

BROADENING EMERGING MARKETS EXPOSURE: THE ROLE OF SMALL CAPS

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Executive summary

Emerging Markets (EM) Small Cap equities are often treated as a niche allocation. In reality, they represent the majority of EM companies by number and a substantial portion of the underlying corporate opportunity set. Standard EM large- and mid-cap benchmarks are structurally narrow by design: they concentrate risk and return in a small number of mega-cap companies, a limited set of industries, and a country mix dominated by China and a handful of Asian Conglomerates.

In contrast, the small-cap segment represents the majority of EM companies by number, but only a minority of total EM market capitalization. This imbalance matters. For systematic and active investors, breadth is a core ingredient in expanding the opportunity set for alpha generation: it increases the cross-sectional opportunity set, reduces dependence on a small number of mega-cap narratives, and diversifies the sources of active risk.

- Opportunity set vs capital: EM Small Cap is ~61% of EM IMI constituents but ~13% of EM IMI market capitalization (as of 31-Dec-2025).
- Lower concentration: EM Small Cap's top-10 weight is ~4% vs ~31% in MSCI EM; the largest constituent is ~0.5% vs ~11.9%.
- Different EM: EM Small Cap shifts country exposure toward India, Taiwan and Korea and away from China relative to MSCI EM.
- Implementation is both the constraint and a potential source of competitive differentiation: the segment rewards investors with disciplined liquidity, cost and governance frameworks.

The implication for institutional portfolios is straightforward: EM Small Cap can serve as a distinct and structurally differentiated component of EM equity exposure, rather than simply a satellite allocation. The primary requirement is implementation discipline—liquidity-aware portfolio construction, robust transaction cost modeling, and operational readiness.

1. Why Emerging Markets Small Cap

Most institutional EM equity allocations are implemented through broad EM large- and mid-cap benchmarks. These benchmarks are investable and liquid, but they embed two structural distortions: (1) extreme concentration in a small set of mega-cap names and industries, and (2) capital-weighted exposure that can underrepresent the true breadth of the EM corporate landscape.

EM Small Cap is structurally different. It expands the investable universe, reduces top-end concentration, and provides more diversified exposure to domestic-oriented business models. For systematic investors in particular, these features are not cosmetic—they are the conditions under which cross-sectional signals remain robust, scalable and less crowded.

1.1. Three structural drivers of the EM Small Cap opportunity set

- Breadth: a larger number of investable companies spanning a wider set of industries and business models.
- Lower top-end concentration: less reliance on a handful of mega-cap franchises for benchmark risk and returns.
- Different macro and sector exposures: less embedded mega-cap technology and more exposure to sectors tied to domestic activity.

1.2. Alpha potential for systematic investors

Systematic equity strategies tend to benefit from (i) a large cross-section of securities, (ii) dispersion in fundamentals and returns, and (iii) reliable implementation. EM Small Cap increases the cross-sectional surface area available for stock selection. This has practical implications for factor breadth, signal decay, and crowding. A broader universe can support more diversified sources of active return and may reduce dependence on a narrow set of mega-cap or regime-specific outcomes.

2. Defining the EM Small Cap universe

This paper uses MSCI's index family as a benchmark framework. MSCI EM represents the large- and mid-cap segment (~85% of free-float market cap in each country), while MSCI EM Small Cap represents the small-cap segment (~14%). MSCI EM IMI combines large, mid and small caps (~99% coverage).

