Concentration in Emerging-Markets Equities

Implications for Investors and Emerging-Markets Equity Funds

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A Concentrated Emerging-Markets Equity Market

In this report, we look at market concentration trends in emerging-markets equity markets and assess portfolio construction implications for investors.

Market Concentration in Emerging Markets

- Similar to the US market's concentration in the "Magnificent Seven" (Alphabet, Amazon.com, Apple, Meta Platforms, Microsoft, Nvidia, and Tesla), the emerging markets have witnessed a comparable and remarkable rise in market concentration over the past decade.

- The technology sector has become a dominant force in emerging markets, driving a significant portion of the market's growth. Companies like TSMC, Tencent, Alibaba, and Samsung Electronics have become major drivers of market capitalization and accounted for almost 20% of the Morningstar Emerging Markets Target Market Exposure Index in December 2024.

- Similarly, country-level concentration is notable, with the top five countries—China, India, Taiwan, Korea, and Brazil—accounting for 80% of the Morningstar Emerging Markets Target Market Exposure Index.

- It can be challenging for active managers to beat market indexes and, therefore, passive funds, when giant-cap stocks make outsize gains, as tends to be the case in periods of high concentration. This is because the biggest driver of returns tends to be relative weight in the top stocks, as opposed to stock selection elsewhere.

Active Versus Passive: Success Rates, and What Should Investors Choose?

- In emerging markets, only 35% of active funds have managed to beat their passive peers over five rolling years to 30th June 2024. This has been in part driven by the two top names in the Morningstar EM TME index, TSMC and Tencent, which drove 50% of the benchmark's five-year returns. Underexposure to these two names has been a common source of underperformance for many active managers.

- The one-year success rate has been slightly better at 40%. One of the reasons was that China had become synonymous with underperformance and many active emerging markets managers found an easy way to beat passive alternatives by taking an underweight position to China.

- Active funds have a place in markets that are less concentrated or where investment opportunities are abundant owing to market inefficiencies, such as China or India stock markets.

- Highly concentrated country active funds, e.g. Taiwan, Korea, or Brazil, may struggle to outperform passive alternatives when returns are driven by a few dominant index stocks. However, investors opting for passive funds in markets where high concentration is the norm should be aware of severe downside risk they face if market conditions change. Passive funds lack the flexibility to adjust to shifting market dynamics, leaving investors vulnerable when the top stocks underperform.

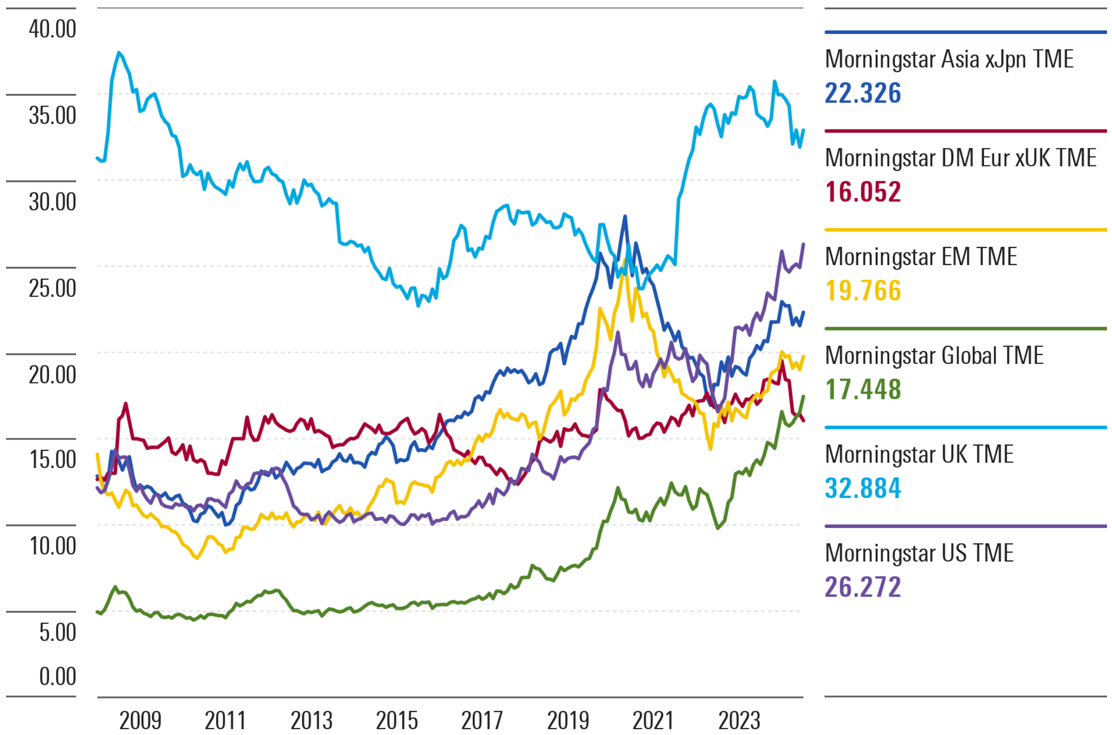
Market Concentration Is a Global Trend

- The recent rise in market concentration in the US equity market has been a significant trend in recent years. The top five names in the Morningstar US Target Market Exposure Index—all mega-cap technology companies that are part of the "Magnificent Seven"—almost tripled to 32.6% as of December 2024 from 11.0% a decade ago. Their dominance in sectors such as artificial intelligence, cloud computing, e-commerce, and semiconductors has been the primary driver of growth.

