LetkoBrosseau
Emerging Markets Strategy


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Avoiding the Noise within the MSCI Emerging Markets Index

The MSCI Emerging Markets (EM) Index serves as a crucial benchmark for investors seeking exposure to emerging markets.

Comprising approximately 1,400 constituents across 24 countries, this index represents the performance of large and mid-cap companies in these regions. To effectively navigate and leverage the opportunities within emerging markets, understanding the MSCI EM index's structure and the dynamics between its larger and smaller constituents is important for optimizing investment strategies and achieving long-term objectives in this evolving market.

MSCI Emerging Markets Index composition

# of Companies	# of Countries	Market Cap / Size of Companies
1400	24	Large & Mid Cap

Composition and Weighting of the MSCI Emerging Markets Index

The MSCI EM Index follows a market capitalization-weighted structure, meaning companies with larger market caps have a proportionally greater influence on its performance. This design reflects the economic scale of the companies within the index.

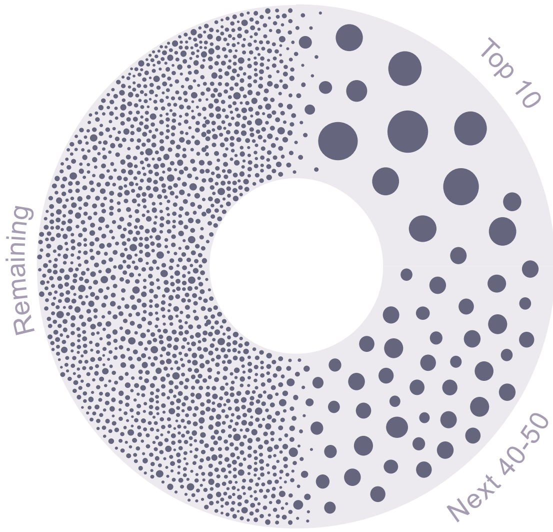
Weighting Analysis

To quantify the influence of different companies within the MSCI EM Index, consider the following:

- **Top 10 Holdings:** These often account for 20-30% of the total index weight, primarily consisting of large-cap stocks with significant market capitalizations
- **Next 40-50 Holdings:** Collectively contribute another 20-30% of the index, encompassing other large companies that still have a meaningful impact on the index.
- **Remaining Constituents:** The remaining 1,300-1,350 companies make up the remaining 40-60% of the index weight. However, many of these have minimal weightings, often below 0.05% individually.

Given this distribution, a sizable portion of the companies in the index have minimal individual impact on its overall performance. In fact, today, more than 70% of the index's constituents hold weightings below 0.05%, translating to a negligible impact on overall returns.

MSCI EM Index Composition



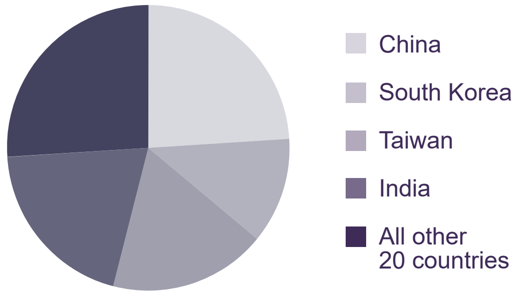
Benchmark: MSCI Emerging Markets Total Return Net Index

Key Features of the MSCI Emerging Markets Index:

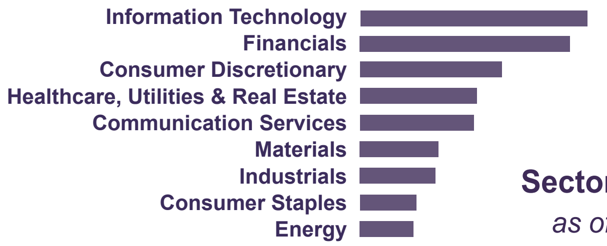
- **Dominant Holdings:** The MSCI EM index is heavily influenced by a select group of large multinational corporations. Companies such as Taiwan Semiconductor Manufacturing Company (TSMC), Tencent, Alibaba, and Samsung Electronics frequently hold substantial weightings, driving the index's overall performance significantly.
- **Country Allocation:** The index represents a broad array of companies from 24 emerging market countries. Notably, China, South Korea, Taiwan, and India dominate the index, collectively contributing a major share of its total market capitalization.
- **Sector Allocation:** The index spans several sectors, including Information Technology, Financials, Consumer Discretionary, and Energy. Sector allocation within the index is a by-product of the underlying security selection. Sector allocation can influence which companies are heavily weighte

Country Weights

as of July 2024



Benchmark: MSCI Emerging Markets Total Return Net Index



Sector Allocation

as of July 2024

Benchmark: MSCI Emerging Markets Total Return Net Index

- **Minor Constituents:** A substantial portion of companies in the index have weightings of less than 0.01%, contributing little to the index's overall performance despite being numerous.

