these are interesting questions with no clear answers.

This is why diversification still remains the best game in investment town. And diversification not just across different kinds of stocks and mutual funds, but all across other investment assets like fixed deposits and gold. But then this is not exciting. It doesn't get the adrenaline going. As Chuck Prince, a former chairman of the Citigroup, once said in a different context: "But as long as the music is playing, you've got to get up and dance." Which is what retail investors have been doing through this year. The trouble is once the clock strikes 12, Cinderella will lose one of her glass slippers and will have to go back home as poor as she always was. Of course, the question is, how soon will the Prince Charming come back looking for her all over again. On that your guess is as good as mine.

Vivek Kaul is a Mumbai-based writer who explains economics, investments, and finance in a simple, lucid, and jargon-free way.