

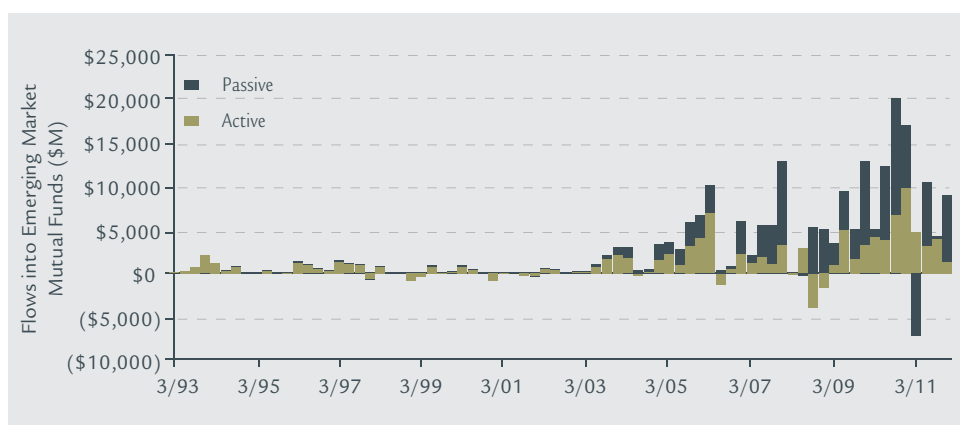
Broad is the New Narrow

How Passive Investing Creates Concentrated Portfolios

Passive investing, particularly in emerging markets, has become an increasingly popular means of quick, “diversified” exposure to a particular segment of the markets. Flows into passive emerging market products have been so strong that assets in exchange-traded funds (“ETFs”) designed to capture this region of the world now rank third behind ETFs tracking the S&P 500 Index and gold. Yet it’s the presumption of diversification that can lead investors astray. Many passive investments are, in fact, extremely concentrated owing to the disproportionate size of their largest holdings and blindly weighting by market capitalization. As emerging markets is now the largest region of the equity markets by number of investable securities, it may create opportunities for investors willing and able to invest actively outside of the largest securities.

The popularity of emerging markets and, in particular ETFs, has reached an all new level. Recent flows have pushed the ratio of collective assets invested in passive and ETF strategies to active strategies in emerging markets to parity. That is, there’s as much money invested passively as actively today in emerging markets. Just 10 years ago, active strategies managed 10 times as much. While other areas of the world have also seen a surge of passively invested money in recent years, actively managed products still manage twice as much assets as passive.

Exhibit 1: Quarterly Flows into Active and Passive Emerging Market Strategies (1993-2011)



Source: Morningstar, the Brandes Institute, as of 12/31/11. Passive includes passive funds and ETFs.

Looking across the universe of 3,963 exchange-traded funds globally, 48 ETFs¹ track a broad measure of emerging markets (the overwhelming majority track the MSCI Emerging Markets Index). Aggregate net assets under management in these funds totaled \$114 billion as of December 31, 2011. Additionally, there is another \$42 billion in BRIC (Brazil, Russia, India, China) ETFs or its individual country components and \$4.0 billion in ETFs tracking regional carve outs of emerging markets (Asia Pacific, Latin America, and Europe).

¹As there are several established index vendors for emerging markets and gold, this total includes funds meant to track indices published across multiple providers. For example, gold ETFs include those that track the spot price, physical gold, London Fixed Gold price return, etc.

Exhibit 2: ETF Net Assets by Asset Class Tracked

Target Investment	Net Assets (\$M)	# of ETFs
S&P 500	\$142,768	53
Gold	\$125,788	69
EM	\$114,340	48
BRIC	\$3,378	13
China	\$19,313	37
Brazil	\$12,715	29
India	\$4,201	35
Russia	\$3,031	17

Source: Morningstar, the Brandes Institute, as of 12/31/11.