- Much like the US market, the technology sector has become a dominant force in emerging markets, driving a significant portion of the market's growth. Companies like Alibaba, Tencent, Samsung Electronics, and TSMC have become major drivers of market capitalization. At its peak in late 2020, concentration in the top five index names accounted for as much as 25% of the Morningstar Emerging Markets Target Market Exposure Index, similar to the levels observed in the US market.

- The growth of passive investment vehicles, such as exchange-traded funds and index funds, has contributed to market concentration in emerging markets. As global investors continue to flow into emerging-markets ETFs, large-cap companies that dominate these indices, like Alibaba, Tencent, TSMC, and Samsung, see an increasing demand for their stocks, further driving up their market caps and concentration.

Top Five Index Constituents' Weight (%)

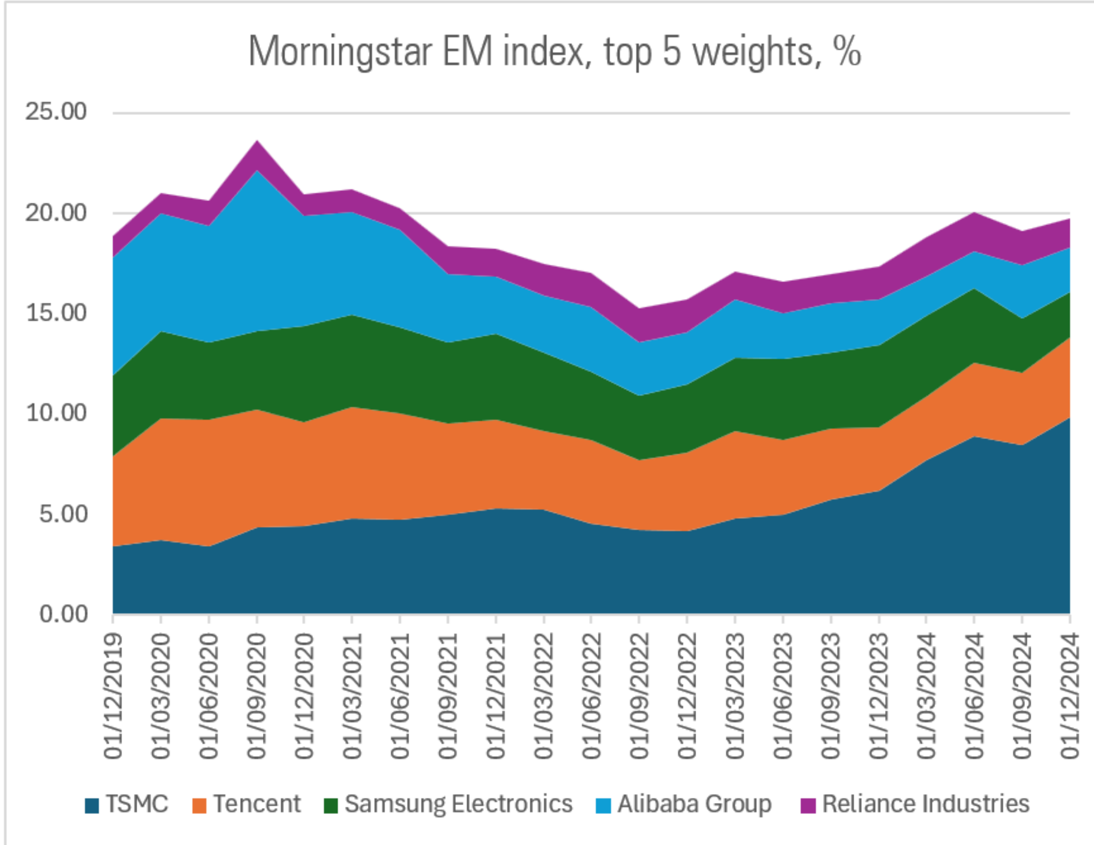


Source: Morningstar Direct; Data as of Dec. 31, 2024.

Emerging Markets – Top 5 Index Stocks

- The top five index names (TSMC, Tencent, Samsung Electronics, Alibaba, and Reliance Industries) accounted for almost 20% of the Morningstar Emerging Markets Target Market Exposure Index in December 2024.
- Over the past five years, TSMC's weight in the index has tripled from 3.4% in 2019 to 9.9% in December 2024, owing to its dominance in the semiconductor industry and ability to capitalize on the growing global demand for chips.
- The shrinking weight of Alibaba and Tencent in the index from 6.0% and 4.5% to 2.2% and 4.0%, respectively, can be attributed to regulatory issues and market conditions in China. While both have suffered, Tencent has been more resilient because of greater diversification in gaming, social media, and cloud services.
- Samsung Electronics has also come down from 4.0% to 2.3%. The company has had mixed results in the last five years owing to a combination of macroeconomic and operational challenges.
- Reliance Industries has grown slightly from 1.0% to 1.5% and has performed strongly in the past few years. It has been able to effectively capitalize on India's growth as it has positioned itself as a key player in key growth areas, including telecom, retail, and digital services.

