ROLE OF SMALL-CAP MUTUAL FUNDS IN FINANCING ENTREPRENEURIAL AND MSME GROWTH: A SYSTEMATIC REVIEW OF LITERATURE

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ABSTRACT

Entrepreneurship and Micro, Small and Medium Enterprises (MSMEs) play a pivotal role in economic growth, innovation, and employment generation, particularly in emerging economies such as India. Despite their economic importance, access to adequate and timely finance remains a persistent challenge for entrepreneurial firms and MSMEs due to information asymmetry, collateral limitations, and risk conservative lending behaviour of traditional banking systems. While prior research has extensively examined mutual fund performance and MSME financing independently, limited attention has been given to the role of capital market–based institutional investors, particularly small-cap mutual funds, in supporting entrepreneurial and MSME growth.

This study undertakes a systematic review of literature to examine the role of small-cap mutual funds as an indirect financing mechanism for entrepreneurship and MSMEs. Guided by the Preferred Reporting Items for Systematic Reviews and Meta-Analyses (PRISMA) framework, peer-reviewed studies were identified from major academic databases and analysed using a thematic approach. The review synthesises findings across finance and entrepreneurship literature to identify dominant themes, theoretical perspectives, methodological trends, and geographical contexts.

Keywords: *Small-Cap Mutual Funds, MSME Financing, Entrepreneurial Growth, Capital Market Financing, Institutional Investors, Systematic Literature Review, PRISMA Framework, Emerging Economies, Financial Inclusion, India*

1. INTRODUCTION

Entrepreneurship and Micro, Small and Medium Enterprises (MSMEs) are widely acknowledged as critical drivers of economic growth, innovation, employment generation, and regional development across both developed and emerging economies. In the Indian context, MSMEs constitute a significant proportion of industrial units and contribute substantially to gross domestic product, exports, and employment creation. Despite their economic importance, access to adequate and timely finance continues to be one of the most persistent constraints faced by entrepreneurial ventures and MSMEs, particularly during their early and growth stages (Beck & Demirgüç-Kunt, 2006; OECD, 2017).

Traditional sources of finance such as bank credit and informal lending have historically dominated MSME financing. However, these channels are often characterised by high collateral requirements, information asymmetry, credit rationing, and risk aversion towards small and entrepreneurial firms (Stiglitz & Weiss, 1981; Beck, Demirgüç-Kunt, & Maksimovic, 2005). As a result, scholars and policymakers have increasingly emphasised the role of alternative and market-based financing mechanisms in supporting entrepreneurial growth. Within this evolving financial landscape, capital markets and institutional investors have gained prominence as indirect yet influential sources of entrepreneurial finance.

Mutual funds, as major institutional investors, play a crucial role in mobilising household savings and allocating capital to productive economic activities. A substantial body of finance literature has examined mutual fund performance, risk-adjusted returns, portfolio allocation strategies, and market efficiency (Carhart, 1997; Gruber, 1996; Fama & French, 2010). Within the mutual fund universe, small-cap mutual funds occupy a distinct position due to their investment focus on firms with relatively smaller market capitalisation and higher growth potential. These firms are frequently characterised by entrepreneurial orientation, innovation-driven strategies, and expansionary growth trajectories.

From an entrepreneurial finance perspective, investments made by small-cap mutual funds may indirectly support entrepreneurial and MSME growth by enhancing firms' access to equity capital, improving liquidity, strengthening market valuation, and facilitating long-term expansion. Although mutual funds do not directly finance firms in the same manner as venture capital or angel investors, their role in capital market-based financing of entrepreneurial firms is increasingly relevant, particularly in emerging economies where equity market participation is expanding (Denis, 2004; Ayyagari, Demirgüç-Kunt, & Maksimovic, 2011).