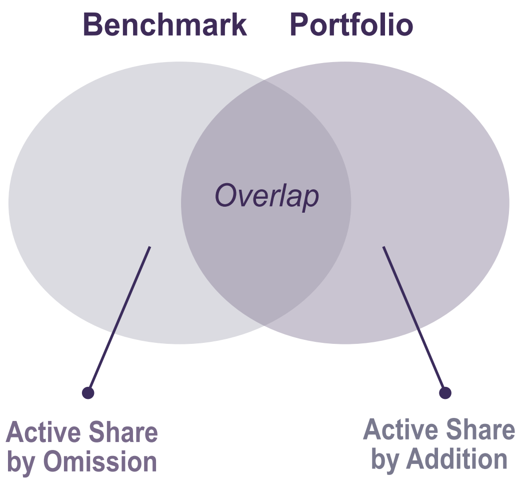
> **"...the MSCI EM Index follows a market capitalization-weighted structure, meaning companies with larger market caps have a proportionally greater influence on its performance ..."**

Active Share: Measuring Portfolio Differentiation

Active share measures the percentage of portfolio holdings that differ from its benchmark index. It is a useful tool for understanding the degree of active management and portfolio diversification.

Key Points about Active Share:

- **High Active Share:** Portfolios with a high active share (typically above 60%) have lower correlation with the benchmark, increasing the potential for outperformance. This indicates that the manager is making distinct choices in stock selection.
- **Low Active Share:** Portfolios with a low active share closely mirror the benchmark, offering limited scope for outperformance as they track the benchmark's movements.



Portfolio Manager can add Active Share by:

- Being underweight or avoiding securities present in the benchmark
- Being overweight securities present in the benchmark
- Adding securities that are not part of the benchmark

Benefits of Including Small-Cap Names

Despite their smaller individual weightings, small-cap companies in emerging markets offer several benefits:

- **Enhanced Growth Potential:** Often in earlier phases of development, small-cap companies can exhibit higher growth trajectories compared to their larger counterparts. Successful investments in these businesses can lead to significant appreciation as they mature and expand.
- **Portfolio Diversification:** Adding small-cap names to a portfolio helps diversify holdings, reducing concentration risk associated with a handful of large-cap companies. This broader exposure across sectors and geographies can provide stability through varied business cycles.
- **Exploiting Market Inefficiencies:** Small-cap stocks often receive less analyst coverage, leading to potential mispricing. Active managers with deep research capabilities can capitalize on these inefficiencies by identifying undervalued opportunities that may be overlooked by the broader market.
- **Localized Economic Exposure:** Small-cap companies tend to be more domestically oriented, offering direct access to local economic growth drivers. This focus on local markets can be particularly advantageous in emerging economies, where domestic developments can play a key role in driving corporate performance.

Avoiding the Noise: Focusing on Meaningful Investments

While small-cap names can be beneficial, it is important to recognize that many companies in the MSCI EM Index have minimal impact on its overall performance. Avoiding the distraction of these lower-weighted names allows investors to focus on more meaningful investments.

Mitigating Noise and Optimizing Strategy:

- **Focus on High-Impact Holdings:** Companies with weightings below 0.05% have limited influence on index performance. The aggregate of the smaller constituents has minimal impact on overall returns. Instead, emphasizing larger, more impactful holdings—the true drivers of index performance—can lead to more meaningful results.
- **Selective Exposure to Small-Caps:** While many small-cap companies in the index have negligible individual weightings, carefully chose small-cap names with robust growth potential or undervaluation present valuable opportunities. By selectively incorporating these names, active managers can benefit from their potential upside, while avoiding the excess noise created by numerous lower-weight constituents.
- **Prioritizing Research-Driven Investments:** Successful investment in emerging markets demands rigorous analysis. Identifying small-cap companies with strong fundamentals and favorable growth prospects requires in-depth research. By concentrating on well-researched, high-conviction investments, investors are well-positioned for their exposure to add value to the portfolio, supporting long-term performance rather than being diluted by less impactful positions.

"...emphasizing larger, more impactful holdings can lead to more meaningful results...."

Conclusion

The MSCI Emerging Markets Index is a comprehensive benchmark for investors seeking broad exposure to emerging markets. While its market capitalization-weighted structure leads to concentration in a few large companies, understanding the composition, weighting, and the concept of active share is crucial for constructing effective portfolios.

Incorporating small-cap names in a portfolio may add growth potential, diversification, and access to market inefficiencies. However, investors must be mindful of the noise from the index's smallest weightings and focus on high-impact investments. With a disciplined approach and thorough research, investors can leverage the MSCI EM Index to capitalize on the unique opportunities within emerging markets, achieving their investment objectives, while navigating these complex environments effectively.

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