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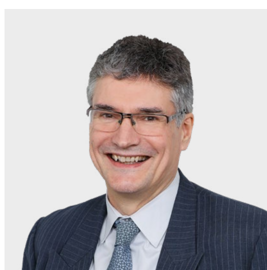
Investing for a
world of change

Why it pays to be active in EM equities



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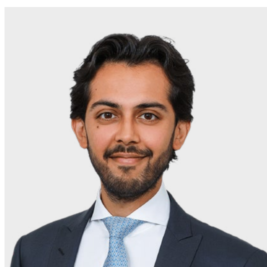

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Passive equity strategies have gained considerable market share in large, liquid, developed markets. However, their adoption in emerging markets remains limited. Here we explore why emerging markets reward active investors.

Weighing up the right investment approach

Many asset owners choose to assign their emerging market (EM) equity allocations into active strategies, and as long-term, active investors, we share this perspective. This approach reflects the inefficiencies, complexities, and growth potential inherent in EM equities.

The performance of active managers in emerging markets

The common narrative that most active managers fail to beat their passive counterparts tends to be framed over recent time periods, and in many cases captures the broadest sweep of the fund universe. Using eVestment data — a trusted resource for institutional strategy assessment — we analysed the performance of active managers. Across 150 equity categories, the median active manager has delivered positive excess returns over 20-, 15-, 10-, and 5-year periods.

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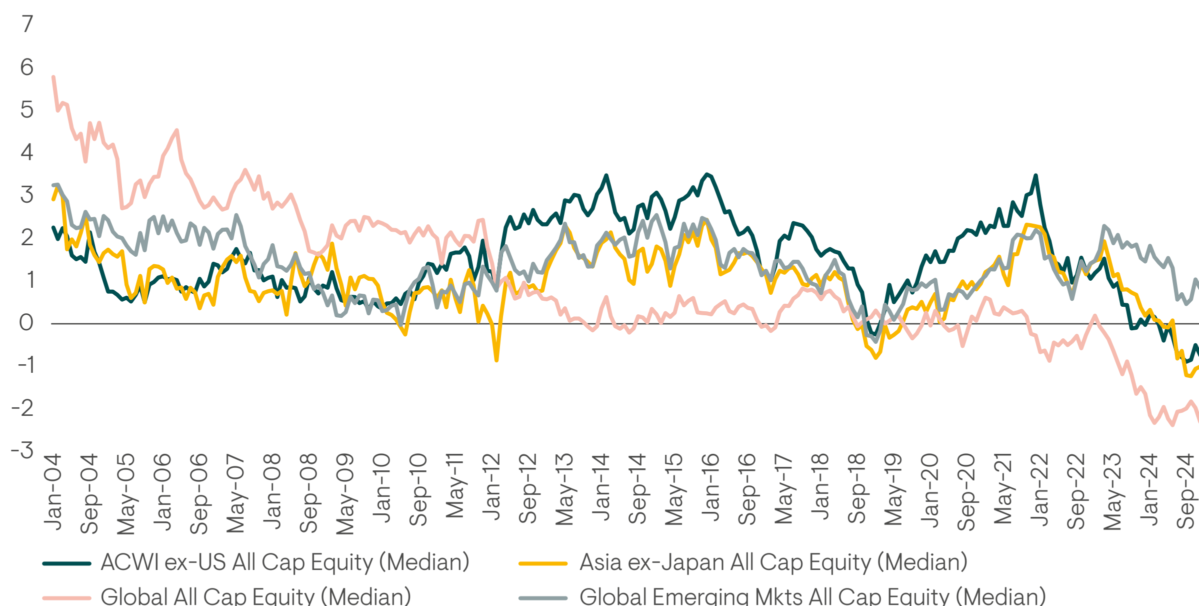
However, there is significant dispersion. Active managers in emerging markets have delivered considerable outperformance, while in developed markets, the outperformance has been less pronounced.

Long-term data further suggests that alpha generation is cyclical and more persistent over extended investment horizons, reinforcing the benefits of patient capital and strategic partnerships.

This is illustrated in Figure 1, where we plot rolling 3-year excess returns delivered by the median active manager in each market category over the past 20 years (an approach that accounts for different market regimes).

Figure 1: Rolling 3Y alpha in select eVestment fund categories (median alpha per category)



Source: eVestment, 20-year data to end-Dec 2024 to give a long-term data horizon.

