Global Matters Weekly

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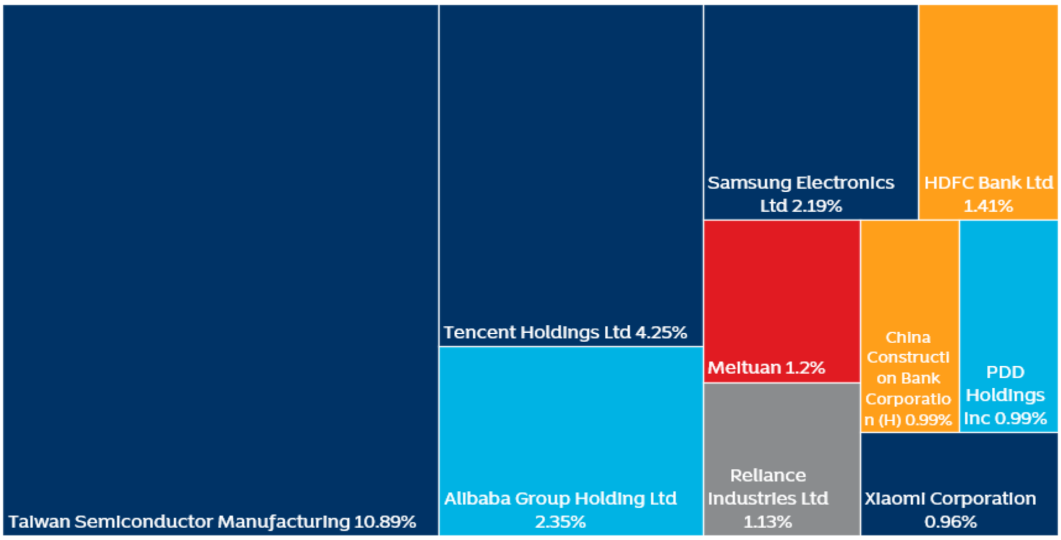
Emerging, but top-heavy

Gabby Byron, Investment Services Executive

Chart of the Week

IShares MSCI EM Top 10 Holdings



Source: FactSet as at 31 January 2025.

What this chart shows

Lots of attention has been paid to the concentration risk in US equities over the past two years, with the "Magnificent 7" dominating returns and index composition. However, emerging market (EM) indices have also become increasingly top-heavy. This week's chart shows the top 10 stocks in the MSCI Emerging Markets Index as at end January, highlighting the dominance of technology stocks (navy blue in the chart) in the index — and particular concentration in just one company, Taiwan Semiconductor Manufacturing Company (TSMC) which currently accounts for over 10% of the index. Meanwhile, in the MSCI Emerging Markets ex-China Index, its weight increases to 15%. Interestingly, ten years ago, TSMC accounted for just 2.9% of the index. The market itself is also highly concentrated geographically, with China, India, Taiwan and Korea making up 75% of the index as at end January. On top of this, over the last five years, TSMC and Tencent alone have contributed to 50% of the benchmark's return, which illustrates the effect of this concentration risk further.

Why this is important

Top holdings, TSMC, Tencent and Samsung are increasingly tied to the same AI-themes that have driven US tech giants' returns, making EM index/passive exposure less of a diversifier in a global portfolio. This concentration also creates potential downside risk, as past regulatory interventions in China's tech sector – such as those that impacted Alibaba, Tencent and Meituan between 2020 and 2023 – serve as a reminder that sentiment can shift rapidly.

Our active managers in the EM space, such as Aikya and Schroder EM Value, offer a more diversified approach across countries, sectors and companies. Aikya, known for its quality-focused strategy, remains underweight in tech and specifically semiconductors. While they recognise that Taiwan has produced some of the world's best semiconductor firms, Aikya believes valuations have become increasingly difficult to justify, leading them to reduce exposure. It remains to be seen whether the enthusiasm for Generative AI can sustain the industry's record-high valuations.

From an asset allocation perspective, we see attractive valuations in EM compared to developed markets, where large-cap equities have re-rated on the back of soft-landing expectations and monetary easing. These elevated multiples in developed markets introduce vulnerability to any negative earnings surprises, whereas EM equities trade at more appealing price-to-earnings (P/E) multiples – currently at a c30% discount. Additionally, material fiscal stimulus in China and continued easing in the US could further improve sentiment for EM equities. Concentration remains a challenge, though the combination of compelling valuations versus developed market counterparts and diversification benefits makes active management a compelling strategy in this space.

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