

# Benchmark Blind Spots: Emerging Markets

Concentration Is Common. The *Right* Concentration Is Rare.

## The Problem with the Default Framing

Emerging Markets are often treated as a passive allocation first, with active managers evaluated relative to that baseline. That framing implies the index itself is a reasonable default. In Emerging Markets, it is not.

The EM index is highly concentrated. Long-term outcomes are driven by a small number of companies. Passive exposure embeds these concentrated bets without judgment, while many active approaches dilute them without improving them.

Understanding this tension is essential to understanding why passive strategies struggle — and why only certain types of active managers can outperform in a structurally concentrated market.

## Capital Constraint Concentrates Outcomes

Emerging Markets are inherently defined by capital constraints.

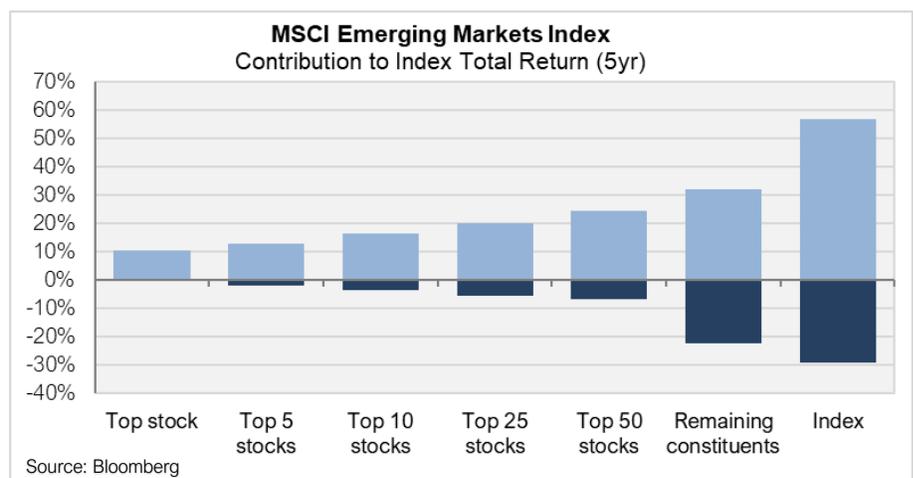
Capital is scarcer, more expensive, and unevenly distributed. Access to funding varies widely across companies and countries, and investment cycles are frequently interrupted by currency stress, policy shifts, or balance-sheet repair. As a result, not everyone can invest — even when opportunities exist.

Over time, this produces a defining pattern: **returns concentrate in a select few companies.**

Years of underinvestment narrow the field of viable reinvestors. When growth and capital availability return, gains accrue disproportionately to the companies with the balance sheets, scale, and operating leverage to deploy capital immediately.

The chart illustrates this dynamic over a multi-year period. A single company accounts for a meaningful share of total index returns, while a small group of leading stocks drives the majority of performance. In contrast, the remaining constituents add little and disproportionately detract from returns.

This is not a one-off dynamic nor a timing artifact. It is the natural result



of capital scarcity. In EM, prolonged underinvestment creates cycles where a handful of large winners dominate.

Importantly, this concentration does not persist indefinitely. It lasts only as long as companies reinvest capital productively. Concentration ends when returns on invested capital deteriorate — not simply because prices rise or narratives change.

**Success in Emerging Markets is not about owning yesterday’s winners indefinitely; it is about continuously assessing whether investment remains disciplined, and returns on capital remain durable.**

## The Index Is Concentrated – But in the Wrong Way

Once an index becomes heavily concentrated, it is tempting to conclude that simply owning the largest names is sufficient. After all, a small group of companies already drives most of the index’s return.

But index construction allocates capital based on size and liquidity — the result of past success — not on whether that concentration is being **earned** through ongoing investment discipline and improving returns on capital.

In Emerging Markets, this gap matters. Companies that are investing prudently and earning high returns on capital often become tomorrow’s leaders well before they are fully reflected in index weights. By the time concentration is obvious in the benchmark, much of the value creation has already occurred — and the risk of capital misallocation may be rising.