The median alpha in Global All Cap Equity has diminished over time. It makes sense that as more liquid, mainstream markets become increasingly efficient and assets become more accurately priced, the alpha-capture potential diminishes. For others, including Global EM All-Cap Equity, this is not the case — alpha capture has fluctuated, but it persists[1]. It is clear that markets deemed more inefficient, like China, where retail investors and regulatory barriers limit foreign participation, present a rich environment for active strategies. The key takeaway is that it pays to be active in emerging markets.

The obvious shortcoming of the above analysis is that it is based on gross returns. However, even after fees, alpha in key strategies remains positive. Matching actual fee data paid by consultant-advised clients to eVestment categories, we find that active managers have typically generated positive net alpha and sometimes substantial alpha (see table below).[2]

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1. From Warren paper: see Huij and Post, 2011(63); Dyck et al. 2013(64) ; Gallagher et al. 2017(65).
2. Global consultant research fee report.

Meanwhile, passive funds tracking an index have an inherent disadvantage, as they are almost certain to underperform after fees.

Figure 2: Net alpha estimate for key products

Fund	Monthly average of 5Y rolling alpha since 2004 - gross	Actual fees for seg mandates[3] at US$100m	Monthly average of 5Y rolling alpha since 2004 - net
ACWI ex-US Large Cap Core Equity	0.96	0.65	0.31
Asia ex-Japan Equity	1.30	0.74	0.56
China All Shares Equity	3.73	0.80	2.93
Global EM All Cap Core Equity	1.37	0.80	0.57

Source: Global consultant research, June 2022 (latest available).

Why active investors generate alpha in EMs

Market inefficiencies

The primary reason an active approach has been more effective in emerging markets is that these markets are less efficient. In other words, asset prices may not fully reflect all available information, creating opportunities for skilled investors to generate alpha. The inefficiencies in EMs broadly fall into two categories: structural and behavioural.

Structural

Structural factors refer to the fundamental characteristics of EM financial markets that make price discovery less effective than in developed markets. These include:

- **Weaker financial infrastructure:** EMs have made progress over several years implementing stronger institutions and regulatory frameworks that support capital markets, however gaps remain when compared with developed markets. Corporate governance standards are more variable, and financial disclosures often less transparent. One of the defining features of the EM opportunity set is the prevalence of family-run businesses. Often times, this can lead to decision making that comes at the expense of minority shareholders. Outsized related party transactions are a symptom of this, for example.

3. Actual fees for seg mandates at US$100m for consultant-advised clients.

- **Lower Liquidity and trading volumes:** EM stock markets often experience lower liquidity and trading volumes, making them more susceptible to price swings and less reflective of fair value. Fewer high-frequency trading participants contribute to this. A look at average bid/ask spreads show Thailand has one of the widest (over 50 bps) followed by Indonesia (35 bps) and Taiwan (28 bps). In developed markets, average bid/ask spreads are usually single digits like Australia (9 bps) or Japan (5 bps).
- **Less analyst and data coverage:** Compared to developed markets, EM stocks tend to receive less coverage from sell-side analysts and independent research providers. Whilst this phenomenon exists predominantly across the mid-cap opportunity set, it is also prevalent across certain markets. Take the Middle East, for example, which is a comparatively sparsely covered region but now accounts for almost 8% of the benchmark.

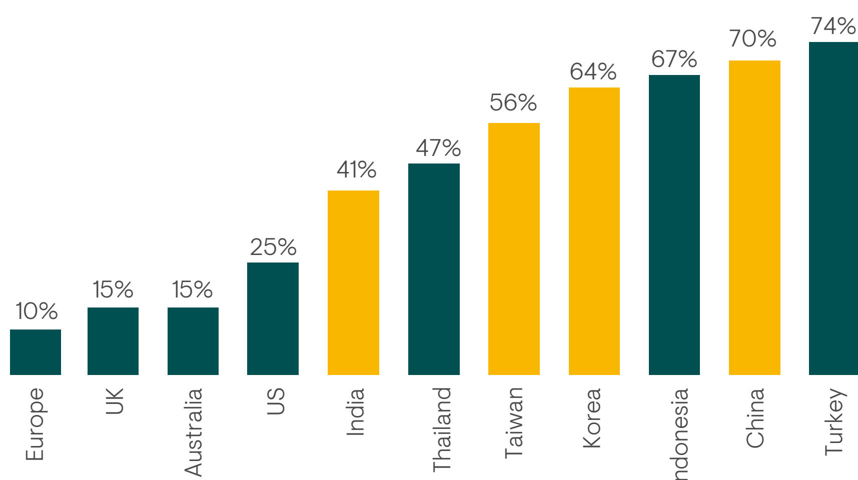
Behavioural

The second category of inefficiencies arises from investor behaviour, particularly due to the retail-heavy composition of market participants in EM equities:

- **Higher retail investor participation:** EM stock markets tend to have a larger proportion of retail investors, who are generally more reactive to short-term news and speculative trends. This dynamic often leads to exaggerated price swings, as seen during the 2023 rally in small-cap stocks in China, where retail speculation caused extreme volatility before a sharp correction.

