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SMALL CAPS - THE WEALTH CREATOR

The real economic growth is always reflected by the mid and small companies. Not only are they job creators, they also are wealth creators for people who invest in their shares. In any economy across the world, masses love to invest in them.

Even though the Sensex and Nifty are scaling new highs on a regular basis, the broader markets represented by the BSE smallcap Index is still below its Jan 2008 highs by 36%. The earnings of the small-cap companies has trailed far behind the growth in GDP between the years 2007 and 2014. The BSE smallcap Index has been badly impacted by fall in operating margin even though the revenue growth remained strong.

In any smallcap company, two components are very important in improving the profitability of the company. One is the energy cost and the other is the interest cost. Unless these two become cheaper, a small-cap company's profitability cannot increase. The interest cost incresed from 24.7% of EBITDA in 2011 to 40% in 2013. Even though the revenue grew during the last five years, margins contracted becase of the high energy and interest costs.

I carried out a study of a few small-cap mutual fund schemes to assess their performance between January 2008 and February 2014, since the markets were below the same levels during this period. A Systematic Investment Plan (SIP) is always the best tool for creating wealth for a salaried middle class family. The results were startling! An SIP monthly investment in these schemes has shown an annualised return of 16 to 18% CAGR per annum in this period.

As the economic recovery takes off, it is my conviction that the small and mid-cap space will outperform the broader markets by a wide margin since they were disproportionately hammered during the downturn. The sheer magnitude of the downturn (5 consecutive quarters of GDP decelerating) combined with 11 repo rate hikes till April 2012 has meant that the small and mid-caps were hammered mercilessly. With a foreseeable uptick in the economy, my hypothesis is that these battered-down sectors would be disproportionate beneficiaries too!

Over the last 5 years, foreign investors have invested US $ 90 billion and bulk of this money has been invested in select large cap stocks creating a huge valuation gap between the large cap and the mid and small cap stocks. It therefore makes great sense now to invest in the small cap sector. History shows that during a bull market, they create a disproportionate wealth compared to the frontline Indices. We are now on the verge of a secular bull market which can last for atleast 7 to 10 years.

Sri. SAMRUDHI INVESTMENT SERVICES
SUNDEEP.J.PISSAY, CFP^CM
(Ph:- +91-9900940123)
Email: samrudhi_nx@yahoo.in