FIERA CAPITAL

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Evolving Country Concentration in Emerging Market Indices

Opportunities for Investors

Key Takeaways

- Structural changes in the EM universe and indices present new and important considerations for global investors
- EM Countries share of world economic growth steadily increasing relative to total world GDP
- North Asia Equity allocations expanding and investment in Chinese Equities increasingly carved out of broader EM strategies
- "Smaller" Emerging Market countries present a compelling "alpha" opportunity for active investment management

In this Insight we address the changes and concentration of the MSCI Emerging Market Index over the last decade and the implication for investors of the growing size of China within these Indices. The last 10 years have seen some significant changes to the emerging market investment landscape, both in terms of the shifting geographical bias and the types of investors that make up the shareholder bases of many emerging market companies.

Shifting Landscape

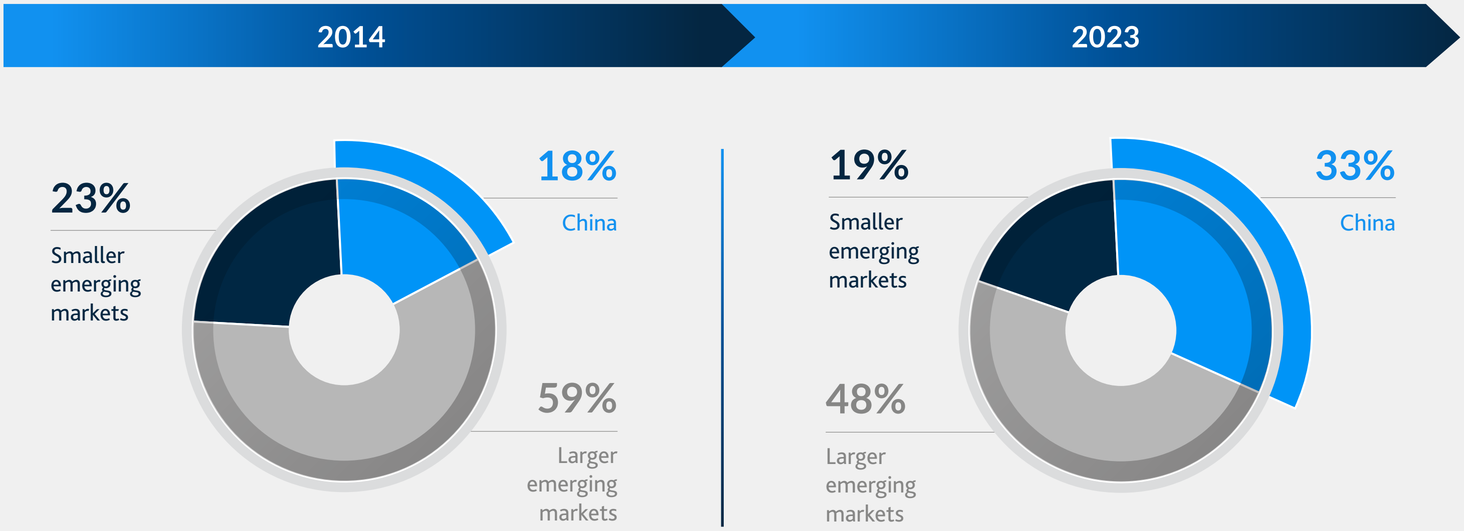
The first paradigm shift which has affected the equity universe globally has been the move by international investors into passively managed funds. In the year 2000, passive holdings accounted for just 1% of the foreign money in emerging markets (this is for publicly available funds). This rose to around 10% by 2006 and almost 33% today, worth over USD 1.2tr.[1] The size and weight of passive money is crucial to the evolution of emerging markets Indices as this money is obliged to automatically follow and reconstitute to the index.

Secondly, the shape of the emerging market Indices has altered dramatically over the last few years in terms of regional weightings and there have been some very large changes in country weights.