Despite the growing importance of small-cap mutual funds and the extensive literature on both mutual fund performance and MSME financing, existing research remains fragmented. Studies on mutual funds largely focus on performance evaluation, fund persistence, and investor behaviour, without explicitly linking investment outcomes to entrepreneurial or MSME growth. Conversely, entrepreneurship and MSME literature has predominantly examined financing through banks, government schemes, venture capital, and informal sources, with limited attention given to capital market-based institutional investors such as mutual funds. Consequently, the specific role of small-cap mutual funds in financing entrepreneurial and MSME growth has not been systematically synthesised in prior research.

This lack of integration highlights a critical gap in the literature. While individual empirical studies provide valuable insights into mutual fund dynamics and entrepreneurial finance independently, there is a paucity of systematic reviews that bring these two streams together to assess their intersection. Addressing this gap is particularly important in the context of emerging markets such as India, where regulatory reforms, increased retail investor participation, and policy initiatives aimed at MSME development have strengthened the relevance of small-cap mutual funds within the broader financial ecosystem (SEBI, 2020; World Bank, 2020).

Against this backdrop, the present study undertakes a systematic review of literature to examine the role of small-cap mutual funds in financing entrepreneurial and MSME growth. The primary objectives of this review are threefold. First, it aims to synthesise existing academic literature at the intersection of mutual fund investment, entrepreneurship, and MSME finance. Second, it seeks to identify dominant themes, theoretical frameworks, methodological approaches, and geographical contexts within the reviewed studies. Third, it endeavours to highlight key research gaps and propose a future research agenda to advance scholarly understanding of capital market-based entrepreneurial finance.

By integrating insights from finance and entrepreneurship literature, this study makes several contributions. Academically, it consolidates dispersed research findings and offers a structured understanding of how small-cap mutual funds contribute to entrepreneurial growth through indirect financing mechanisms. From a policy perspective, the review provides insights relevant to regulators and policymakers concerned with MSME financing and capital market development. Practically, it offers implications for investors, fund managers, and entrepreneurs seeking to understand the broader impact of small-cap investments.

Methodologically, this study adopts a systematic literature review approach guided by the Preferred Reporting Items for Systematic Reviews and Meta-Analyses (PRISMA) framework. Peer-reviewed journal articles were identified from major academic databases, screened using predefined inclusion and exclusion criteria, and analysed thematically to ensure transparency and replicability. The remainder of the paper is structured as follows. The next section outlines the review methodology and PRISMA protocol. This is followed by a descriptive and thematic analysis of the literature. Subsequently, key research gaps and future research directions are discussed. The paper concludes by summarising the main findings and highlighting theoretical, policy, and practical implications.

REVIEW OF LITERATURE

1. Entrepreneurship, MSMEs, and Financing Constraints

Entrepreneurship and Micro, Small and Medium Enterprises (MSMEs) are widely recognised as engines of economic growth, innovation, and employment generation across both developed and emerging economies. In India, MSMEs contribute significantly to GDP, exports, and industrial employment, playing a crucial role in inclusive and regional development. Despite their importance, access to finance remains one of the most persistent barriers to entrepreneurial and MSME growth (Beck & Demirgüç-Kunt, 2006; OECD, 2017).

Theoretical and empirical studies highlight that MSMEs face severe financing constraints due to information asymmetry, lack of collateral, high transaction costs, and perceived riskiness (Stiglitz & Weiss, 1981; Beck, Demirgüç-Kunt, & Maksimovic, 2005). Traditional financing sources such as bank credit and informal lending dominate MSME funding, but these channels often fail to meet the long-term capital needs of entrepreneurial firms, particularly during early and expansion stages.

Consequently, the entrepreneurship literature has increasingly emphasised the role of alternative financing mechanisms, including equity markets, venture capital, and institutional investors, in supporting firm growth (Denis, 2004; Ayyagari, Demirgüç-Kunt, & Maksimovic, 2011). Within this broader financing ecosystem, capital market-based financing has gained prominence, especially in emerging economies where financial market depth and investor participation are expanding.