Top 5 Emerging-Markets Index Constituents, Weight Change (%)

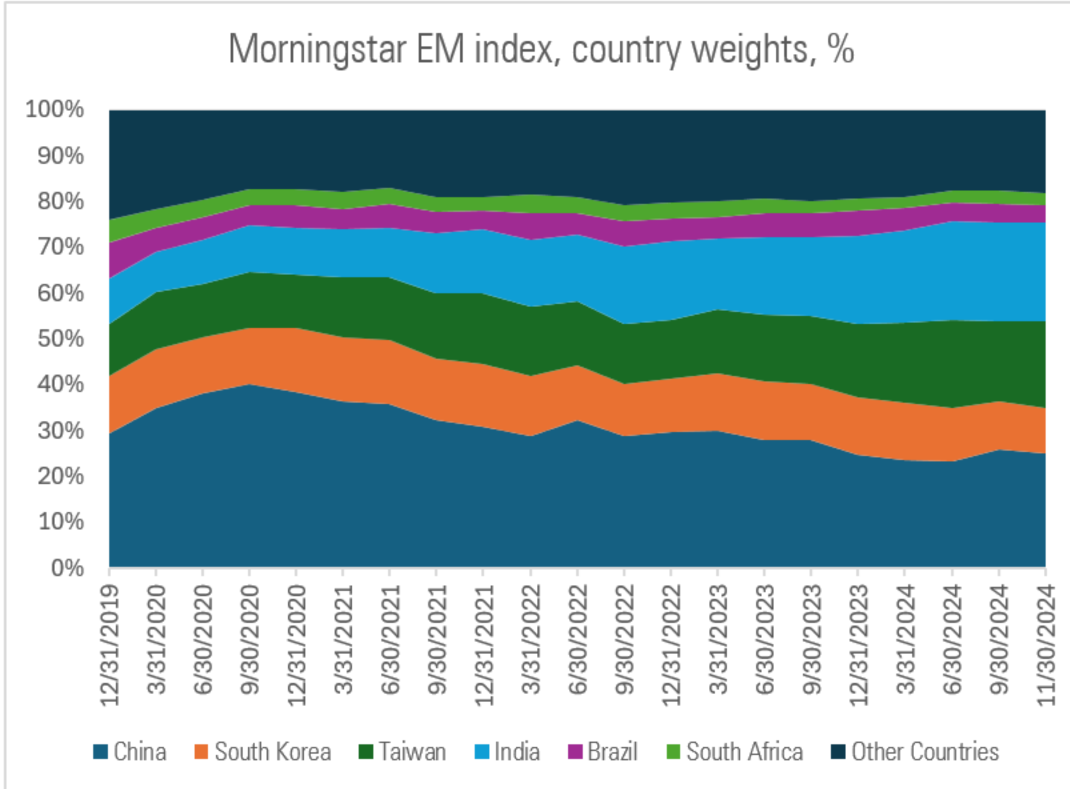


Source: Morningstar Direct; Data as of Dec. 31, 2024.

Emerging Markets – Country Weights

- The last five years have been marked by significant shifts in the Morningstar Emerging Markets Index.
- India's weight has doubled (from 10% in 2019 to 21% in December 2024), driven by the growing investor interest in India as a key growth market, strong economic factors, structural reforms, and increased foreign direct investment.
- Taiwan's market growth (11.5% in 2019 to 19.0% in 2024) has been primarily driven by the strong performance of its technology sector, particularly TSMC, which plays a crucial role in the global supply chain. The combination of global demand for technology, government support, and Taiwan's resilient economy has made its equity market one of the standout performers.
- China's weight has shrunk from 29% in 2019 to 25% in 2024. The country has seen high volatility, especially names such as Alibaba and Tencent, owing to regulatory actions, economic challenges, and global market conditions.
- South Korea's weight has shrunk a little (from 12% to 10%) owing to the underperformance of some large names, such as Samsung Electronics and Hyundai.
- Smaller countries like Brazil and South Africa have seen their influence diminish (from 8% and 5% to 4% and 3%, respectively), driven by economic challenges.

Top Emerging-Markets Countries, Weight Change (%)



Source: Morningstar Direct; Data as of Nov. 30, 2024.

