Is Passive Investing in Emerging Markets Really Diversified?

EXECUTIVE SUMMARY

We believe that for investors seeking exposure to emerging markets (EM):

- diversification is an important part of mitigating risk
- they may assume passive exchange-traded funds (ETFs) are widely diversified
- in fact, ETFs that track the MSCI Emerging Markets Index may be concentrated in a handful of stocks

Those interested in diversifying their EM investments may want to explore other options.

Many investors are attracted to passive index funds as a way to spread their risk. Those interested in the growth potential of emerging markets, for example, may be unfamiliar with specific company reputations or could have concerns about market transparency in individual countries. An ETF designed to replicate performance of a broad emerging markets index would seem to offer the twin benefits of potential growth along with diversification.

The popularity of such funds has risen markedly. Passive flows, which accounted for just 27% of EM fund flows in 1999, grew to 74% by 2019. Exhibit 1 shows that for four consecutive years, passive flows have outpaced active flows to the EM category. And since 2009, in years with positive flows to both active and passive funds, passive funds have taken the lion’s share six out of 10 years.

Exhibit 1: U.S. Active and Passive Flows to EM Funds (1999 to 2019)

Exhibit 2: Weight of 5 Largest Stocks in the MSCI EM Index (12/31/10 to 3/31/20)

But does the perceived diversification bear out in reality? In fact, if EM index funds are tracking the MSCI Emerging Markets Index, they are likely to be highly concentrated in stocks of a handful of the largest companies. And that concentration has been growing. Exhibit 2 shows that in 2020 the five largest stocks accounted for 21% of the MSCI EM Index market capitalization—more than double the concentration in 2010.

CONCLUSION

There’s no question that passive ETFs are an increasingly popular means of investing in the growth potential of emerging markets, and may warrant a place in investor portfolios. At the same time, we believe it is important for investors to understand that the diversification of such passive funds may not be as substantial as it appears. For investors seeking greater diversification benefits, active managers may offer an attractive alternative.

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The MSCI Emerging Markets Index with gross dividends captures large and mid cap representation of emerging market countries.

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Diversification does not assure a profit or protect against a loss in a declining market.

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