MEKETA

Emerging Market Equities without China

WHITEPAPER
MAY 2024

CONTRIBUTORS
HAYLEY TRAN, CFA, CAIA
ALISON ADAMS, PHD
LAUREN GIORDANO
FRANK BENHAM, CFA, CAIA

Key takeaways

- **EM ex-China Consideration: Investors are re-evaluating their exposure to China due to geopolitical events, regulatory changes, and economic slowdown, leading to an interest in Emerging Market ("EM") equities strategies that exclude China.**

- **Meaningful Country Weight Changes: Removing China from the MSCI EM index (and opportunity set) significantly alters country weightings, with India becoming the largest country weight, followed by Taiwan and South Korea. The index remains concentrated in Asia. Sector and company concentration also shift when removing China from the index, with the top ten holdings becoming slightly more concentrated.**

- **Performance and Valuation: Historically, the EM ex-China index has outperformed the EM index, but this is largely driven by the underperformance of China over the past three years. Despite different compositions, both indices tend to exhibit similar valuations, though they have recently started to diverge.**

Why are we talking about EM ex-China?

Recent geopolitical events combined with regulatory and policy changes are causing investors to re-evaluate their exposure to China. Market-friendly policies and openness are waning, while Chinese Communist Party ideology and nationalism are growing. The odds of conflict between China and the US appear to be increasing, especially over Taiwan. Additionally, China's economy is slowing due to the challenges posed by the three D's of debt, demographics, and deflation.[1]

Equity market performance has reflected this pessimism about slowing growth and intrusive government policies in recent years. Emerging market equities have not kept pace with US or global equity returns over the past three years, and this was primarily due to China's recent underperformance. Chinese equities have produced negative returns in each of the last three calendar years (see Figure 1), declining 11.2% in 2023 when US equities were up 26%.[2]

[1] See Meketa's whitepaper on Understanding China, Part III.

[2] Source: MSCI and Russell for MSCI China and Russell 3000.

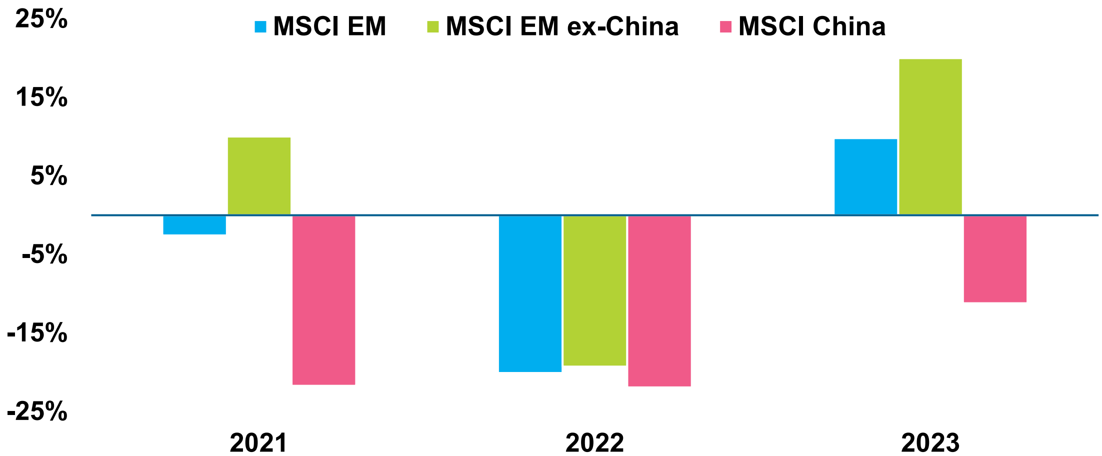

FIGURE 1
Calendar Year Returns

Source: Bloomberg, as of December 31, 2023. Indices used: MSCI EM Net, MSCI China Net, MSCI EM ex-China Net. Returns are in USD.

For many investors, the combination of poor performance with geopolitical concerns, regulatory constraints, and internal growth issues calls into question what an appropriate allocation is to China, and emerging markets more broadly. This question is underscored by China's outsized weight in the MSCI Emerging Markets ("EM") index historically. Over the past 17 years, China has represented the largest country weight in the MSCI EM index, peaking at 43% in October 2020 (see Figure 2). While it has since declined from its peak to 26.5% as of December 2023, it is still by far the largest country in the index. Because of its significant size, China often has a larger influence on EM performance than most other countries.