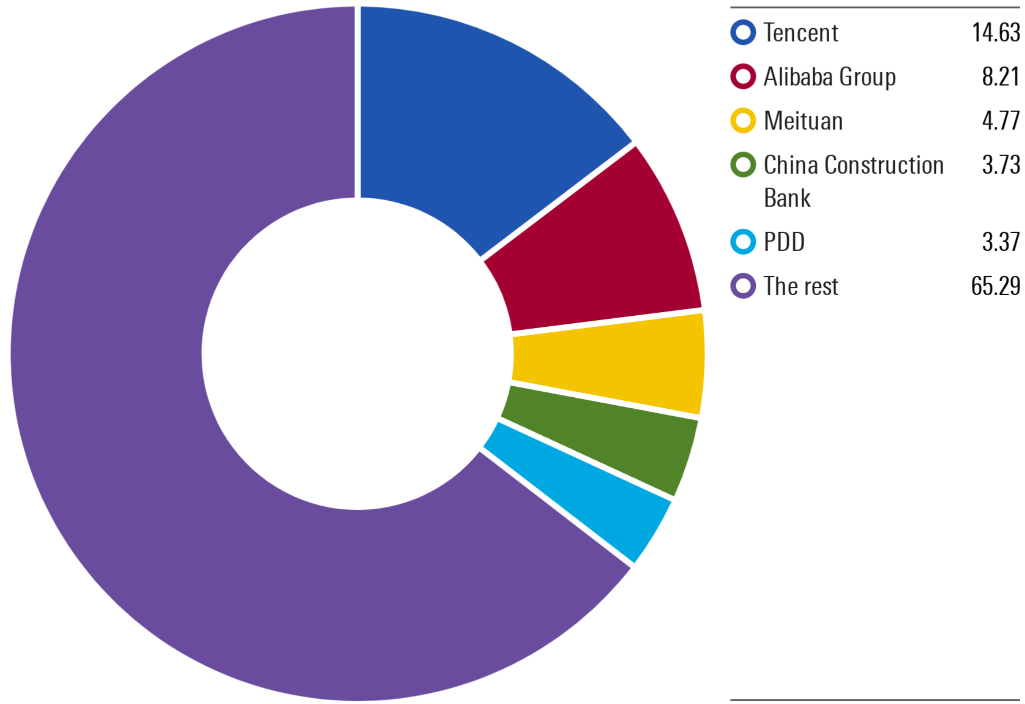
Emerging Markets—China

- Historically, the Chinese stock market has been dominated by "old economy" companies, including major state-owned banks, insurance firms, telecom providers, and energy companies. However, as China transitioned from a capital-intensive economy to one driven by consumption, a growing number of "new economy" companies, primarily consumer-focused internet businesses, began to emerge.

- These new market leaders, including Tencent, Alibaba, PDD, and Meituan, rode on the long-term rise of the middle class and the consumption upgrade in China. At the market concentration peak in October 2020, Alibaba and Tencent made up 35% of the index. However, these market leaders faced significant headwinds since 2021 amid the country's economic challenges, property woes, and regulatory tightening.

- Over the past five years (through Nov. 30, 2024), Tencent, Meituan, and PDD alone contributed more than the entirety of the benchmark's return, helped by revenue growth and market share expansion. Alibaba was the largest detractor, as the stock more than halved over this period because of the soft consumption environment, regulatory challenges, and increased competition in China.

Morningstar China TME Index, %



Source: Morningstar Direct; Data as of Dec. 31, 2024

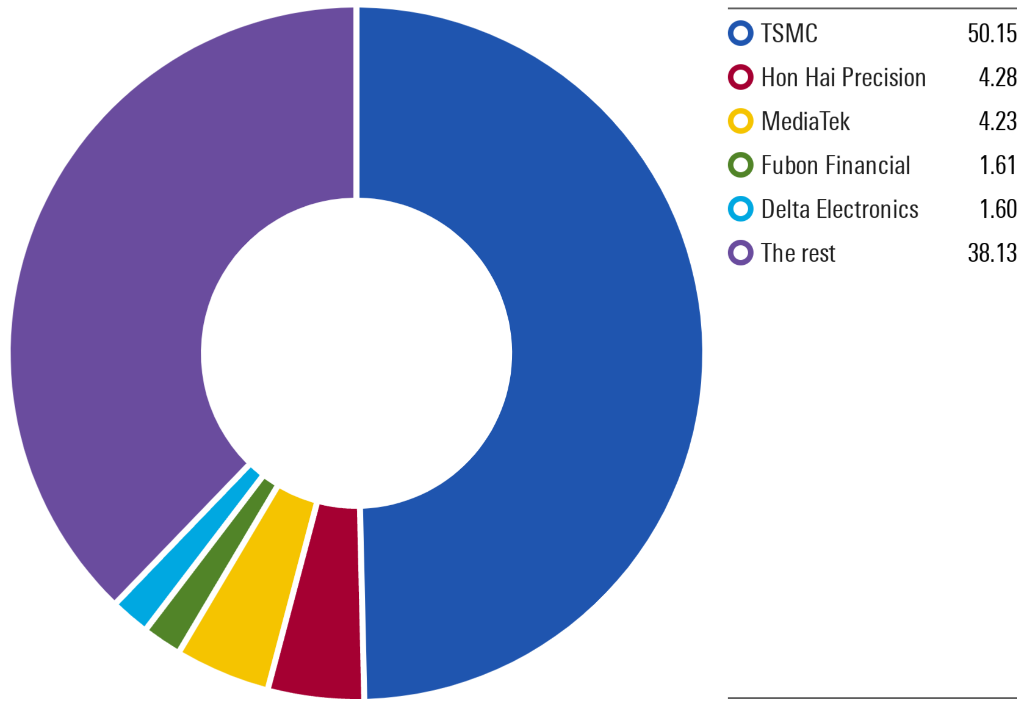
Emerging Markets—Taiwan

- Taiwan's technology-driven market is heavily concentrated at the top, largely owing to the dominance of semiconductor giant TSMC, which makes up 50% of the Morningstar Taiwan Target Market Exposure Index (as of Dec. 30, 2024). Over the past decade, the company experienced significant growth, fueled by the long-term expansion of the technology sector and the notable boom in artificial intelligence since 2023.

