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Retail Investor Behaviour and Performance in Mid-Cap and Small-Cap Investments

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Abstract

This study examines the behaviour and performance of retail investors in mid-cap and small-cap investments. The findings provide insights into the factors which influence investment decisions and the impact of market conditions on retail investor behaviour. The objective of this paper is to explore the behaviour and performance of retail investors in mid-cap companies and small-cap sectors and to compare the risk-return characteristics of these investment portfolios.

Introduction

Over the years, there has been a paradigm shift in the way people invest in different investment arenas. The number of investors with knowledge about equities and investing in them has also seen a considerable increase. However, has it affected the way people invest their funds in stocks? There have been many factors that have contributed to this. An attempt has been made to understand the behaviour of the Indian investor, as well as the concepts related to investing.

Through the evaluation of various articles and past research, this study aims to gather information that analyses the behaviour of retail investors towards mid-cap and small-cap investments.

Literature Review

Anish Narang (2014) explores the role of small-cap companies in India, which generally have market capitalisations between ₹60 crore and ₹ 600 crore, in the nation's economy, and their significant contributions to industrial output and employment. However, the institutional investors view them as risky due to their volatile nature. The study highlights the importance of substantial returns offered by small-cap stocks when managed effectively, which is especially true for strategic investments that identify essential factors for success, such as earnings potential, corporate governance, and industry growth. Investors who carefully assess these factors can effectively mitigate risks and achieve long-term gains in this sector.

Gaurav Kumar and AK Mishra (2015) examine the role of liquidity. In this study, the liquidity of Indian mid-cap stocks was analysed using the Amihud illiquidity ratio,

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trading volume, spread, and depth as proxies. The findings revealed a varying degree of liquidity among these stocks. The authors also identified key determinants of liquidity, including the price-earnings (P/E) ratio, price-to-book (P/B) ratio, dividend yield, and the Index of Industrial Production (IIP). Further, a “L-shaped” intraday liquidity pattern was observed, where liquidity declines towards the business closing hours.

Abbas Valadkhani (2022) examines the performance of large- and small-cap ETFs under extreme market conditions, employing a threshold model to distinguish between the responses. The results indicate that small-cap ETFs tend to decline more during market downturns than they rise during market upswings, while large-cap ETFs generally perform better during market gains. It suggests that investors should be cautious about over-weighting small-cap ETFs, especially in volatile markets, as their downside risks are significantly higher. These findings emphasise the importance of portfolio diversification based on market capitalisation.

Tamal Datta Chaudhari and Indranil Ghosh (2015) write a paper whose purpose is to predict stock returns of mid-cap companies in India and understand the factors that can be used for stock selection. The explanatory factors considered in our study are: Price-Earnings (P/E) Ratio, Price to Book Value (P/BV) Ratio, Debt-to-Equity Ratio, Interest Coverage Ratio, Gross Profit Margin, Dividend Pay-Out Ratio, Extent of Promoter Holding of Shares, Sectoral Returns, and Volume. These variables have been considered in the literature to understand their role in explaining stock returns. However, they have not been considered together.

Discussion on Investors’ behaviour

Compared to institutional investors, retail investors represent a separate part of the financial markets due to their smaller investment amounts and different behavioural patterns. The objective is to conduct a thorough analysis of retail investors’ actions in the small- and mid-cap stock categories, which are highly volatile but attractive segments of the market.

Mid-cap and small-cap stocks refer to companies with market capitalisations that are smaller than large-cap firms but still offer significant growth potential. Mid-cap stocks typically have market capitalisations between Rs. 5,000 crores to Rs. 20,000 crores, while the market cap of small-cap stocks lies below Rs. 5,000 crores. Due to their smaller size, these companies are often in the growth stage, making them attractive to retail investors seeking higher returns. However, their volatility and lack of established market presence mean that investments in these stocks carry higher risk.

Retail investors are typically motivated by short-term gains, and various factors, including risk tolerance, market trends, peer influence, and media reports drive their behaviour in mid-cap and small-cap segments. Many retail investors are drawn to these stocks for their potential to generate high returns, particularly during bullish market periods. However, the volatile nature of these stocks often leads to uncertain behaviour, especially when investors lack thorough knowledge of company fundamentals or a clear investment strategy.

One of the critical aspects of understanding retail investor behaviour is examining how emotional and cognitive biases influence their decisions. Retail investors are vulnerable to herding behaviour, where they follow the actions of other investors without doing proper research. It is particularly noticeable in mid-cap and small-cap stocks, where investors might be influenced by market hype or recommendations from financial influencers and media outlets. Overconfidence is another common bias, where investors believe they can predict market movements or outperform the market based on limited information. It often leads to overtrading or taking excessive risks in volatile stocks.

Retail investors are individual investors who buy and sell securities for their accounts, and their behaviour can be influenced by various factors such as market trends, economic conditions, and fund performance.

Additionally, retail investors in these segments often exhibit loss aversion, a bias where they are more sensitive to potential losses than to potential gains. This bias can cause them to sell off stocks prematurely during market downturns, and they may miss opportunities for long-term growth. Moreover, many retail investors lack the resources and tools available to institutional investors, such as access to advanced market research and advanced trading platforms. As a result, they often rely on superficial indicators, such as short-term price movements, rather than conducting an in-depth analysis of a company's financial health.