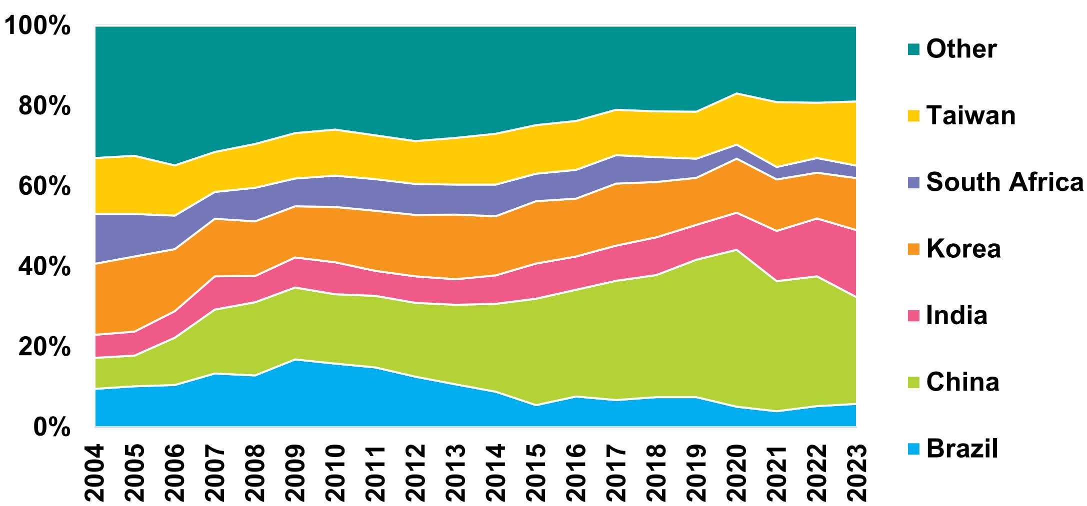

FIGURE 2
Largest Country Weights in the MSCI EM

Source: FactSet and MSCI, as of December 31, 2023. The countries included in the "Other" category are: Argentina, Chile, Colombia, Czech Republic, Egypt, Greece, Hungary, Indonesia, Israel, Jordan, Kuwait, Malaysia, Morocco, Mexico, Russia, Pakistan, Peru, Philippines, Poland, Qatar, Saudi Arabia, Thailand, Turkey, United Arab Emirates, and Venezuela.

Taken together, these factors have given rise to interest in splitting out China from emerging markets exposure, and the asset management industry has responded with an increasing number of options for doing so. An EM ex-China mandate would continue to provide exposure to the other major emerging markets, though it would have meaningful differences, which are discussed below. Combining an EM ex-China mandate with other mandates, such as a traditional emerging markets portfolio or China-only portfolio, may allow an investor to more precisely fine-tune their exposure to China.

Differences in equity index composition

Removing China from the broader emerging markets group would affect many characteristics, the most obvious of which would be the weighting of countries in the index. Figure 3 below shows the differences in the country weightings of MSCI's EM and EM ex-China indices as of March 2024. Notably, India takes China's position of largest country weight, with Taiwan very close behind, and Korea as the third largest country. This results in the MSCI EM ex-China index being only slightly less regionally concentrated in the Asia-Pacific region (71%) compared to the MSCI EM index (79%).[3]

[3] Source: MSCI, as of March 29, 2024. MSCI's Asia/Pacific ex-Japan countries include China, Taiwan, Korea, India, Thailand, Malaysia, Indonesia, Philippines.

