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Midcap mayhem

The surveillance process to curb speculative excesses in small-caps must be transparent

Bellwether indices have lately signalled that all's well with the stock market, but this has masked considerable turmoil in mid- and small-cap stocks. While the Nifty 50 is up by 2 per cent on a year-to-date basis, the Nifty Midcap index and Nifty Smallcap index are down by 12 and 17 per cent, respectively. Even these numbers don't fully capture the bloodbath in some of the smaller names, which have tanked 60-80 per cent in the last five months, losing 15-20 per cent in the last week alone. This has extracted a heavy toll on retail portfolios, given that domestic investors favour mid- and small-cap stocks over index names.

Three factors appear to have triggered the mayhem. First, there's concerted selling by domestic funds. In October 2017, to enforce truth-in-labelling in mutual funds, SEBI had stipulated new rules that required managers of large- and mid-cap funds to stick mainly to the top 250 stocks in the market. This forced active funds to trim their portfolio weights in such stocks. Governance concerns have also flared up around a few mid-sized firms lately, after abrupt resignations by their auditors. But the most proximate cause for the recent sell-off appears to be the stock exchanges' decision on May 31 to sweep 109 stocks into Additional Surveillance Measures (ASM). Stocks under ASM are subject to 100 per cent upfront margins and 5 per cent circuit limits and these curbs prompted intra-day traders to flee these counters. Market participants have been critical of ASM, but such pre-emptive measures by SEBI or the stock exchanges to curb speculative excesses ought to be welcomed by long-term investors. The correction has helped dissipate some of the speculative froth in obscure names that were trading at an unjustifiable valuation premium to blue-chips. ASM is also a more market-friendly measure than the Periodic Call Auctions or Graded Surveillance Measures deployed earlier, which actually froze trading.

But SEBI and the stock exchanges need to do a better job of convincing market participants that their processes to identify stocks for ASM and disseminate this information to the market are completely above board. The exchanges must use uniform, objective and publicly disclosed criteria for placing stocks under ASM. Given the significant wealth erosion in such candidates, simply stating that stocks will be selected for high volatility based on 'dynamic' criteria, will not suffice. Reports of the ASM list being leaked to select traders ahead of the official announcement — which helped them make a killing through short-sales — are even more disconcerting. Given that unpublished information of this nature is far more price-sensitive than social media leaks on company results, SEBI will need to pursue this investigation as seriously as insider trading cases. Offenders, both at the regulators and the exchanges, need to be identified and swiftly punished to reinforce faith in market integrity.