This is the core benchmark blind spot in Emerging Markets: **concentration without accountability.**

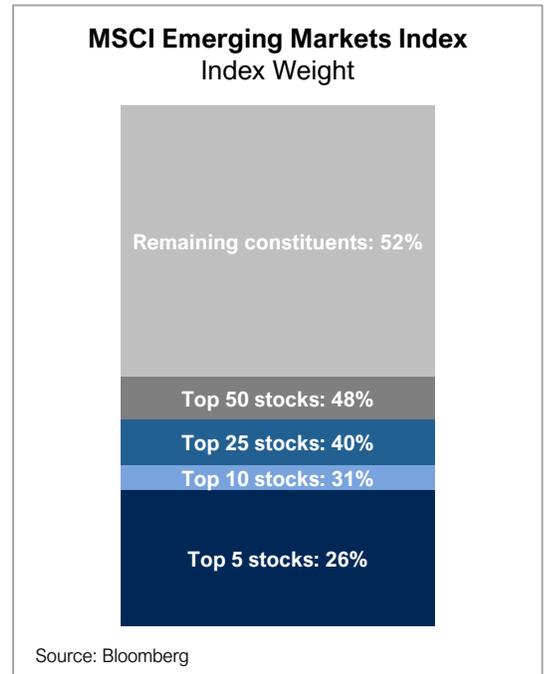
## Why Passive Struggles in a Concentrated Index

Passive investing assumes market capitalization is a reasonable proxy for future returns. In positively skewed markets like EM, that assumption breaks down.

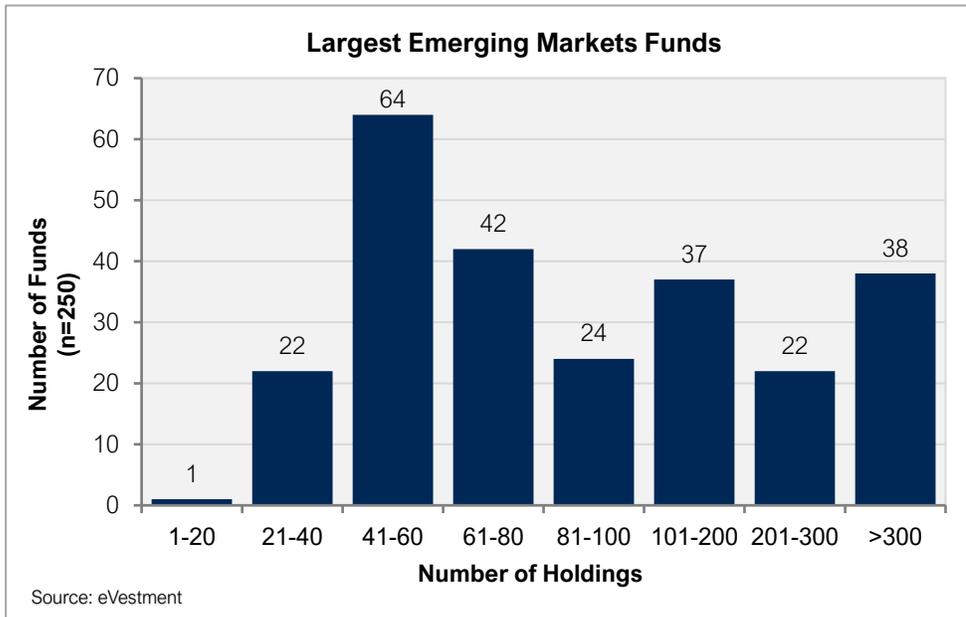
Passive exposure cannot:

- Distinguish **earned concentration** from inherited scale
- Detect changes in investment behavior or improving returns on capital
- Adjust nimbly when leadership changes
- Allocate capital based on what companies are becoming, only on *what they’ve been*.

In a cap weighted index, the risk is not concentration — it’s *misguided* concentration.



## Why Diluted Active Fails Too



Many active managers have recognized the shortcomings of passive exposure but respond simply by spreading capital across more holdings under the auspices of risk management.

In practice, this has become the industry norm. Most active Emerging Markets portfolios hold well over 100 names, and some hold several hundred. In a market where outcomes are driven by a small number of companies, this approach systematically reallocates capital away from the stocks that matter most and toward the unproductive long tail.

We refer to this tendency as **diluted active**.

## Competing in a Concentrated Index Requires Deliberate Concentration

A concentrated index requires a deliberate response. Consistent Emerging Market outperformance is not achieved by owning more stocks than the index. It's achieved by maintaining concentration, avoiding systematic dilution, and selecting the right names- **tomorrow's market leaders**.

That means:

- Identify companies that compound aggressively via disciplined capital allocation
- Avoid exposure where returns on invested capital (ROIC) is deteriorating
- Hold these businesses at meaningful active weights

**Concentration must be earned, not inherited.**

## Why Vaughan Nelson Emerging Markets

Vaughan Nelson Emerging Markets is built to compete where both *passive* and *diluted active* approaches fall short.

Vaughan Nelson's Capital Allocation Framework identifies companies allocating capital prudently and earning the right to become tomorrow's leaders. We allocate capital with judgment, not inertia.

The result is a concentrated portfolio with the right names- not just the largest ones- and a singular focus on delivering superior risk adjusted returns to investors.

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