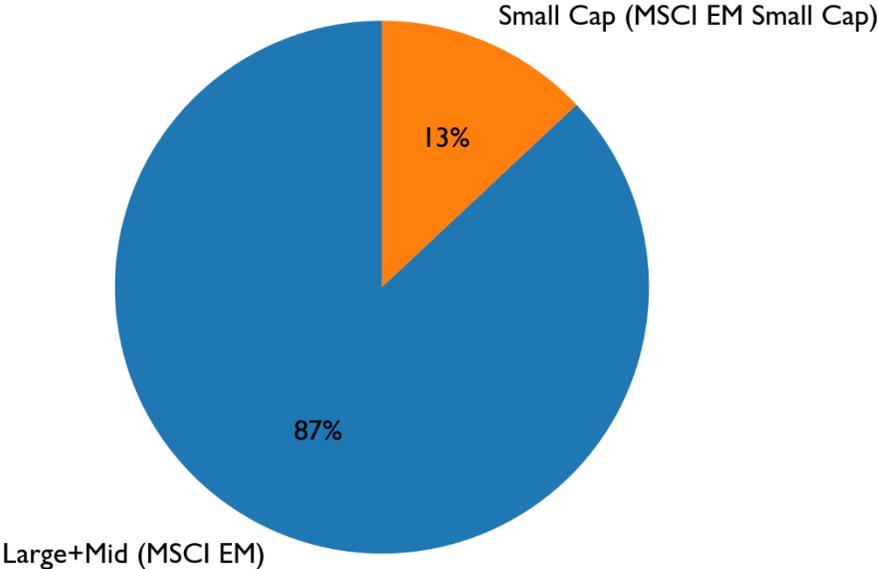
The defining feature of EM Small Cap is not its market cap label; it is the mismatch between breadth and capital. At 31-Dec-2025, MSCI EM Small Cap represented ~61.1% of MSCI EM IMI constituents but only ~13.0% of market capitalization (index market cap USD 1,534bn out of USD 11,763bn).

This is the organizing principle of the paper: the opportunity set is not where the capital is. Capital-weighted EM benchmarks allocate the majority of risk to a narrow slice of the corporate universe. Systematic investors should care about this because breadth is what sustains cross-sectional efficiency and reduces the fragility of any single narrative.

At Ativo, our research universe spans over 3,500 EM small-cap companies—nearly double the number of constituents in the MSCI EM Small Cap Index—reflecting the depth and breadth of the underlying opportunity set beyond benchmark construction.

EM Small Cap: ~61% of names, ~13% of market cap (as of 31-Dec-2025)

Market cap share



Constituent share

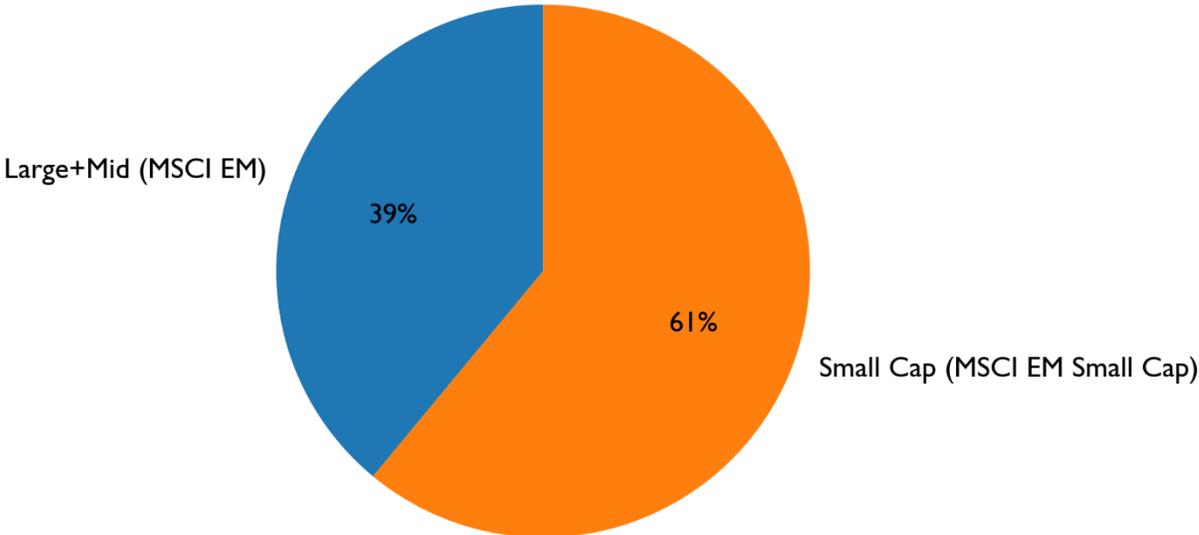


Exhibit I. Share of MSCI EM IMI represented by Large+Mid vs Small Cap (constituents and market cap). Source: MSCI factsheets (as of 31-Dec-2025).

