

## Panam - Newsletter - Dec - 2025

### Market-Cap Reality vs. Fund Flow Distortion

India's equity markets continue to display a striking imbalance between the true market-cap structure and the way investors—particularly retail investors—have been allocating their money through mutual funds. This divergence has widened significantly in the post-COVID era, driven by the strong performance of mid- and small-cap segments during 2020–2023 and the perception that these categories offer superior long-term returns.

At the broad market level, India's total listed market capitalization stands at approximately **₹450 lakh crore**, heavily skewed toward larger, more established companies:

- **Large caps** : ~70% of total market cap
- **Mid + Small caps** : ~30% of total market cap

Ideally, mutual fund flows would broadly reflect this distribution. Instead, the fund flow data reveals the opposite trend. When examining the assets under management (AUM) of the top funds in each category, the imbalance becomes even more pronounced:

- **Top 5 Large Cap Funds AUM** : ~₹2.36 lakh crore
- **Top 5 Mid Cap Funds AUM** : ~₹2.24 lakh crore
- **Top 5 Small Cap Funds AUM** : ~₹1.60 lakh crore
- This means - **Mid + Small Cap AUM = ₹3.85 lakh crore** → **which is 163% of Large Cap AUM**

In other words, although mid- and small-cap companies represent only around **42% of the large-cap universe in actual market size**, they attract nearly **1.6 times** the AUM invested in large caps. This reflects a powerful behavioral trend: **retail investors have aggressively chased the outperformance of mid and small caps**, often without fully considering the risks associated with stretched valuations, lower liquidity, and heightened cyclicality.

The surge in inflows has pushed these segments to levels where valuations have run ahead of fundamentals. As a result, the vulnerability to corrections has increased significantly. The inherent volatility of mid- and small-caps—usually masked during bull phases—has started resurfacing, making the investment environment riskier than headline index movements may suggest.

## Valuations Running Ahead of Reality

The rapid buildup of flows into mid- and small-cap categories has driven valuations to historically elevated levels. Currently, these segments trade at valuations that are difficult to justify based on past or current earnings performance. To put this into perspective, here are the key numbers that highlight the disconnect:

- **Current mid- & small-cap valuations: > 32x earnings**
- **Required profit growth for 15% IRR over 10 years: ~19% CAGR**
- **Historical profit growth (last decade): ~13% CAGR**
- **Recent earnings (Q1 FY26): Large caps: ~8% YoY profit growth , Mid caps: ~10% YoY profit growth**

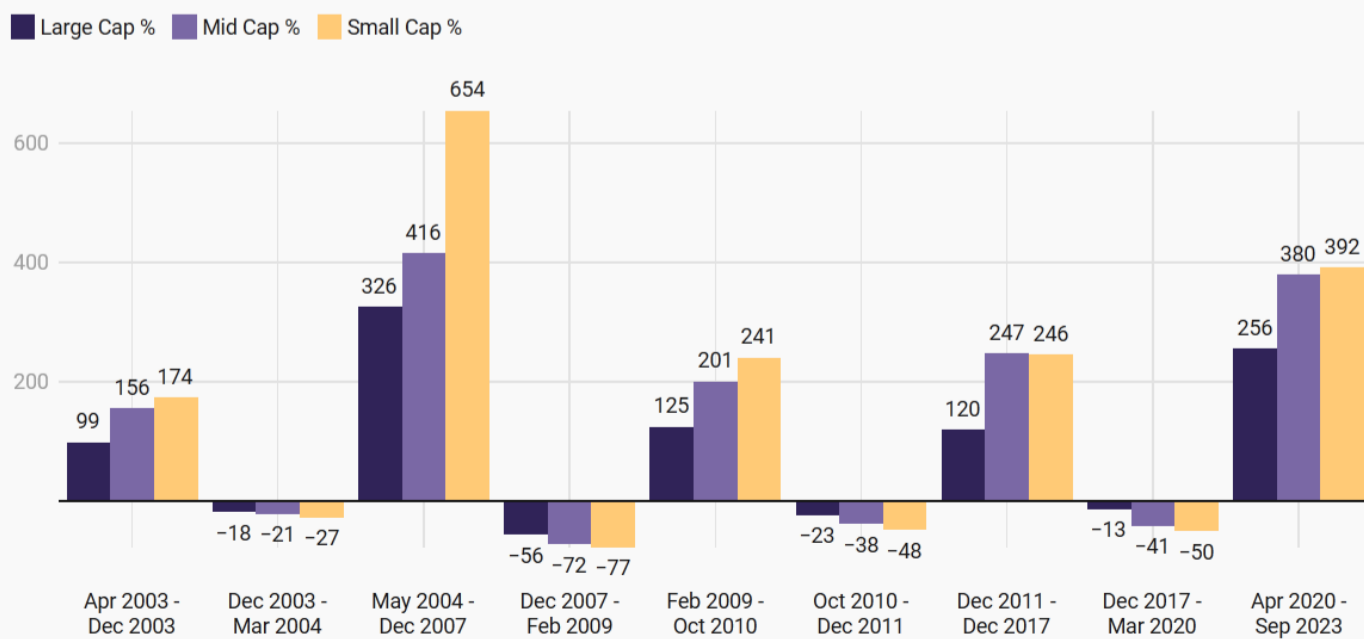
Despite many mid and small cap companies having strengthened their balance sheets post COVID largely through deleveraging and improved cash reserves—these balance sheet improvements alone cannot justify valuations that have surged beyond 35 times earnings. The current pricing of these segments reflects optimistic expectations about future growth, expectations that are not yet supported by underlying earnings momentum or actual profit delivery. As inflows continue to outpace fundamentals, the valuation gap between expectation and reality becomes increasingly difficult to sustain.