Understanding retail investor behaviour in mid-cap and small-cap stocks requires an analysis of not only what drives their investment decisions but also how they react to market conditions. By studying their investment patterns, we can gain insight into why retail investors are drawn to these segments, despite the potential risks, and how their decision-making processes differ from those of more seasoned or institutional investors.

Mid-cap and small-cap stocks often show significant growth during bullish market periods but are prone to sharp declines during market downturns. As a result, the performance of retail investors in these segments is often more volatile than that of those investing in more stable large-cap stocks. It is essential to ask: Can retail investors withstand this volatility, or will they face more significant losses due to emotional and impulsive decision-making?

Retail investors often focus their portfolios in a few risky stocks, particularly in small-cap segments. This lack of diversification increases their exposure to individual stock risks, which makes their portfolios more vulnerable to sharp declines. On the other hand, institutional investors diversify across a broader range of asset classes and sectors, thereby reducing their overall risk exposure.

By analysing the long-term performance of retail investors in these segments, we can determine whether their strategies align with their risk tolerance and financial goals. It's also essential to evaluate how well retail investors adapt to market changes, such as economic downturns or industry-specific disruptions and whether they display panic during volatile periods.

The final objective is to identify the key factors that influence retail investors' decisions when investing in mid-cap and small-cap stocks. These factors can be classified into internal factors (such as investor psychology, financial goals and risk tolerance) and external factors (such as market trends, economic conditions and information sources).

The important key factors are

- Risk Tolerance
- Liquidity
- Diversification Strategy
- Tax Implications
- Peer Influence and Social Media
- Macroeconomic Factors (e.g. interest rates, inflation)
- Financial Information and Company Fundamentals

One of the most important internal factors is risk tolerance. Retail investors with a higher risk tolerance are more likely to invest in mid-cap and small-cap stocks due to their potential for higher returns. Still, their understanding of the risks associated with these stocks may not always align with their risk appetite, which can lead to poor decisions.

Another internal factor is financial literacy. Retail investors with limited financial knowledge are more vulnerable to cognitive biases, such as overconfidence and herd mentality. These biases can lead to poor decision-making, particularly in volatile segments such as mid-caps and small-caps. Overconfidence often leads investors to believe they can time the market or select the subsequent "winning stock," while herding encourages investors to follow market trends without conducting sufficient research.

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External factors also play a significant role in influencing retail investors. Media reports, social media influencers and market analysts often influence retail investors' decisions. With the rise of online platforms, retail investors are more exposed to real-time market opinions, which can lead to impulsive trades driven by fear of missing out (FOMO) or market panic during downturns.

Economic conditions, such as interest rates and inflation, also affect retail investor behaviour. In a low-interest-rate environment, retail investors are more likely to invest in riskier assets, such as mid-cap and small-cap stocks, in pursuit of a higher return on their investment. On the other hand, during periods of high inflation or economic instability, retail investors may exhibit loss aversion and opt for safer investments or exit the market entirely.

Retail investors in mid-cap and small-cap segments are primarily motivated by the possibility of large gains. Several factors, including risk tolerance, market trends, peer influence, and media reports, influence their behaviour. Emotional and cognitive biases, such as herding behaviour and overconfidence, impact their investment decisions. Retail investors often follow market hype or recommendations without proper research, which can lead to overtrading and excessive risk-taking.

Mid-cap funds have seen strong inflows, particularly in Q2 and Q3 of 2023. It indicates retail investors' confidence in the growth potential of mid-sized companies. Small-cap funds have also experienced positive inflows, although not as substantial as those of mid-cap funds. This suggests that retail investors are willing to take higher risks for potentially higher returns.

Retail investors in mid-cap and small-cap stocks often experience high volatility in their portfolios due to the nature of these stocks. Without proper risk management strategies, such as diversification and hedging, retail investors can be negatively impacted by market fluctuations. It can lead to lower performance compared to experienced investors. Retail investors who frequently trade tend to achieve lower returns than those who adopt a long-term strategy, as trading costs and market timing errors can reduce profits.

Internal factors, such as risk tolerance and financial literacy, play crucial roles. Retail investors with higher risk tolerance are more likely to invest in mid-cap and small-cap stocks. External factors, such as media reports, social media influencers, and market analysts, have a significant influence on retail investors' decisions. Economic conditions, such as interest rates and inflation, also affect their behaviour.

Concluding Remarks

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Retail investors are drawn to mid-cap and small-cap stocks for their growth potential; however, emotional and cognitive biases can influence their decisions. These biases can lead to suboptimal investment decisions, such as overtrading and excessive risk-taking. Retail investors' performance in mid-cap and small-cap segments is highly volatile. Without proper risk management and a long-term investment strategy, retail investors are likely to experience lower returns compared to institutional investors. Financial advisors and brokers should focus on educating retail investors about the risks and rewards of mid-cap and small-cap investments. Demonstrating the importance of diversification, long-term investment strategies, and risk management can help retail investors achieve better performance.

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