Metric (as of 31-Dec-2025)	MSCI EM (Large+Mid)	MSCI EM Small Cap
Coverage of EM free-float mkt cap (approx.)	85.00%	14.00%
Constituents (#)	1,197	1,883
Index market cap (USD bn)	10,229.40	1,534.00
Largest constituent weight	11.90%	0.50%
Top 10 constituents weight	31.00%	4.00%
Dividend yield	2.28%	2.51%
P/E (TTM)	17.03	23.5
P/B	2.16	1.5

Exhibit 2. Index characteristics (breadth, concentration and valuation). Source: MSCI factsheets (as of 31-Dec-2025).

3. Country mix: shifting away from China toward India/Taiwan/Korea

A second structural distinction is country composition. MSCI EM is heavily influenced by China's weight and by the largest technology platforms in Asia. MSCI EM Small Cap meaningfully reduces China's weight and increases India's representation, while maintaining substantial weights in Taiwan and Korea.

This shift is not a footnote. It changes the benchmark's policy sensitivity, macro drivers, and exposure to country-specific regulatory regimes. For allocators, EM Small Cap represents a structurally different expression of emerging markets exposure, with distinct country and sector dynamics.

Country Weights (Dec 31, 2025): China vs India/Taiwan/Korea

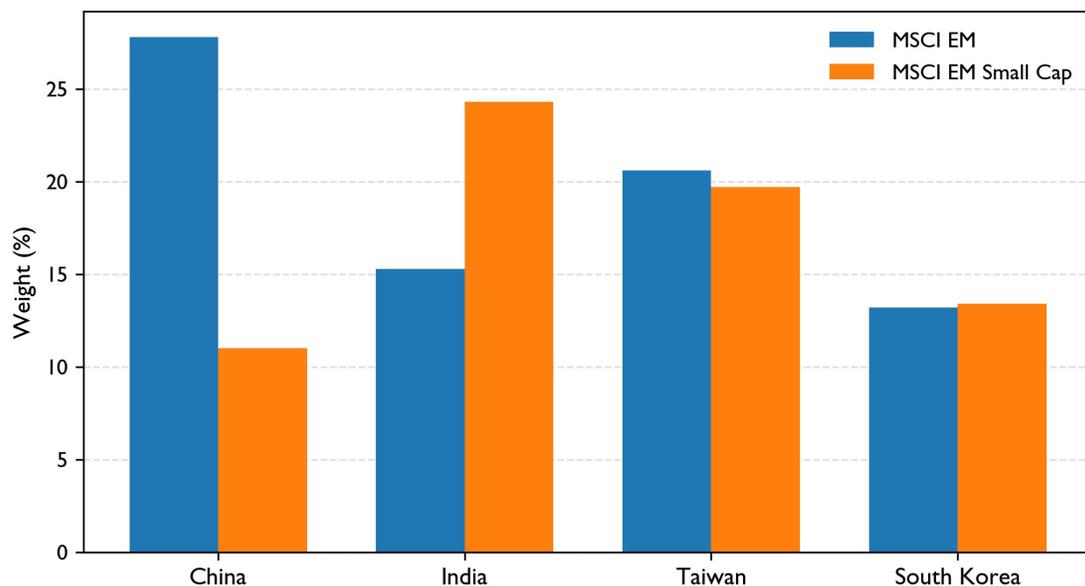


Exhibit 3. Country weights (selected countries), MSCI EM vs MSCI EM Small Cap. Source: MSCI factsheets (as of 31-Dec-2025).

4. Sector mix and “local economy” exposure

Sector composition makes the structural difference between EM and EM Small Cap immediately visible. EM Small Cap is not a scaled-down version of EM; it is a different set of businesses.

At 31-Dec-2025, EM Small Cap had higher weights in Industrials, Health Care, Real Estate and Materials, and lower weights in Information Technology and Financials. This is consistent with a more domestic-activity and local-economy exposure profile.