1 JP Morgan, March, 2023.

Figure 1

The evolving emerging market universe – the growing dominance of China



Source: Fiera Capital, MSCI Database, 31 March 2023.

These changes have been driven by both increases in free float factors or Index inclusions for some countries, and by relative performance of economies and stock markets.

For example, in 2019 MSCI increased the inclusion ratio of China A shares from 5% to 20% in the MSCI Emerging Markets Index. These changes over time have resulted in the correlation of China with the MSCI Emerging Markets Index going from around 0.65 in 2003 to 0.88 in Q1, 2023. Finally, and a more recent phenomenon driven by COVID-19 and a lower global interest rate environment, local investors have become much more active in their own domestic equity markets thus somewhat changing the dynamic shorter-term drivers of many emerging equity markets.

The shifting landscape has caused emerging market investors to increasingly reevaluate the appropriate allocation framework of their equity portfolios, and the growing dominance of China.

The growing dominance of China

China's growing economic strength and improving market accessibility may transform the characteristics of the emerging market asset class further and thus its role in global portfolios.

In addition to China, Korea and Taiwan have become much larger economies and stock markets over the last 20 years, with Korea even being upgraded to developed market status by FTSE, and most likely also by MSCI in the coming few years. India is now the largest country in the world by population and current strong rates of economic growth are likely to increase its dominance within the EM economies and Indices.

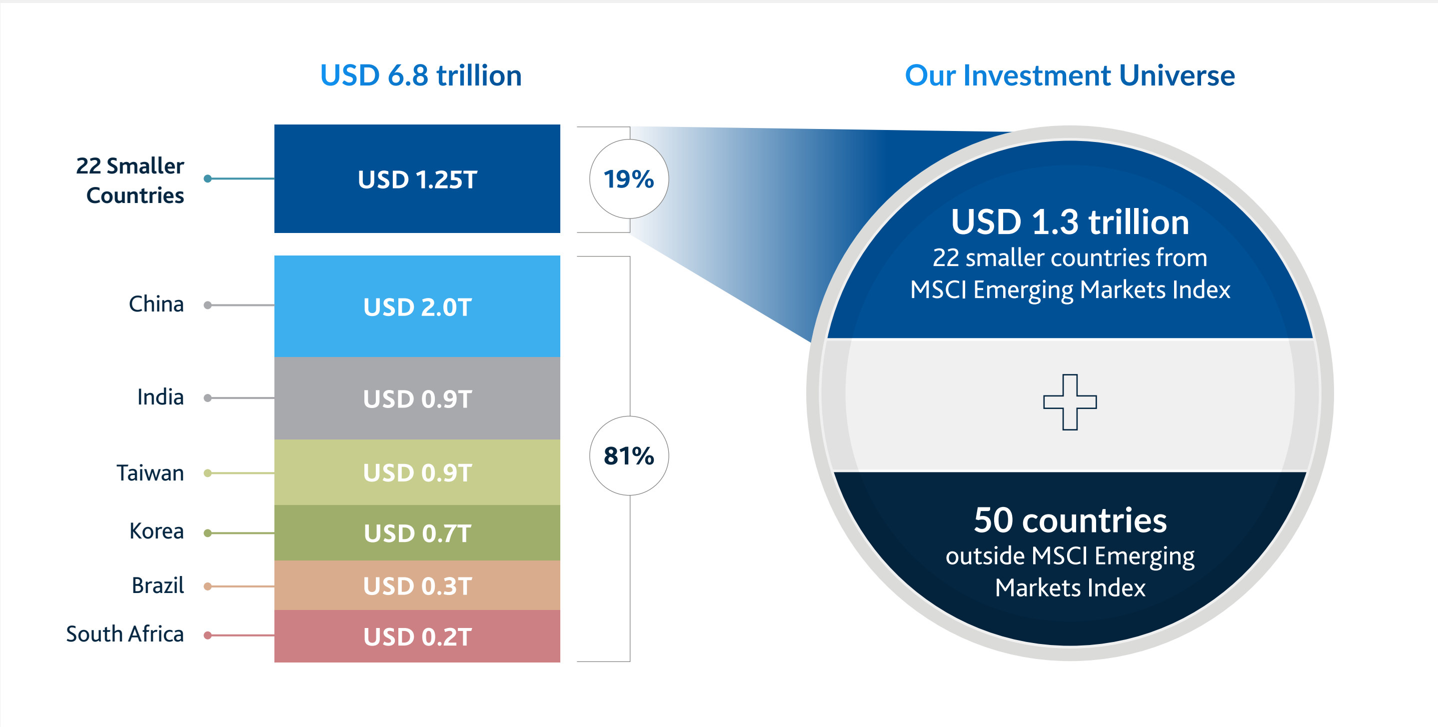
China A shares are currently, as at March 31, 2023, included at only 20% of their market capitalization weight. If this were to increase to their full free float market capitalization weight, China's weight in the Emerging Markets Index would rise to 44.4% (UBS, March 2023).