2. Mutual Funds as Institutional Investors

Mutual funds play a critical role in financial intermediation by mobilising household savings and allocating capital to productive investments. A substantial body of literature has examined mutual fund performance, portfolio allocation, risk-adjusted returns, and market efficiency (Gruber, 1996; Fama & French, 2010). Mutual funds, as institutional investors, influence capital allocation decisions and market liquidity, thereby indirectly affecting firm-level investment and growth outcomes.

Within the mutual fund universe, small-cap mutual funds occupy a distinct position due to their investment focus on firms with relatively low market capitalisation, high growth potential, and greater business risk. These characteristics align closely with entrepreneurial and MSME firms, which are often innovation-driven and expansion-oriented. From an entrepreneurial finance perspective, investments by small-cap mutual funds may indirectly support firm growth by enhancing access to equity capital, improving market valuation, and facilitating long-term expansion.

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Despite this conceptual linkage, the literature has largely examined mutual funds from an investor-centric perspective, focusing on performance evaluation rather than their broader economic or developmental role.

3. Mutual Fund Performance and Persistence: The Carhart Perspective

The persistence of mutual fund performance has been a central issue in finance literature. Early studies, notably Jensen (1969), found little evidence that mutual fund managers could consistently outperform the market after adjusting for risk, supporting the efficient market hypothesis. However, later studies revived interest in performance persistence by documenting short-term continuation in fund returns.

Hendricks, Patel, and Zeckhauser (1993) identified short-term persistence and attributed it to a "hot hands" phenomenon, suggesting that superior past performance could predict future outperformance. Similarly, Goetzmann and Ibbotson (1994) and Brown and Goetzmann (1995) reported persistence over one- to three-year horizons, often linking it to managerial skill or common investment strategies. In contrast, other studies emphasised the role of costs and systematic risk factors, arguing that observed persistence may not reflect true managerial ability (Grinblatt & Titman, 1992; Elton et al., 1993, 1996).

Carhart (1997) provided a seminal re-examination of these conflicting findings using a survivor-bias-free dataset of U.S. equity mutual funds from 1962 to 1993. A key contribution of this study was the introduction of the four-factor model, incorporating market risk, size, value, and momentum factors. This methodological advancement allowed for a more accurate decomposition of mutual fund returns and addressed limitations in earlier models.

The findings of Carhart (1997) demonstrated that most short-term persistence in mutual fund performance can be explained by exposure to common risk factors, particularly the momentum effect identified by Jegadeesh and Titman (1993). The study showed that the "hot hands" phenomenon was largely attributable to funds' incidental exposure to momentum stocks rather than superior managerial skill. Once momentum and other systematic factors were accounted for, abnormal performance largely disappeared.

Furthermore, Carhart (1997) highlighted the significant impact of fund-specific costs on performance. Expense ratios were found to reduce returns on an almost one-to-one basis, while higher portfolio turnover negatively affected performance due to transaction costs. Load funds consistently underperformed no-load funds even after controlling for expenses. Long-term persistence was weak, with the only robust pattern being the continued underperformance of poorly performing funds, suggesting that inefficiency and high costs tend to persist over time.

4. Linking Small-Cap Mutual Funds to Entrepreneurial and MSME Growth

While Carhart (1997) and subsequent studies significantly advanced understanding of mutual fund performance, this literature remains largely disconnected from entrepreneurship and MSME finance research. Studies on mutual funds primarily focus on investor returns, fund efficiency, and market efficiency, without explicitly examining how fund investments influence firm-level growth outcomes.

Conversely, entrepreneurship and MSME literature has predominantly examined financing through banks, government schemes, venture capital, and informal sources, with limited attention to capital market-based institutional investors such as mutual funds. Small-cap mutual funds, in particular, invest in firms that often share characteristics with entrepreneurial and MSME ventures, including innovation intensity, growth orientation, and financing constraints.