A complementary lens is revenue geography. Relative to MSCI EM, the EM Small Cap benchmark has less revenue exposure to China and the US and more exposure to India, Korea and Taiwan. This reinforces the argument that EM Small Cap is structurally less dependent on a narrow set of global mega-cap demand channels.

Sector weight differences: MSCI EM Small Cap minus MSCI EM (as of 31-Dec-2025)

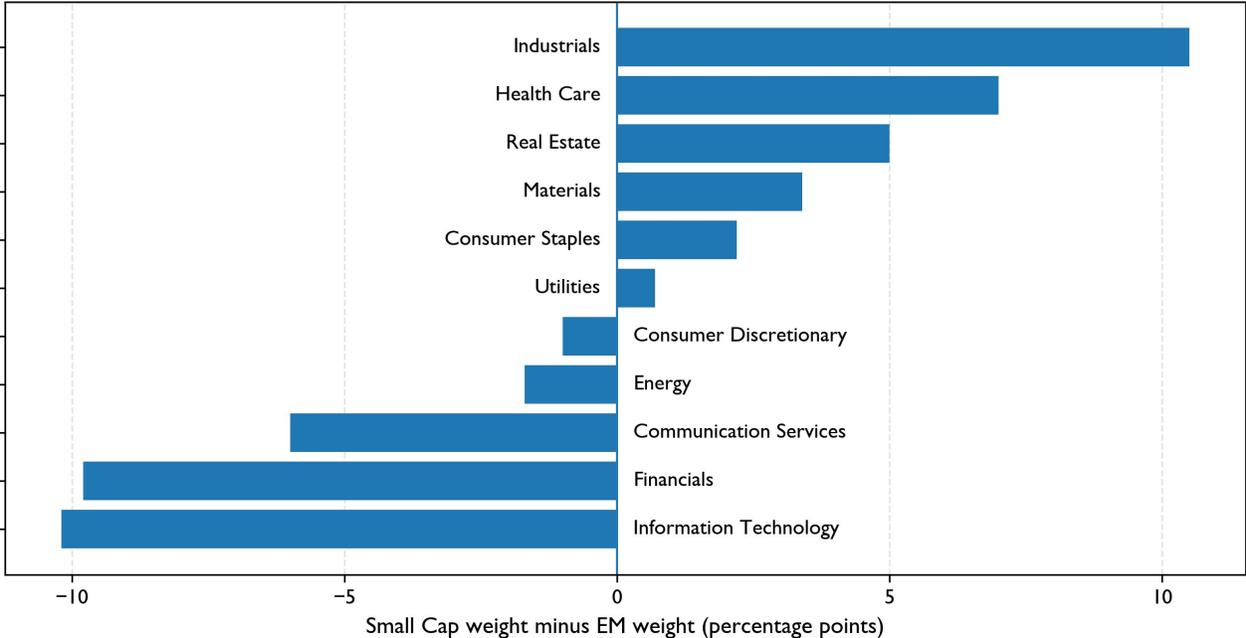


Exhibit 4. Sector weight differences (EM Small Cap minus EM). Source: MSCI factsheets (as of 31-Dec-2025).

Geographic Revenue Exposure: MSCI EM vs EM SC (12/31/2025)