## Cyclicality and Drawdown Risk

Beyond valuations, investors should recognize the inherent cyclicality and volatility that define the mid- and small-cap universe. Over the past two decades, these segments have repeatedly seen drawdowns of 25% or more, often following sharp rallies similar to the one observed in the post-COVID period. While headline indices may not fully reveal the recent stress, the underlying pain in mid- and small-cap stocks has been considerably more pronounced than in large caps.

### Indices Market Cycle 2003 - 2025

Small and Mid Cap while providing higher returns , draw downs are also higher. Proper exit necessary .



Historical cycles underscore that higher returns in these categories come with significantly greater volatility, and downturns can be both severe and prolonged. As valuations detach further from earnings support, the likelihood of future volatility increases, particularly if profit growth fails to meet elevated expectations.

**Higher returns from small caps come at the cost of significantly greater risk and deeper drawdowns.** Small caps can deliver extraordinary returns during bullish phases, but this outperformance often masks the severe volatility they experience in downturns. A classic example is the period around the 2008 global financial crisis. A notional investment of **₹100 in a small-cap index grew dramatically to ₹754 by December 2007**, reflecting the explosive upside potential in strong market environments. However, when the cycle turned, the same index **collapsed to just ₹174 by 2009**, wiping out the majority of the gains and highlighting how quickly momentum-driven returns can reverse. This illustrates that while small caps can multiply wealth rapidly, they also expose investors to disproportionately large drawdowns

## A Time for Prudence and Balance

Despite these challenges, India's long-term structural growth story remains intact, and prudent investing continues to offer attractive opportunities. However, in the current environment of stretched valuations and moderate earnings growth, investors should maintain realistic expectations and emphasize resilience over aggressiveness. Some normalization in mid- and small-cap valuations appears likely, either through earnings catching up or market prices adjusting. Large caps offer relatively better value today, supported by stronger balance sheets, superior liquidity, steadier earnings visibility, and more reasonable valuations. Rather than exiting markets, investors should ensure their portfolios remain balanced, diversified, and aligned with long-term objectives.

Systematic investment plans remain a sensible tool to navigate volatility, but investors should avoid extrapolating the extraordinary returns seen immediately after COVID. With global uncertainty high and domestic valuations elevated, the coming phase is likely to favor quality companies, stable cash flows, disciplined asset allocation, and measured risk-taking. Our focus remains on constructing portfolios that prioritize clarity, stability, and long-term value creation, helping clients navigate this evolving landscape with confidence.

## Where to Invest Now?

Consumption, which forms almost **60% of India's GDP**, is entering what looks like the early phase of a recovery cycle, offering a timely opportunity for investors to position capital before demand visibly improves. Urban consumption has been softer due to salary moderation, higher leverage and the IT slowdown, but much of this is already reflected in valuations and sentiment appears close to bottoming. The real momentum, however, is visible in rural India where wage and employment indicators have clearly turned.

## Key improving rural drivers:

- Nominal wage growth: ~7%.
- Real rural wages: **5–8% (8-year high)**.
- Above-average monsoon.
- Lower MNREGA demand (signal of stronger private labour market)

### Stimulus - Very Significant

Tax Cuts (0.3% of GDP), GST Cut (0.5%), 100 bps Rate Cuts (0.3%), 100 bps CRR cut (0.7%), 8th Pay Commission Revision (0.8%)

Component	% of GDP	Calculation	Value (₹ lakh crore)
Tax Cuts	0.30%	$0.003 \times 330.68$	0.99
GST Cut	0.50%	$0.005 \times 330.68$	1.65
8th Pay Commission	0.80%	$0.008 \times 330.68$	2.65
<b>Total</b>			<b>5.29</b>

At the same time, policy support has been extremely material and already implemented, even if households have not fully deployed this into spending yet.

The stimulus already deployed into the economy is far more meaningful than what the market narrative currently discounts. Based on the latest calculations, tax cuts alone amount to roughly **0.3% of GDP**, translating into **₹0.99 lakh crore**, while GST reductions (0.5% of GDP) add another **₹1.65 lakh crore**. The 8th Pay Commission revision contributes **₹2.65 lakh crore**, taking the total stimulus to nearly **₹5.29 lakh crore**, excluding the additional impact of rate cuts and CRR reductions.

This is a very material injection of purchasing power into households at a time when rural wages are accelerating and urban consumption appears to be bottoming out. In our view, such a large stimulus pool has the potential to power a meaningful consumption rebound over the coming **12–18 months**—providing an attractive setup for investors looking to position ahead of a domestic demand recovery.

Given this backdrop, we anticipate a sharp improvement in **discretionary spending, which should directly benefit companies across categories such as travel & tourism, paints, home improvement, and the electrical and electronics segments**. Moreover, the companies in this segment have largely underperformed over the last five years, creating a favorable opportunity for investors now.

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