Figure 3 maps retail participation across emerging and developed markets showing data points collected over the last five years where data is available. The graph highlights that the four largest markets by weighting in the MSCI EM Index, which together account for c.76%, show significantly higher retail participation compared to their developed market counterparts.

Figure 3: Retail participation in stock markets by country and region



Source: Ninety One. Participation rates compiled or estimated and reported by local exchanges. Data points are drawn from available data over the last five years. See important information for sources for retail participation. MSCI, Jan 2025.

A combination of these structural and behavioural inefficiencies leads to persistent mispricings, regardless of investment styles. For active managers with a disciplined and repeatable investment process, these inefficiencies provide opportunities to identify underappreciated future winners and avoid value traps.

By focusing on long-term, risk-adjusted returns driven by stock-specific fundamentals — rather than broad market movements — active investors in EMs are better positioned to deliver sustained alpha than passive investors tracking an index. Furthermore, these inefficiencies are persistent and reflective of these nations' status as developing economies, meaning an active approach will remain relevant for many years to come.

Investing in businesses, not just indices

Investing in emerging markets is not just about what's in the index — it's also about what's missing. Adding off-benchmark stocks to a portfolio has several well-documented benefits, including enhanced diversification, increased alpha potential, or the ability to access markets or regions underrepresented in traditional indices. Active EM investors can pursue off-benchmark opportunities by investing in EM stocks that are not included in benchmark indices or in DM-listed companies with significant emerging market exposure.

When evaluating EM-listed stocks outside the benchmark, it's easy to assume their exclusion signals poor quality — but that's not necessarily true. Many successful companies remain outside the index for reasons unrelated to their fundamentals. Some may be early-stage businesses experiencing rapid growth but not yet meeting market capitalisation, balance sheet strength, or liquidity thresholds. Others may face regulatory or transparency hurdles that could be addressed through improved governance and oversight.

Additionally, companies – or even entire markets - may be in the process of securing index inclusion, a transition that takes time to complete. Take Vietnam — a high-growth economy still classified as a frontier market but poised for MSCI EM inclusion. Passive investors miss early-stage gains that active managers can capture. Over the past year, Vietnam's role as an AI supply chain hub has expanded as firms diversify away from China amid geopolitical and tariff concerns. Its omission from the index signals not inferiority, but future potential.

Including DM-listed companies with significant EM exposure brings a different dimension to the portfolio. In the instance of these larger, more established firms, their inclusion can enhance the overall growth and revenue profile of the portfolio, through their EM exposure, but also benefit from the enhanced downside protection inherent with being a DM-listed company i.e. reduced direct geopolitical risk for example.

Looking past headline valuations

Skilled bottom-up stock pickers can identify mispriced opportunities irrespective of broader market valuations at any stage of the cycle. A sector or country may appear expensive at the index level, potentially deterring investment. For example, India's valuations have risen, as noted here. However, active management allows investors to uncover individual Indian companies with strong earnings potential or expanding market share, even in a higher-valuation environment.

Mitigating risks through active management

In emerging markets, avoiding the bad apples can be as important as picking the winners when it comes to generating alpha. A key benefit of active over passive investing is the ability to navigate a variety of risks that can compromise alpha.

Resilience and governance

Investment approaches that incorporate deep fundamental analysis can help to mitigate risks. Emerging market companies that demonstrate strong operational and ethical standards will likely be less exposed to regulatory sanctions, reputational damage, consumer opposition, talent loss, and other risks to their intrinsic value.

There is a common perception that governance standards in emerging markets are lower. While this is not universally true, certain areas require heightened scrutiny from active investors. Passive investing provides broad exposure to underlying securities but lacks the ability to assess individual governance frameworks, such as board composition and related-party transactions. In contrast, active investors can conduct detailed evaluations of financials, director proposals, and key stakeholder dynamics, offering a more informed approach to managing financial and reputational risk.