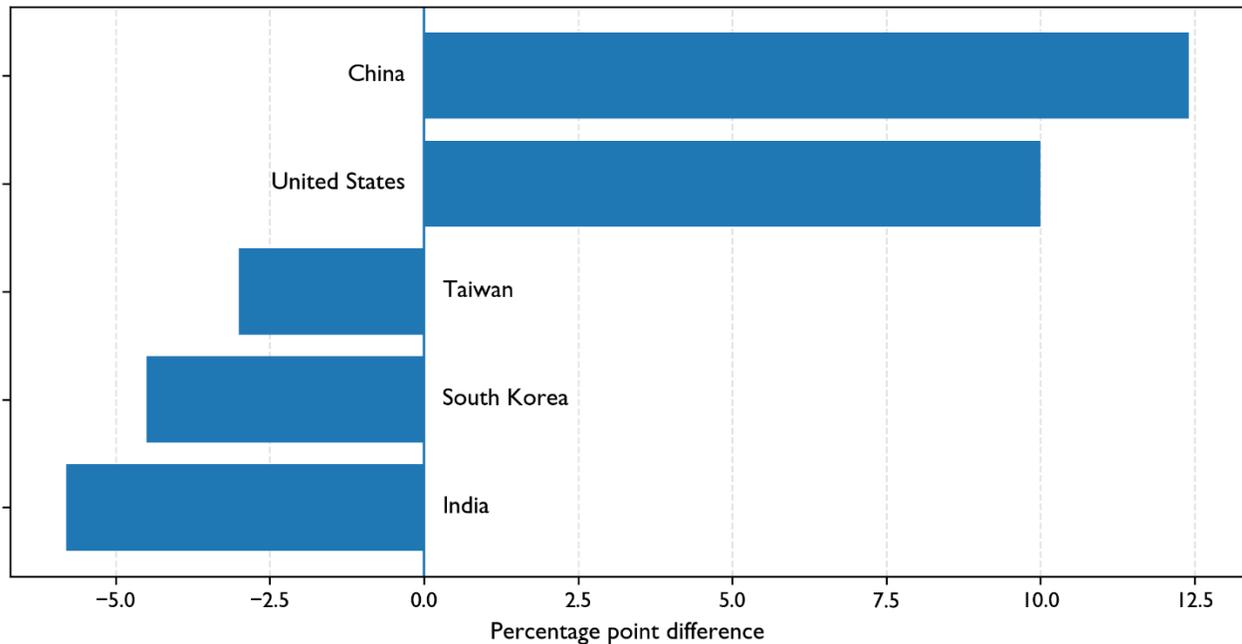
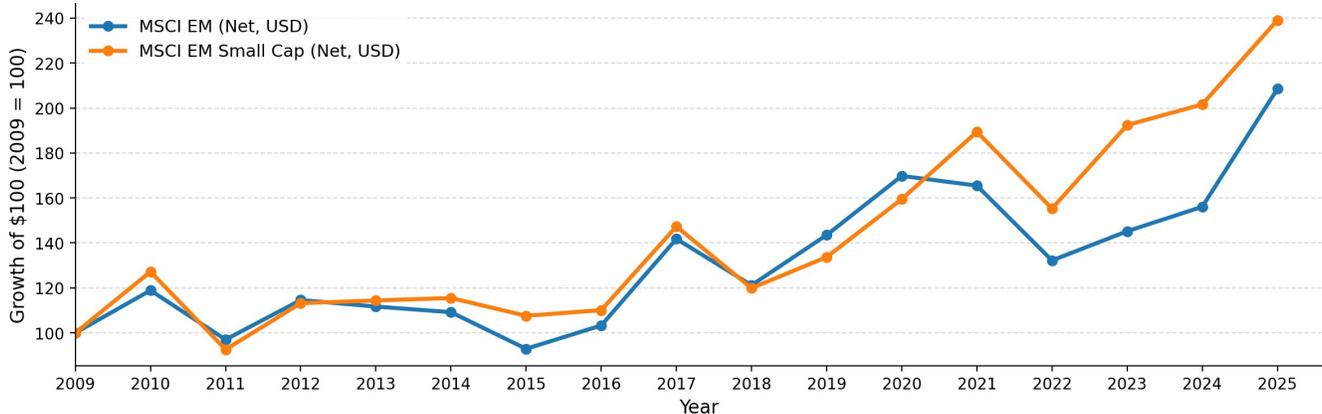


Exhibit 5. Geographic revenue weight differences (EM Small Cap minus EM). Source: FactSet (as of 31-Dec-2025).

5. Return and risk context

This paper does not rely on back test theatrics. Instead, we provide transparent benchmark context using MSCI net USD returns. Exhibit 6 shows cumulative growth of \$100 for MSCI EM vs MSCI EM Small Cap using annual net USD returns from 2012–2025. Risk and return statistics (3-, 5- and 10-year annualized) are sourced from MSCI factsheets.

Cumulative Growth of \$100 (Net Returns, USD | Rebased to 100 at 31-Dec-2009)



Source: MSCI | Net total return indices | USD.

