BRANDES INSTITUTE

Has The First Shoe Dropped?

An update on "Investor Strategy: Market Concentration Has Been Extreme...but Not Everywhere"
(Brandes Institute, May 2021)

In May 2021, we noted the extreme concentration spikes in two segments of the world markets: the S&P 500 Growth Index, and the MSCI Emerging Markets Growth Index. As of March 31, 2021, the share of each index's total market capitalization accounted for by the top 10 stocks (by index weight) approached 50%--at or close to two-decade highs, based on historical analysis of index constituents provided by MSCI.

Our observations in that article:

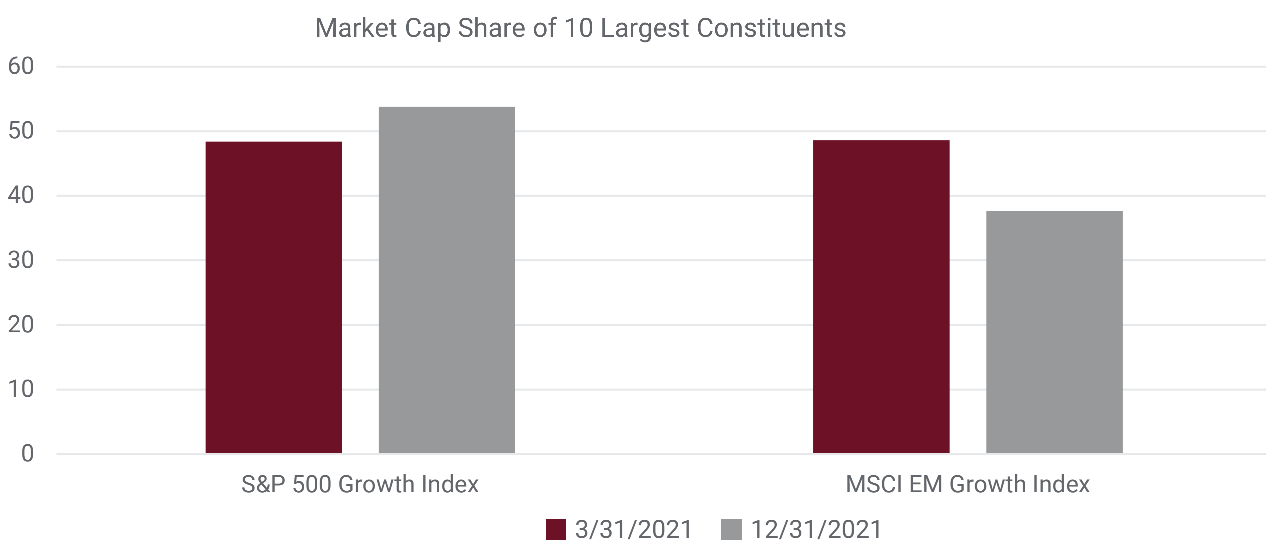
1. Active managers would struggle to outperform if concentration stayed at those levels or went even higher
2. We didn't know if or when these spikes in concentration would reverse, but historically such patterns have been transient and when they do reverse, it may presage a change in market style leadership for five years or longer
3. Over the last 20 years, when concentration has started to unwind from extreme levels, it has been good news for both value and growth managers

Last year, we suggested investors pay attention and be ready to take action when they see evidence of the change happening.

Well, it started to happen! Perhaps the "first shoe" has dropped.

You may have missed this as it hasn't happened in the United States (at least not yet), where the top ten concentration of the S&P 500 Growth Index hit a new high of 54% on December 31, 2021. But the top ten concentration of the MSCI Emerging Markets Growth Index dropped to 38% (from 49%) over the last three quarters of 2021, according to data provided by MSCI.

Exhibit 1: Divergence in Top Ten Concentration for S&P 500 Growth and MSCI Emerging Markets Growth Indices



Source: S&P Global, MSCI, Brandes Institute

In the last nine months of 2021, the median return for active EM value managers has beaten the broad EM Index (the MSCI Emerging Markets Index), helped by the performance of the MSCI EM Value Index, based on analysis of fund returns accessed via Morningstar. And while the median of active EM Growth managers trailed the broad EM Index, it was able to beat its style index.[1]

At the time of writing (January 10, 2022), growth still dominates the performance tables in the United States, which is consistent with the increasing top ten concentration of the S&P 500 Growth Index. We believe this is not a tenable long-term situation, but we can't predict what might "pop this bubble."