In economic terms, China is likely to overtake the US to become the world's largest economy by 2028, five years earlier than previously forecast, a report from CEBR states. China's share of the world economy has risen from just 3.6% in 2000 to 18.5% in 2022.[2]

2 Worldeconomics - https://www.worldeconomics.com/Share-of-Global-GDP/China.aspx

Figure 2

Looking beyond the MSCI GEMs benchmark



Source: Fiera Capital and Bloomberg, 31 March 2023 (Investible Market Capitalization of Shares in Index). All numbers presented in US dollars.

Following closely behind China, India has a good chance of becoming the third largest economy in the world by 2030. India had overtaken the UK as the fifth-biggest economy in 2019 but has slipped behind it again due to the pandemic's impact. It might not take over again until 2024 but is likely to then go on to overtake Germany by around 2027 and Japan around 2030.

In addition, market concentration of individual stocks in the MSCI EM Index, on the rise since the 2010s in most equity markets, accelerated markedly during the recent pandemic. For example, the largest five issuers in the MSCI Emerging Markets and MSCI World Indexes reached a collective weight of 19.1% and 13.2%, as at March 31, 2023[3], respectively, significantly above the previous peaks, during the dot-com bubble.

Investment Opportunity

Today's emerging market universe has become dominated by a small number of large markets, with the largest 6 countries accounting for more than 81% of the MSCI Emerging Markets Index.

Two investment based trends born out of the above changing EM landscape have conspired to present an active opportunity in the universe of countries outside of the six largest Emerging Markets.

With the relative underperformance of EM vs DM since 2014, investment teams have gotten smaller as market concentration has risen. We believe specialist global emerging market investors need to focus on these largest six markets in order to have a chance of generating performance. This is inevitably leading to a reduction in focus on the other 22 markets that make up just 19% of the MSCI Emerging Markets Index.

3 MSCI, 31 mar 2023.

MIFID II pressures have multiplied this effect by reducing the focus on companies in these smaller emerging markets from the global investment banks representing the sell-side. As research budgets have been cut, the reduction in analysis has fallen on smaller countries and smaller companies. The magnitude of the variations on sell-side focus can be seen in **Figure 3**.

Combining these smaller emerging and frontier markets together, they are home to over 19,000 listed stocks and USD 1.3 trillion of market capitalization in their indices. The alpha generating potential from inefficient stock pricing in frontier and emerging markets has been well demonstrated by our investment team over the last 12 years. Over the last few years, many of these 22 smaller emerging markets have begun to exhibit characteristics that meet our definition of frontier markets, namely markets and stocks that are "*under researched and under owned.*"

Fiera OAKS Emerging Markets Select Strategy looks beyond these 6 major markets to the smaller countries in the MSCI Emerging Markets universe, as well as all frontier markets where we believe, due to the factors above, a significant alpha generating opportunity continues to exist and is growing.