Exhibit 6. Cumulative growth of \$100 (net returns, USD), MSCI EM vs MSCI EM Small Cap (2012–2025). Source: MSCI factsheets (as of 31-Dec-2025).

Metric (as of 31-Dec-2025)	MSCI EM	MSCI EM Small Cap
Annualized return 3Y	16.40%	15.47%
Annualized return 5Y	4.20%	8.43%
Annualized return 10Y	8.42%	8.31%
Annualized stdev 3Y	13.60%	11.64%
Annualized stdev 5Y	15.42%	13.63%
Annualized stdev 10Y	16.51%	16.99%

Exhibit 7. Risk/return statistics (annualized). Source: MSCI factsheets (as of 31-Dec-2025).

6. Market structure and depth in key Ems

Market structure—depth, liquidity, turnover, and institutional infrastructure—shapes implementation feasibility. The exchange-level data below contextualize why markets such as India, Taiwan, Korea and Saudi Arabia represent a large share of EM Small Cap.

Exchange	Listed companies (Dec 2025)	Domestic market cap (Dec 2025, USD bn)
NSE India	2994	6503
Korea Exchange	2639	1911
Taiwan Stock Exchange	1052	2850
Saudi Exchange	392	3168

Exhibit 8. Exchange summary (listed companies and domestic market cap). Source: WFE Focus – Market Statistics (Feb-2026 issue).

These exchange-level data also highlight an important point: the investable subset for institutional portfolios is smaller than the listed universe. Free float, ownership limits, governance screens, and liquidity constraints will determine the true implementable opportunity set.

7. Implementation framework for systematic EM Small Cap

EM Small Cap is not constrained by opportunity. It is constrained by implementation. This is not a weakness of the segment—it is the barrier to entry that preserves it.

Compared with EM large+mid, EM Small Cap portfolios typically face higher implementation costs due to lower liquidity and higher turnover. A credible institutional process must therefore be designed around implementation from day one: liquidity-aware portfolio construction, explicit turnover budgets, and transaction cost modeling calibrated by market and venue.

- **Liquidity & market impact:** EM small caps can exhibit lower liquidity, wider spreads and episodic liquidity gaps. Capacity should be managed with explicit liquidity budgets and conservative position limits.
- **Trading costs & turnover sensitivity:** Higher turnover increases sensitivity to costs (taxes, FX costs, spreads and impact). Research should use realistic, time-varying cost assumptions and include stressed conditions.
- **Capacity & scalability:** Capacity is constrained by the least liquid names and by concentration limits; AUM growth may require tighter investability screens or lower turnover.
- **Governance & model risk:** Systematic approaches require documented objectives, robust change-control, independent review, and monitoring for drift, crowding and unintended exposures.
- **Operational & regulatory risks:** EM markets can feature capital controls, foreign ownership limits, trading suspensions, and settlement frictions; workflows should be designed for country-specific rules.

In short: EM Small Cap works if—and only if—implementation discipline is institutional grade. For investors who meet that standard, the segment offers a structurally broader and less concentrated foundation for EM equity exposure.

Conclusion

Emerging Markets Small Cap comprises most of the EM universe by number of companies, yet remains underrepresented in capital-weighted benchmarks. This is not a curiosity; it is the central flaw in standard EM allocations.

The limiting factor in EM Small Cap is implementation, not opportunity. When managed with appropriate liquidity, cost and governance discipline, EM Small Cap should be viewed as a structurally superior opportunity set for stock selection and a compelling foundation for diversified EM equity exposure.

The natural question for institutional investors is not whether EM Small Cap is worth a small sleeve. It is why EM equity allocations remain so dominated by a structurally narrow benchmark in the first place.

ABOUT ATIVO

Ativo Capital Management, LLC is an investment advisor focused on delivering both top-quartile performance and exceptional service to clients. We follow a rules-based process utilizing quantitative methodologies to build long-only equity portfolios with high active share. We invest globally with an emphasis on international markets. Central to our approach is a proprietary multi-factor model that scores stocks based on our assessment of their intrinsic value and other internally developed factors, which have low correlation with one another over time.

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