Consumer expectations in emerging markets are also shifting. Just like in developed markets, people are increasingly focused on corporate responsibility, including environmental impact, labour practices, and ethical business conduct. Companies that fail to adapt to these changing priorities may face growing scrutiny.

Active investors play a critical role in engaging with companies to assess sustainability-related risks and opportunities. This is particularly valuable in emerging markets, where data availability is limited, and quality can be inconsistent.

Geopolitical and regulatory risk

Overexposure to either regulatory or geopolitical risks can potentially impair a company's business model and operating performance. One market where these risks are particularly pertinent is China. The government has penalised the tech and internet companies in recent years, promoting 'Common Prosperity' across China, by reducing the influence and reach of the major companies to safeguard social, economic, health and family welfare ideals. Active managers are better placed to weigh these risks at the individual company level to navigate the regulatory uncertainties.

Furthermore, with Trump back in office, attention has once again turned to US-China geopolitical relations. However, after eight years of adapting to Trump-era trade policies, China is now far more resilient to additional measures. Today, only around 13% of Chinese exports go to the US, down from 20% in 2014 — a 35% reduction. Active management enables investors to identify new beneficiaries of these shifting trade patterns and capitalise on evolving opportunities. While the future trajectory of trade tensions and tariffs remains uncertain, integrating geopolitical considerations into company-specific analysis is essential for assessing risk-return trade-offs.

Corporate governance also plays a critical role in mitigating value destruction from sanction risks. Active investors conduct in-depth analysis of ownership structures, business activities, and related-party transactions to assess potential exposure. By scrutinising value chains, they can identify and manage links to sanctioned entities, strengthening portfolio resilience.

Concentration risks

Traditional emerging market indices contain fewer mega-cap companies than their developed market counterparts, often resulting in large-cap stocks carrying disproportionate weightings. Taiwan Semiconductor Manufacturing Company (TSMC) illustrates this dynamic when compared to US tech giant NVIDIA. NVIDIA, with a market capitalisation of approximately US$3.2 trillion[4], represents around 4% of the MSCI All Country World Index. In contrast, TSMC, with a market cap of roughly US$800 billion — one-fifth the size of NVIDIA — accounts for 9.6% of the MSCI Emerging Markets Index and nearly 50% of Taiwan's overall index weighting. While TSMC's dominance in the semiconductor industry has driven significant growth, maintaining this position will be crucial for sustaining future share price performance.

This level of concentration is a key risk in passive portfolios, particularly if future returns do not align with past performance. While portfolio management constraints may limit exposure to individual stocks beyond 10%, active management provides the flexibility to size positions appropriately, mitigating the return impact of an over-weighted single stock.

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4. Bloomberg, November 2024. This is not a buy, sell or hold recommendation for any particular security.

The bottom line

Emerging markets remain a fertile ground for active management, where structural inefficiencies and market complexities create opportunities beyond passive exposure. Unlike developed markets, where efficiency has eroded alpha, EMs continue to reward research - driven stock selection and off-benchmark investing. These efficiencies are set to persist given the regions continuing economic development and rapid growth.

Long-term data shows that active managers have consistently delivered excess returns, even after fees. Market inefficiencies — stemming from drivers including lower liquidity, regulatory barriers, and high retail investor participation — lead to persistent mispricings that skilled investors can exploit. Moreover, active strategies provide the flexibility to navigate governance risks, geopolitical shifts, and index concentration, areas where passive funds fall short.

In a market where risk and opportunity are closely intertwined, a selective, research-led approach is essential. Active investors not only seek alpha but also manage risks that can erode returns, reinforcing their edge in capturing long-term value in emerging markets.

General risks: The value of investments, and any income generated from them, can fall as well as rise. Past performance is not a reliable indicator of future results. Environmental, social or governance related risk events or factors, if they occur, could cause a negative impact on the value of investments.

Specific risks: **Emerging market (inc. China):** These markets carry a higher risk of financial loss than more developed markets as they may have less developed legal, political, economic or other systems.

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Sources for retail participation

China – Shenzhen Stock Exchange, 2021; **India** – NSE India Ownership Tracker, 2022; **Taiwan** – Taiwan; Stock Exchange, 2023; **Korea** – Korea Securities Depository, 2023; **Thailand** – McKinsey Report, 2021; **Turkey** – Turkish Investor Relations Society, 2020; **US** – The Retail Invesot Report, University of Pennsylvania, 2023; **Europe** – Financial News quoting SIX, 2024; **Australia** – CBOE Australia, 2022; **UK** – The Times referencing LSE, 2024; **Indonesia** – CMS Asia, 2020.

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