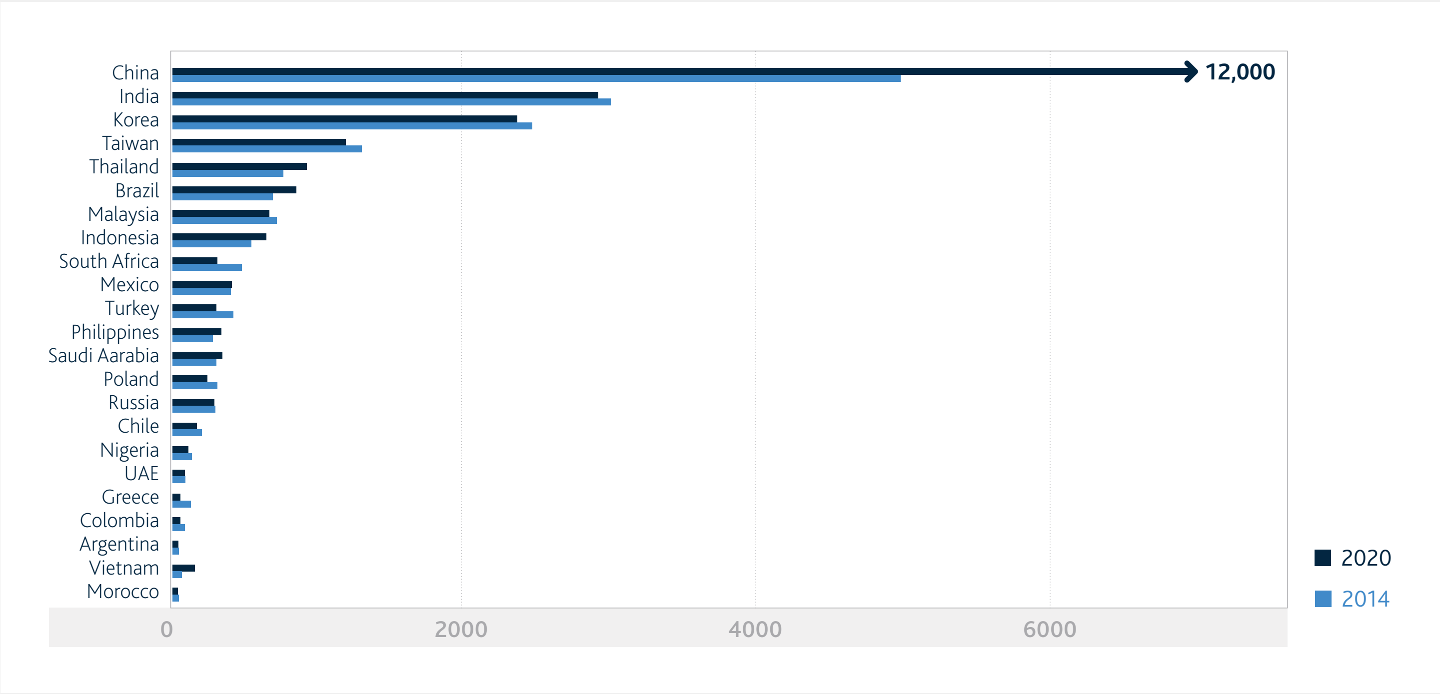
We pursue a very active strategy, with a strong focus on bottom up investing and top down analysis providing a negative country screen. The Strategy is benchmark agnostic with a focus on domestic growth opportunities in economies that are growing strongly due to reform processes enacted by the local administrations.

Due to the many different interested parties involved and implicated by the construction and changing nature of indices amongst the main index providers, it is difficult to predict the future path with high conviction.

Dominic Bokor-Ingram
Senior Portfolio Manager, Emerging and Frontier Markets

Figure 3

Market inefficiencies: analyst numbers by stock



Number of analysts recommendations on stocks per country. **Source:** Fiera Capital, Bloomberg 30 Dec 2020.
This information is presented as supplemental to the GIPS compliant presentation included at the end of this document.

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