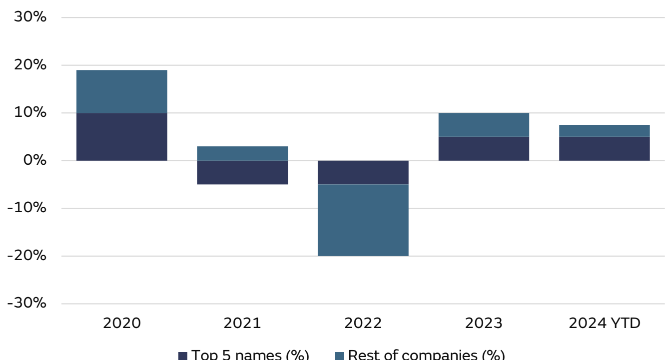
GIB ASSET MANAGEMENT

The concentration conundrum in Emerging Markets

By Kunal Desai, CFA

It's not just Developed Markets that have a concentration conundrum. We have seen the narrowest stock leadership in emerging markets this year in the last five years. MSCI EM have delivered total returns of 5.69% this year, with 5 stocks contributing ~80% of total returns.[1] In line with what we've seen in global markets, EM returns have been increasingly tech driven on AI and internet optimism.

Chart 1[2]: MSCI Emerging Markets performance

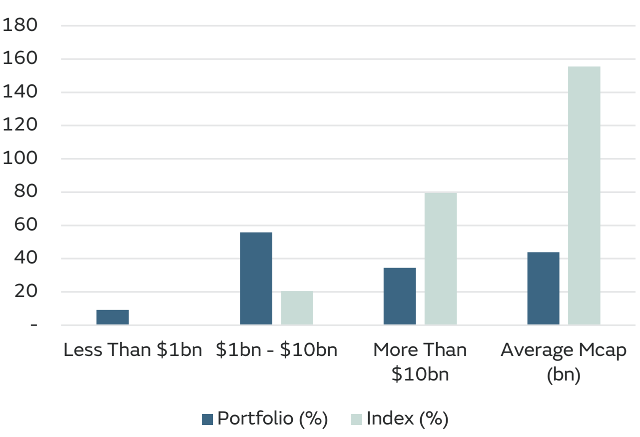


TSMC, Tencent, Reliance Industries, SK Hynix and Hon Hai together contributed ~80% of the entire Index's returns this year. In many ways, such stock concentration has mirrored recent behaviour in the US where stock market concentration has increased dramatically and has taken three broad forms: i) the rise in share of the US equity market globally; ii) the rise in the share of the technology sector and iii) the rise in the dominance of the biggest companies in most regions.

As empirical evidence points to, stock level concentration can be dangerous. Only 10% of the Fortune 500 companies in 1955 have since remained on the list today. Dominant companies often struggle to persist as the best performers over long periods of time. Historically, with new entrants emerging, few companies remain unscathed as competition either forces businesses to shrink, merge or be acquired. An equity market that becomes dominated by a few stocks becomes increasingly vulnerable to either disruption, anti-regulation or over exuberant earnings expectations. History has shown that buying dominant companies in an increasingly concentrated market set up has generated lower returns over time. The Chinese technology sector post COVID, a case in point.

Such a focus on mega cap investing (where the top 5 companies now contribute ~20% of the index weight) runs contrary to our investment approach. Our Active Engagement philosophy – backed by our Process for Active Corporate Engagement approach – focuses on businesses which are underestimated. Our opportunity set continues to rest with quality businesses that are undervalued, not due to deficiencies in their fundamentals, but rather due to fixable deficiencies in their approach to capital allocation, governance, operational & strategic issues and investor relations. This draws us to the mid cap segment of the market where we see the most material engagement outcomes.

Chart 2[3]: Market cap splits; Strategy vs MSCI Emerging Markets Index



With increasing stock and sector concentration, the opportunity for active management should be a fertile ground for stock picking. Inter-sector and pairwise stock correlations are falling and approaching historic lows. Our approach remains on identifying businesses with clear sustainable competitive advantages, attractive reinvestment runways and clear opportunities of value unlock that our constructive approach seeks to unpick.

Concentration unwind risk is real – and something we are looking to take exploit.

[1] As at 30 June 2024
[2] Bloomberg, July 2024
[3] Source of data: Dimension / MSCI as at 30.06.2024
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