- TSMC alone has accounted for 60% of the Morningstar Taiwan Target Market Exposure Index's five-year return of 125% (cumulative). The top five index names, such as TSMC, Hon Hai Precision Industry, MediaTek, Quanta Computer, and Fubon Financial, have been responsible for 77% of Taiwan market five-year returns.

- Owing to TSMC's substantial index weight, which is well above the position limit permitted by regulations for active funds, a passive option may be suitable for investors who wish to obtain exposures comparable with the local market. Nonetheless, skilled active managers, notably those with strong on-the-ground research presence and expertise around the technology cycle and value chain, have been able to add value in the market as they uncover winning ideas beyond the largest index stocks.

Morningstar Taiwan TME Index, %



Source: Morningstar Direct; Data as of Dec. 31, 2024

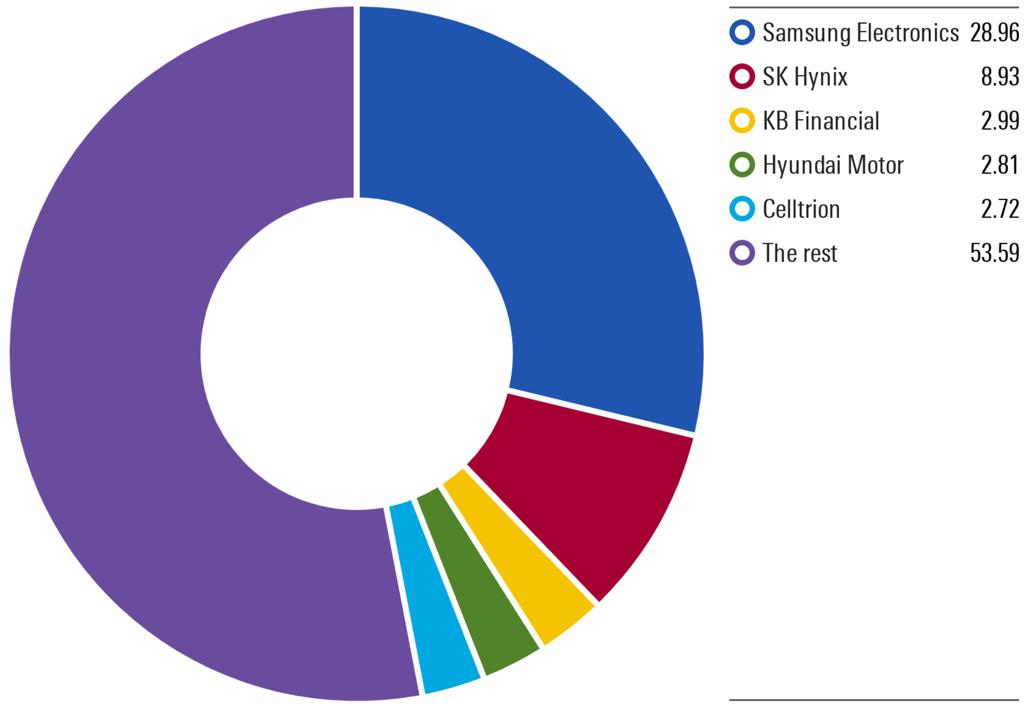
Emerging Markets — Korea

- The Korean equity market is also quite concentrated, with 46% of the Morningstar Korea Index weight in the top five names, of which Samsung Electronics is 29% (as of Dec 31, 2024). This concentration means that the performance of a few key players, especially in technology and semiconductors, can heavily influence the overall market performance.

- In recent years, the market's concentration has also been driven by the growth of index heavyweights like SK Hynix, Hyundai Motor, and Naver, which have become central to the broader market's performance. However, despite this concentration, there are efforts to diversify the market through the growth of smaller companies and increasing foreign investment.

- The top five names in Korea, namely Samsung Electronics, SK Hynix, KB Financial, Hyundai Motor, and Celltrion, have contributed to 85% of the Morningstar Korea Target Market Exposure Index's five-year cumulative return of 12.6%. It is worth noting that Samsung Electronics has experienced periods of volatility over the past few years, mainly owing to the slowing demand for memory chips, competition in the smartphone market, and macroeconomic factors, including inflation, interest-rate hikes, and global economic uncertainty.