By providing equity capital, enhancing liquidity, and improving market visibility, small-cap mutual funds may indirectly support entrepreneurial and MSME growth. However, empirical evidence explicitly linking small-cap mutual fund investments to entrepreneurial outcomes remains sparse and fragmented.

5. Research Gap and Need for a Systematic Review

The review of existing literature reveals a clear gap at the intersection of mutual fund research and entrepreneurial finance. While extensive research exists on mutual fund performance and MSME financing independently, there is a lack of integrated studies examining how small-cap mutual funds contribute to entrepreneurial and MSME growth through capital market-based financing mechanisms.

This gap is particularly significant in emerging economies such as India, where regulatory reforms, increased retail investor participation, and targeted MSME development policies have enhanced the role of small-cap mutual funds within the financial ecosystem (SEBI, 2020; World Bank, 2020). Despite these developments, no comprehensive systematic review has synthesised existing evidence linking small-cap mutual fund investment to entrepreneurial and MSME growth.

6. Conclusion

In summary, the extant literature indicates that although mutual funds play a central role in capital allocation within financial markets, the specific contribution of small cap mutual funds to entrepreneurial and MSME growth remains inadequately examined. Studies in mainstream finance literature, such as those by Gruber (1996) and Carhart (1997), have predominantly focused on mutual fund performance, persistence, and risk adjusted returns. While these studies provide important insights into fund behaviour and portfolio efficiency, they offer limited evidence on the developmental and growth-related outcomes of mutual fund investments for entrepreneurial firms and MSMEs.

Entrepreneurship and MSME research, on the other hand, has consistently highlighted financing constraints as a major impediment to firm growth. Scholars such as Beck and Demirgüç Kunt (2006) and Ayyagari, Demirgüç Kunt, and Maksimovic (2011) emphasise that small and entrepreneurial firms face structural barriers in accessing bank credit due to information asymmetry, lack of collateral, and higher perceived risk. As Denis (2004) argues in his overview of entrepreneurial finance, these limitations necessitate a broader examination of non-bank and market-based financing mechanisms.

Against this backdrop, the findings of this systematic review suggest that small cap mutual funds serve as an important, albeit indirect, channel for supporting entrepreneurial and MSME growth. By design, small cap funds allocate capital to firms with higher growth potential and entrepreneurial characteristics, a feature also noted in studies on equity market-based financing in emerging economies (Ayyagari et al., 2011). Through equity participation, these funds contribute to improved liquidity, enhanced market valuation, and greater investor confidence, which collectively support long term business expansion and financial sustainability (Fama & French, 2010).

A significant contribution of this review is the identification of a disconnect within the existing academic discourse. While finance oriented studies, including those by Fama and French (2010) and Carhart (1997), prioritise performance evaluation and market efficiency, entrepreneurship focused research continues to emphasise traditional financing sources such as bank lending and government schemes (Beck et al., 2005). This separation has resulted in a scarcity of empirical evidence linking mutual fund activity with real world entrepreneurial and MSME outcomes, particularly in the context of small cap investments.

By integrating insights from both finance and entrepreneurship literature, this review advances a more holistic understanding of entrepreneurial finance. It supports the view that small cap mutual funds should be recognised not merely as investment vehicles but as institutional actors that contribute to economic development through capital market participation. In line with the arguments of the OECD (2017) and the World Bank (2020), the findings underscore the importance of strengthening equity market access as a complement to existing MSME financing frameworks.

Finally, this review highlights several directions for future research. In accordance with Denis (2004) and Ayyagari et al. (2011), future studies should adopt longitudinal and cross-country approaches to empirically examine the impact of institutional equity ownership on firm survival, innovation performance, and employment generation. Such research would significantly enhance understanding of the developmental role of small cap mutual funds and inform evidence-based policy interventions aimed at fostering entrepreneurial and MSME growth.

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