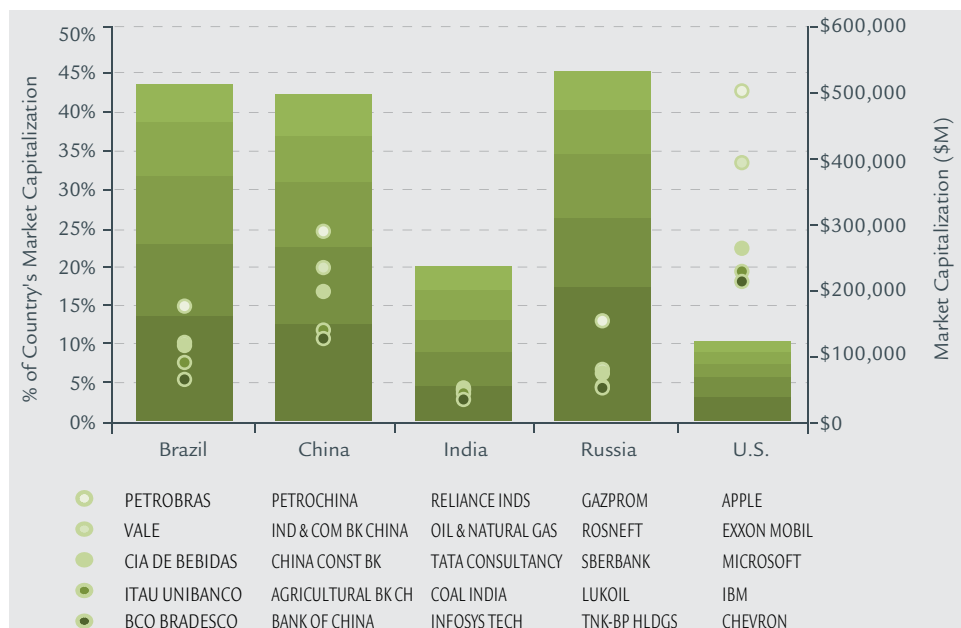
What are the possible ramifications of this surge in passive investment on investors and markets in these areas?

CONCENTRATION RISK

ETFs have not provided the level of diversification many investors expect. As the majority of ETFs invest pro rata on a market capitalization basis, it means that the majority of flows are used to purchase shares in the largest companies. Those purchases in turn push prices and capitalization higher and, coupled by relatively consistent flows the past few years, have turned this pattern into a compounding cycle.

We analyzed the largest companies in the S&P Global Broad Market Index across various countries and identified how much of a country's total capitalization was represented by just the largest five companies. As shown in Exhibit 3, BRIC countries tend to be "top heavy." The largest five companies in Russia account for 46% of that country's total market cap; the top five in Brazil account for 44%.

Exhibit 3: Concentration Among the Largest Five Companies in Select Countries



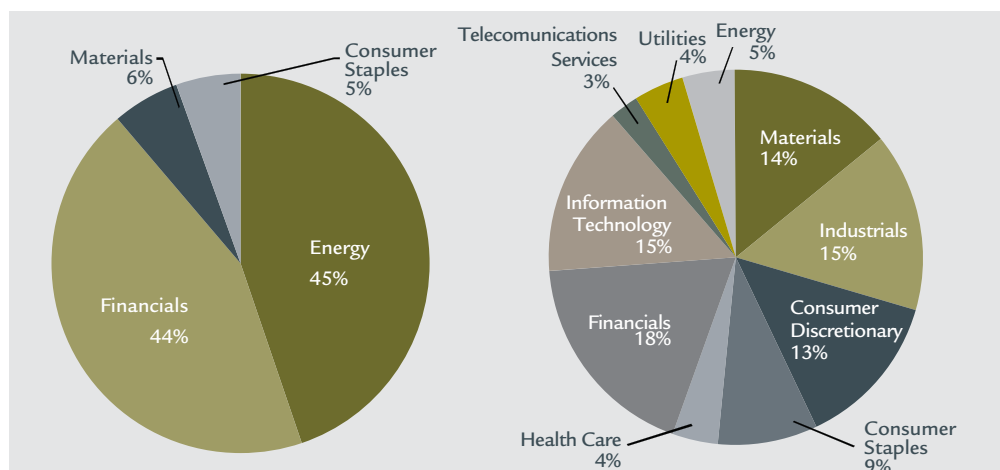
Source: S&P, Worldscope via FactSet, as of 2/29/12. Past performance is not a guarantee of future results.

As profiled in Exhibit 3, the largest five companies in each respective BRIC country also provided little diversification across sectors, being heavily weighted in just two. Roughly 89% of the capitalization of those 20 companies was in financials (banks) and energy (predominantly oil & gas). Exposure to these largest companies alone would miss much of what emerging markets offer and becomes particularly evident when the number of companies in each emerging market sector are tallied on an equally weighted basis. The full 2,802 companies in the S&P Emerging BMI (Broad Market Index) were more broadly distributed, with no sector accounting for more than 18% of the index's constituents. This reveals that beneath the top layer of concentration, emerging markets encompass a fairly diversified set of companies across the globe. See Exhibit 4.