Morningstar Korea TME Index, %



Source: Morningstar Direct; Data as of Dec. 31, 2024

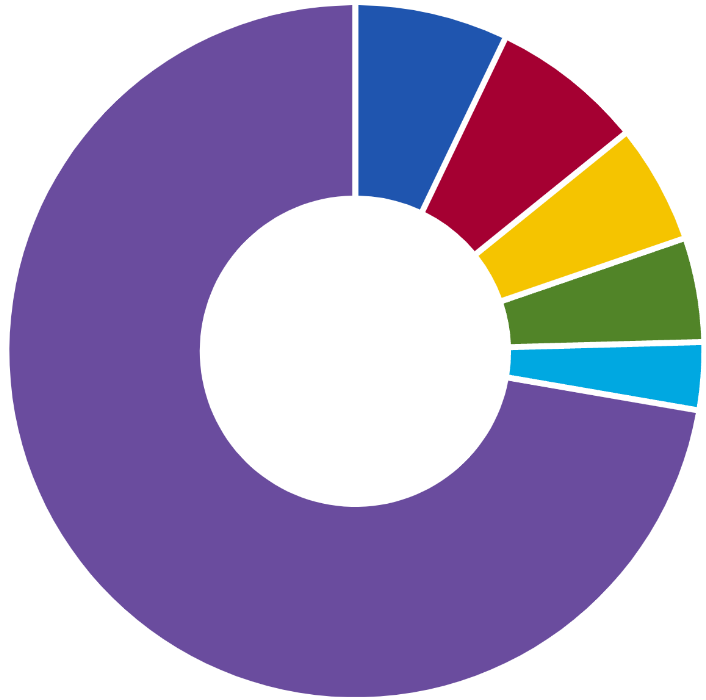
Emerging Markets—India

- The Indian equity market is relatively concentrated, although not to the same extent as Taiwan and Korea, with a few large companies dominating the overall market. The top stocks, namely Reliance Industries, HDFC Bank, Infosys, ICICI Bank, and Bharti Airtel, account for 27% of the Morningstar India Target Market Exposure Index (as of Dec. 31, 2024).

- While there is a growing number of mid-cap and small-cap companies, they still represent a smaller portion of the overall India market. The period between 2018 and 2020 was marked by the relative strength of the large caps. During this time, the weight of top index constituent Reliance doubled from 7% to 15%, as investors were enthused by the company's expansion from its petrochemical roots to new areas such as retail, telecom, and internet. The trend later reversed amid a sharp small-cap rally since 2021 driven by a buying spree from local retail investors, as they flocked to small-caps on the belief that smaller companies may grow faster than the larger ones amid a thriving economy.

- Active managers fared well in the sprawling India stock market over the long run—53% of the surviving active funds in the India equity Morningstar Category beat their passive peers over the past decade ending June 2024. The small-cap rally since 2021 has been a headwind for India-focused equity managers, as many of them were underexposed to small caps owing to high valuations. This weighed on the five-year rolling success ratio of active India equity funds in recent years, although it has since recovered from the 2022 trough, and the long-term prognostics remain decent.

Morningstar India TME Index, %



HDFC Bank	6.96
Reliance Industries	6.94
Infosys	5.37
ICICI Bank	4.66
Bharti Airtel	2.93
The rest	73.14

Source: Morningstar Direct; Data as of Dec. 31, 2024

CONCENTRATION BY MARKET

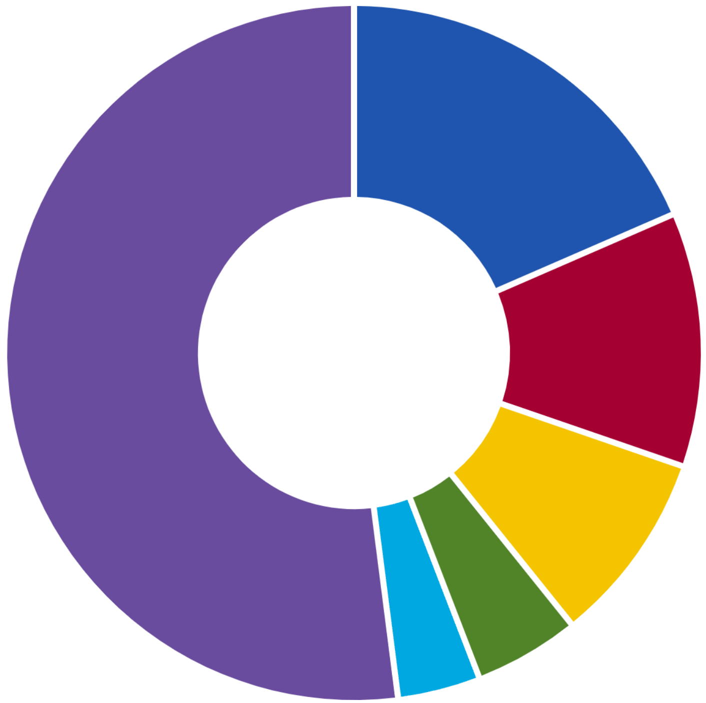
Emerging Markets — Brazil

- Similarly to Taiwan and Korea, the Brazil equity market is very concentrated and heavily weighted toward a small number of mega-caps, with 47% of the Morningstar Brazil Index weight in the top five names, of which Petrobras represents 19% and Vale 12% of the index (as of Dec. 31, 2024).

- Petrobras has been one of the key drivers of the index historically, reaching 20% at its peak. Its weight remains closely tied to global oil price movements and the political situation in Brazil, contributing to ongoing volatility in the stock's weight. In the last five years through Dec. 31, 2024, Petrobras delivered 18.6% annualized (in USD) on the back of higher oil prices, attractive dividends, and favorable government policies, well ahead of the negative 2.0% return for the Morningstar Brazil Target Market Exposure Index.