In emerging markets, last year's drop in concentration was driven largely by the price drop of two Chinese stocks (Alibaba and Tencent). While an argument can be made that this is stock-specific, that misses the point that when an index is dominated by a few "mega cap" stocks, the problem is systemic, not stock-specific.

We believe that a worldwide shift back to active value management may have started in 2021, and that emerging markets could have been the first shoe to drop. We await the next "shoe" and believe it could be in the United States. Forgive the mixed metaphor, but the developed international markets (i.e., MSCI EAFE) do not have a "shoe in this race." As we explained in last year's piece, concentration levels in EAFE countries are not at extremes, and so markets are not directly vulnerable to this effect.

Nevertheless, if the emphasis switches from growth to value in the rest of the world (US and emerging markets), we expect EAFE markets to follow this trend.

Our strategy recommendation for global investors is to monitor concentration levels carefully, and we note that while the evidence we've seen so far is undoubtedly short term in nature, the implications for investor style allocations may have long-term implications.

APPENDIX
PEER GROUP DATA

The emerging market peer group includes US-registered, large-cap active mutual funds in the Morningstar database. As of December 31, 2021, the number of funds in this peer group was 200, including 49 Value, 52 Growth and 99 Blend funds when broken down by style as recorded by Morningstar.

As the peer group members were based on inclusion as of end 2021, there is survivorship bias in the group. In the context of this article, this may make it more difficult for funds to beat the median, and hence implies the results should be robust.

There are no separate value and growth emerging markets universes in Morningstar, but the EM universe funds are labeled by style, and the peer groups in this article consist of those funds labeled in the respective styles.

[1] Note: active management data and analysis is based on US-registered large-cap active emerging market mutual funds, as measured by Morningstar. See Appendix for additional details.

Disclosures

MSCI EAFE Index: The MSCI EAFE Index with net dividends captures large and mid cap representation of developed market countries excluding the U.S. and Canada.

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

MSCI Emerging Markets Growth Index: The MSCI Emerging Markets Growth Index with gross dividends captures large and mid cap securities exhibiting growth style characteristics, defined using long-term forward earnings per share (EPS) growth rate, short-term forward EPS growth rate, current internal growth rate, long-term historical EPS growth trend, and long-term historical sales per share growth trend.

MSCI Emerging Markets Value Index: The MSCI Emerging Markets Value Index with gross dividends captures large and mid cap securities exhibiting value style characteristics, defined using book value to price, 12-month forward earnings to price, and dividend yield.

S&P 500 Growth Index: The S&P 500 Growth Index with gross dividends measures equity performance of S&P 500 Index companies with higher sales growth, earnings change to price, and momentum.

The MSCI information may only be used for your internal use, may not be reproduced or redisseminated in any form and may not be used as a basis for or a component of any financial instruments or products or indices. None of the MSCI information is intended to constitute investment advice or a recommendation to make (or refrain from making) any kind of investment decision and may not be relied on as such. Historical data and analysis should not be taken as an indication or guarantee of any future performance analysis, forecast or prediction. The MSCI information is provided on an "as is" basis and the user of this information assumes the entire risk of any use made of this information. MSCI, each of its affiliates and each other person involved in or related to compiling, computing or creating any MSCI information (collectively, the "MSCI Parties") expressly disclaims all warranties (including, without limitation, any warranties of originality, accuracy, completeness, timeliness, non-infringement, merchantability and fitness for a particular purpose) with respect to this information. Without limiting any of the foregoing, in no event shall any MSCI Party have any liability for any direct, indirect, special, incidental, punitive, consequential (including, without limitation, lost profits) or any other damages. (www.msci.com)

This material was prepared by the Brandes Institute, a division of Brandes Investment Partners®. It is intended for informational purposes only. It is not meant to be an offer, solicitation or recommendation for any products or services. The foregoing reflects the thoughts and opinions of the Brandes Institute.

Brandes Investment Partners does not guarantee that the information supplied is accurate, complete or timely, or make any warranties with regard to the results obtained from its use. Brandes Investment Partners does not guarantee the suitability or potential value of any particular investment or information source.

Past performance is not a guarantee of future results.

No investment strategy can assure a profit or protect against loss.

International and emerging markets investing is subject to certain risks such as currency fluctuation and social and political changes; such risks may result in greater share price volatility.

THE BRANDES INSTITUTE

4275 Executive Square, 5th Floor, La Jolla, CA 92037
858/755-0239 | 800/237-7119

GET THE LATEST RESEARCH AND IDEAS:

BRANDES.COM/INSTITUTE | BRANDESINSTITUTE@BRANDES.COM