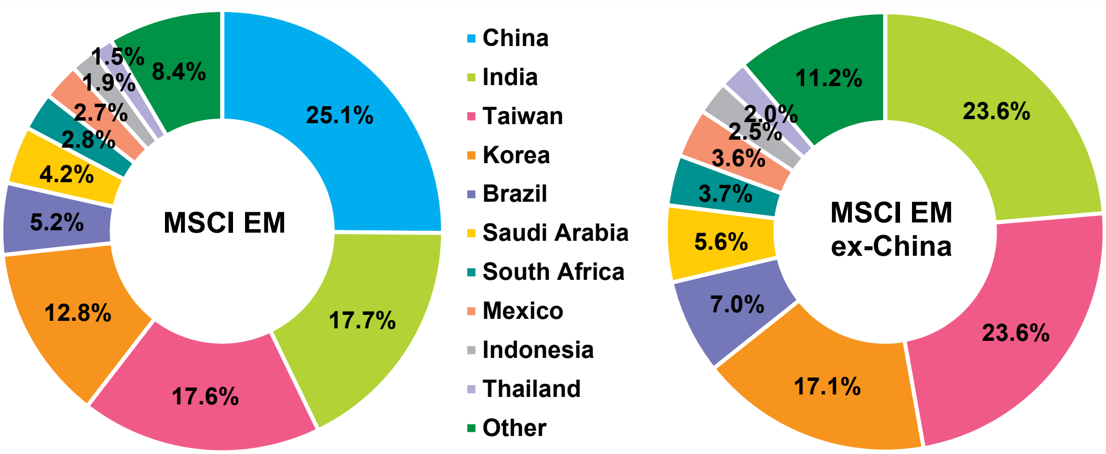

FIGURE 3
Country Breakdown

Source: MSCI, as of March 29, 2024. The countries included in the "Other" category are: Malaysia, United Arab Emirates, Poland, Qatar, Kuwait, Turkey, Philippines, Greece, Chile, Peru, Hungary, Czech Republic, Egypt, Colombia.

Another area that would be impacted by shifting from EM to EM ex-China is the sector compositions of the index. The biggest changes that would result from removing China are a 5.9% increase in the information technology ("IT") sector, a 5.8% decrease in the consumer discretionary sector, and a 4.1% decrease in the communication services sector (see Figure 4).

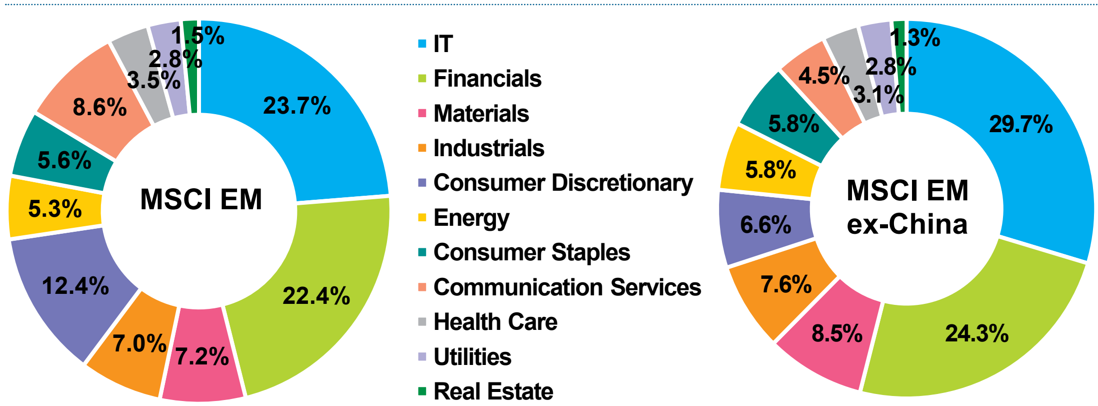

FIGURE 4
Sector Breakdown

Source: MSCI, as of March 29, 2024.

The ten largest companies would also change, and perhaps surprisingly, become increasingly concentrated (see Figure 5). This is because the two largest companies in both indices were the same as of March 2024: Taiwan Semiconductor and Samsung. The major Chinese companies that drop form the list are Tencent (the world's largest video game vendor), Alibaba (an ecommerce giant), PDD (owner of Pinduoduo and Temu), and Meituan (an online shopping platform).

MSCI EM			MSCI EM ex-China		
1.	TAIWAN SEMICONDUCTOR	8.3%	1.	TAIWAN SEMICONDUCTOR	11.1%
2.	SAMSUNG ELECTRONICS	4.1%	2.	SAMSUNG ELECTRONICS	5.4%
3.	TENCENT HOLDINGS LI	3.6%	3.	RELIANCE INDUSTRIES	2.0%
4.	ALIBABA GRP HLDG	2.0%	4.	SK HYNIX	1.4%
5.	RELIANCE INDUSTRIES	1.5%	5.	ICICI BANK	1.3%
6.	SK HYNIX	1.0%	6.	INFOSYS	1.1%
7.	PDD HOLDINGS	1.0%	7.	HON HAI PRECISION IND	1.1%
8.	ICICI BANK	0.9%	8.	MEDIATEK INC	1.1%
9.	MEITUAN	0.9%	9.	HDFC BANK	0.9%
10.	INFOSYS	0.8%	10.	AL RAJHI BANKING	0.8%
Top 10 Holdings Total Weight		**24.1%**	**Top 10 Holdings Total Weight**		**26.1%**

FIGURE 5
Top 10 Holdings

Source: MSCI, as of March 29, 2024.