- However, there is hope for better diversification in the market. More recently, "the new economy" stocks have been entering the space, including the fintech company Nu Holdings, which was added to the MSCI Brazil index in August 2024 at a chunky position of around 10%. This was as a result of MSCI's decision to include Brazilian companies trading on foreign exchanges, and also in recognition of the company's rapid growth and increasing importance in the Brazilian market.

Morningstar Brazil TME Index, %



Petrobras	18.50
Vale	11.73
Itau	8.84
Weg	4.72
Bank Bradesco	3.64
The rest	52.57

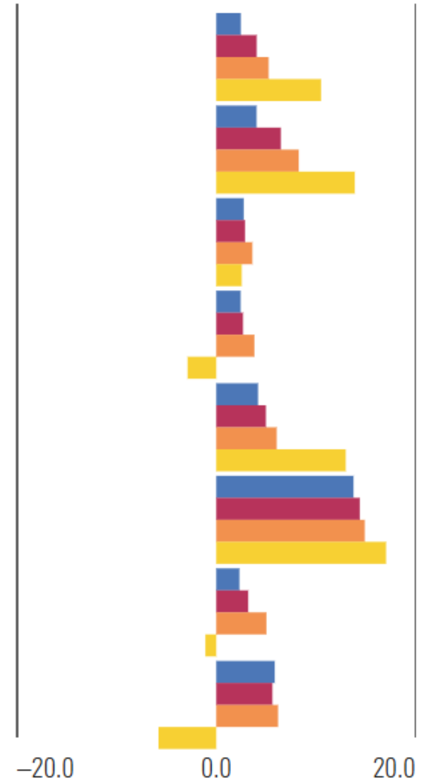
Source: Morningstar Direct; Data as of Dec. 31, 2024

Contribution to Index Returns by the Top Names

- The leading index names are frequently major factors in influencing the overall market performance.
- In the broad emerging-markets space, the two largest names in the Morningstar Emerging Markets Target Market Exposure Index, TSMC and Tencent, drove 50% of the benchmark's returns over the past five years (to Dec. 31, 2024).
- In Taiwan, Korea, and Brazil, where market concentration is notably high, the top five companies have been responsible for most of the market returns.
- In contrast, the market rally in India over the past five years has been much more broad-based. The top five companies in the index were responsible for about 38% of the market returns, as overall growth was largely driven by smaller companies.

Contribution to Five-Year Index Returns (Annualized, %, USD)

Index	Top 3 Return	Top 5 Return	Top 10 Return	Index Return
Morningstar Global TME	2.5	4.1	5.3	10.5
Morningstar US TME	4.1	6.5	8.3	13.9
Morningstar EM TME	2.8	2.9	3.6	2.6
Morningstar China TME	2.5	2.7	3.8	–2.9
Morningstar India TME	4.2	5.0	6.1	13.0
Morningstar Taiwan TME	13.8	14.4	14.9	17.1
Morningstar Korea TME	2.3	3.2	5.0	–1.1
Morningstar Brazil TME	5.9	5.6	6.2	–5.8



Source: Morningstar Direct; Data as of Dec. 31, 2024.

Success Ratio of Active Funds – Emerging Markets

- Morningstar's Active/Passive Barometer shows that in the emerging-markets category, only 35% of active funds have managed to beat their passive peers over five rolling years to end June 2024. This was partly driven by the two top names in the Morningstar Emerging Markets Target Market Exposure Index, TSMC and Tencent, which drove 50% of the benchmark's returns in the period. Underexposure to these two names proved a common source of underperformance for many active managers.

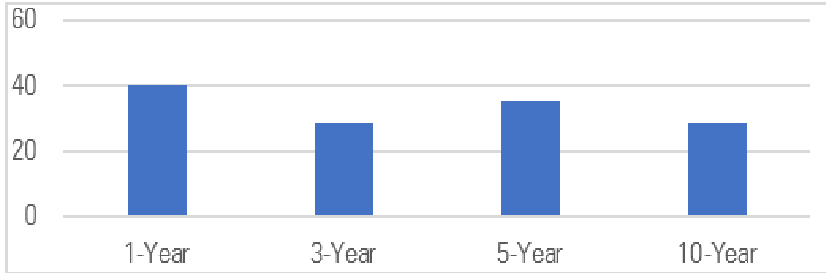
- The one-year success rate was slightly better at 40%. One of the reasons was a bearish view of China adopted by many active emerging-markets managers, which proved to be beneficial considering China's economic slowdown and regulatory challenges. By reducing their China exposure, active managers had the flexibility to have higher exposure in stronger performing markets, such as India and Taiwan.

- As shown in the table on the left, the top 10% of the funds in the Morningstar Global Emerging Markets Equity peer group with the lowest China weight—averaging 15%—had the strongest five-year return (to Nov. 30, 2024).

- In addition, some of the top index names, such as Alibaba and Samsung Electronics, widely held by passive funds, detracted from performance over the period.

- Finally, skillful active managers in emerging markets added value by investing in niche markets or off-benchmark stocks with strong performance, such as MercadoLibre (Argentina), Kaspi.kz (Kazakhstan), and Nu Holdings (Brazil).