Exhibit 4: Sector Composition of Emerging Markets

Five Largest Constituents in
Each BRIC Country (cap-weighted)

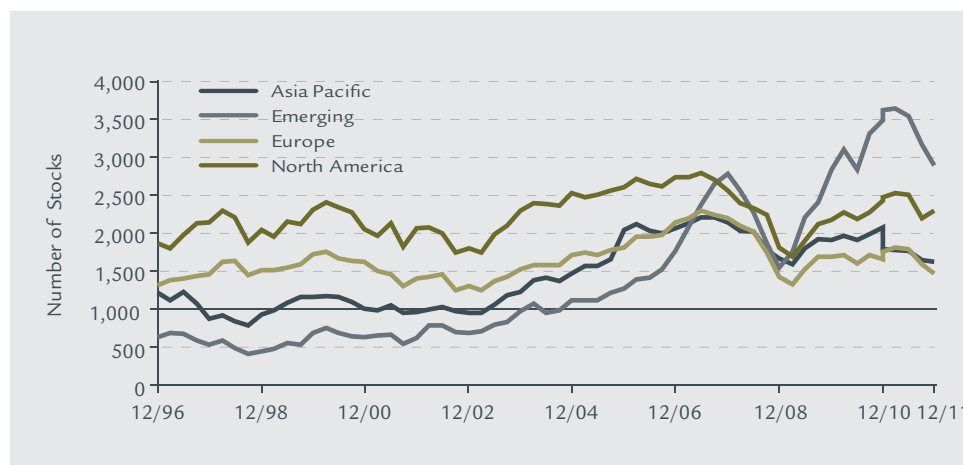
S&P Emerging BMI (equally weighted)



Source: S&P, Worldscope via FactSet, as of 2/29/12. Past performance is not a guarantee of future results.

Additionally, emerging markets is now the single largest opportunity set globally. There are nearly 2,900 stocks in emerging markets with a market capitalization greater than \$500 million, more than any developed market region in the world. Exhibit 5 profiles how this leadership position has evolved historically and transformed over the past 15 years.

Exhibit 5: Number of Stocks Above \$500 Million in Market Capitalization by Region



Source: Worldscope via FactSet, the Brandes Institute, as of 2/29/12. Past performance is not a guarantee of future results.

CONCLUSION

The number of companies available for investment in emerging markets is greater than that in developed markets, reflecting vast opportunity. Yet, the indices (and ETFs tracking these indices) designed to reflect emerging markets tend to be heavily concentrated in just a handful of companies. For investors seeking greater potential in emerging markets and enhanced diversification benefits, active managers may offer a more attractive alternative.

S&P 500 Index - SP500 G: The S&P 500 Index with gross dividends is an unmanaged, market capitalization weighted index that measures the equity performance of 500 leading companies in leading industries of the U.S. economy. Although the index focuses on the large cap segment of the market, with approximately 75% coverage of U.S. equities, it can also be a suitable proxy for the total market. This index includes dividends and distributions, but does not reflect fees, brokerage commissions, withholding taxes, or other expenses of investing.

The S&P Emerging Markets Broad Market Index (BMI) with net dividends is an unmanaged, float-adjusted market capitalization weighted index that measures the equity performance of all capitalization companies from emerging markets around the world. This index includes the reinvestment of dividends and income but does not reflect fees, brokerage commissions, withholding taxes, or other expenses of investing.

The S&P Global Broad Market Index (BMI) with net dividends is an unmanaged, float-adjusted market capitalization weighted index that measures the equity performance of all capitalization companies from markets around the world. This index includes dividends and distributions net of withholding taxes, but does not reflect fees, brokerage commissions, or other expenses of investing. Stocks of small companies usually experience more volatility than mid and large sized companies.

MSCI Emerging Markets (MSCI EM) Index - MSCIEMF: The MSCI Emerging Markets Index with gross dividends is an unmanaged, free float-adjusted market capitalization weighted index designed to measure equity market performance in emerging markets throughout the world. This index includes dividends and distributions, but does not reflect fees, brokerage commissions, withholding taxes, or other expenses of investing.

Investing in exchange-traded funds (ETFs) involves specific considerations for investors including, but not limited to, expenses, liquidity risks, and the possibility that ETF shares may trade at prices above or below their net asset value.

Diversification does not assure a profit or protect against a loss in a declining market.

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