Success Ratio of Active Emerging-Markets Funds (%)



Source: Morningstar EMEA Active Passive Barometer. Morningstar Direct; Data as of June 30, 2024

China Weight vs. Return, %

Decile Rank	China Average Weight	5-Year Return
1	15.4	24.8
2	25.1	21.5
3	28.3	18.4
4	30.1	18.2
5	31.6	20.3
6	32.8	15.3
7	34.2	22.2
8	35.2	20.6
9	36.6	22.9
10	40.7	16.5
Morningstar EM TME	30.7	22.2

Source: Morningstar Direct; Data as of Nov. 30, 2024.

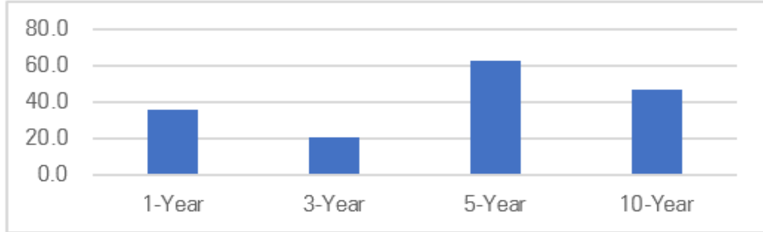
Success Ratio of Active Funds – Regional Markets

- Around 60% of active China equity funds outperformed their passive counterparts over a rolling five-year period to the end of June 2024—a very decent level compared with other markets. Skillful active managers added value by adapting to China's rapidly changing market environment. The high retail participation in the onshore A-shares market, with domestic retail investors accounting for more than two-thirds of the trading volume, creates opportunities that the more sophisticated investors can exploit.

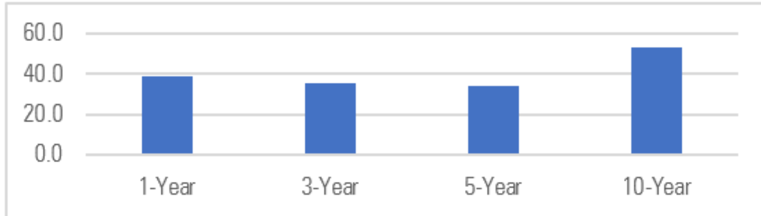
- Active managers have performed well in the growing Indian stock market over the long term. In the India equity category, 53% of active funds outperformed their passive counterparts over 10 years ending in June 2024. The small-cap surge since 2021 posed a challenge for India-focused equity managers, as many had limited exposure to small-cap stocks owing to their high valuations. This impact was reflected in the five-year figure, though it has since bounced back from the 2022 low.

- Regarding the Brazilian market, the significant weight of Petrobras (19% of the index) poses a challenge for active funds, as this is well above the position limit set by regulations (maximum 10% stock weight for UCITS funds). As a result, the success ratio for active Brazil equity funds stands at a poor 13% over a rolling five-year period. However, the market is increasingly becoming more diversified, with the emergence of "new economy" stocks such as Nu Holdings, a fintech company that was added to the MSCI Brazil index in August 2024 at around 10%.

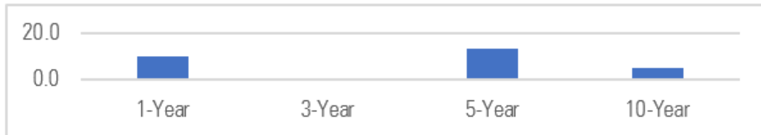
Success Ratio – China Funds (%)



Success Ratio – India Funds (%)



Success Ratio – Brazil Funds (%)



Source: Morningstar EMEA Active Passive Barometer. Morningstar Direct; Data as of June 30, 2024.

CONCLUSION

What Should Investors Do About Concentration?

- It can be challenging for active managers to beat market indexes and, therefore, passive funds, when giant-cap stocks make outsize gains, as tends to be the case in periods of high concentration. This is because the biggest driver of returns tends to be relative weight in the top stocks as opposed to stock selection elsewhere.

- This has been the case for US equities, with the “Magnificent Seven” playing a major role behind the market rally in recent years. The US market is also arguably the most efficient and competitive globally. The case for passives is overwhelming—only 8% of surviving active funds in the US large-cap blend category beat the passive alternative over the decade ending June 2024.

- In emerging markets, highly concentrated country-specific active funds, such as those focused on Taiwan, Korea, or Brazil, may struggle to outperform passive alternatives when returns are driven by a few dominant index stocks. However, investors opting for passive strategies in markets where high concentration is the norm should be mindful of the significant downside risk they face if market conditions change. Passive funds lack the flexibility to adjust to shifting market dynamics, leaving investors vulnerable during downturns or when the top stocks underperform.

- Active funds have a place in markets that are less concentrated or where investment opportunities are more abundant owing to market inefficiencies. Active funds can also prove useful for investors who wish to gain exposure to specific segments of the market, such as growth or value stocks, or small- and mid-cap companies, many of which, particularly in the case of emerging markets, do not make it onto indexes.

- The Chinese and Indian stock markets are fertile grounds for active managers, given their relatively lower concentration than other emerging markets, and local retail investors have occasionally spurred large momentum- or sentiment-driven market swings.

- Investors can tilt the odds in their favor by focusing on high-quality active funds, which are managed by experienced and skilled investment teams based on time-tested and consistently applied approaches. A long-term view is also essential to investment success, and investors can be best served by staying the course.

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