Another variable to consider is the revenue sources for the various countries in these indices. China is a major source of global corporate revenues and profits. China accounts for the largest exposure of the MSCI emerging market index's revenue at ~48%, an amount that far exceeds its allocation based on market capitalization (see Figure 6).[4] When Chinese equities are excluded from the MSCI emerging market index, there are still revenues being derived from China. However, revenues from China represent only the sixth largest exposure, accounting for ~7% of EM ex-China revenues. Hence an EM ex-China mandate would be less heavily influenced by growth and other factors in China.

[4] Source: MSCI, as of March 29, 2024.

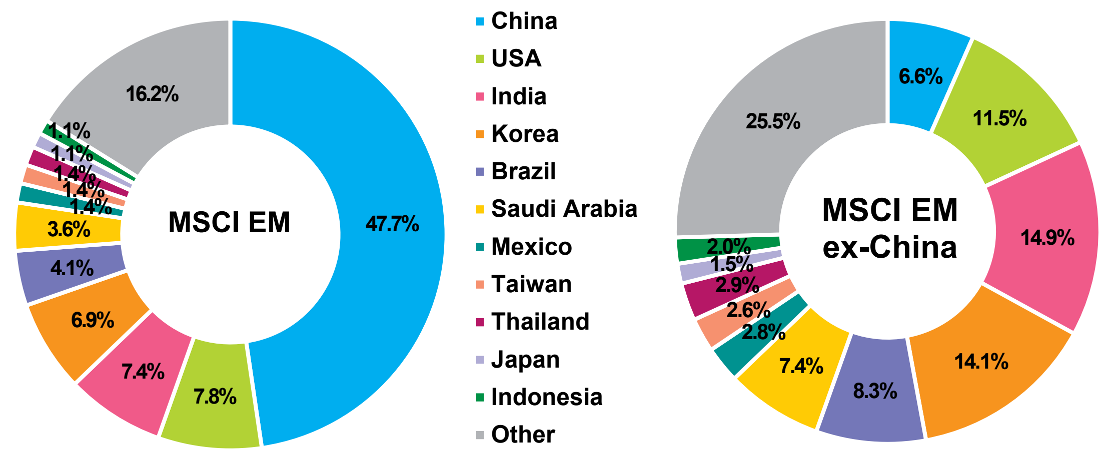

FIGURE 6
Revenue Exposure by Country

Source: MSCI, as of March 29, 2024.

Comparing historical performance

Over the past one, five, ten, and twenty years, the EM ex-China index has outperformed the EM index (see Figure 7). The largest differences between the two occurred in the shortest timeframes, while the smallest differences occurred in the longest timeframes. Hence, China has dragged down emerging market returns. Additionally, in all but the one-year category, EM ex-China has exhibited slightly higher volatility than EM.[5] However, the reader should be wary of endpoint bias when looking at these numbers, as all of the one-, five-, ten-, and twenty-year numbers favored the EM index until three years ago.[6]

[5] The lower level of volatility for the Emerging Markets index may be due to the fairly stable exchange rate maintained by the PBOC for the Renminbi versus the US Dollar.

[6] Source: Bloomberg and MSCI, as of December 31, 2020. Indices used: MSCI EM Net, MSCI EM ex-China Net. Returns are in USD.

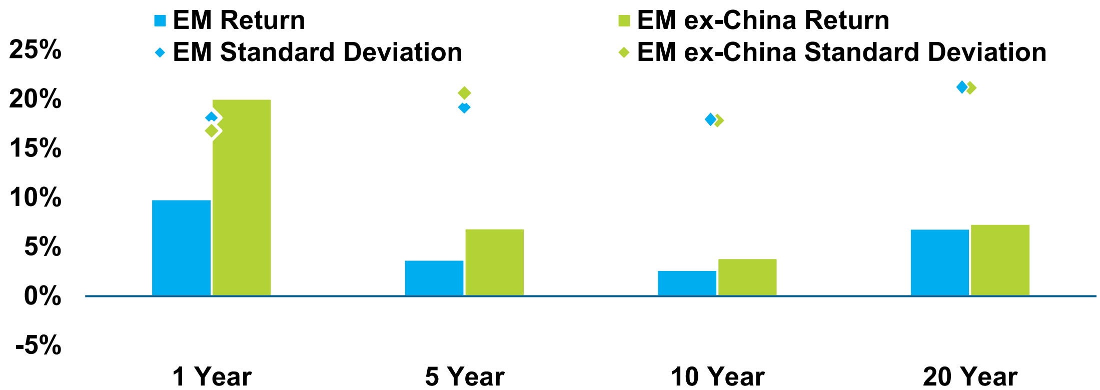

FIGURE 7
Historical Returns and Volatility (in USD)

Source: Bloomberg and MSCI, as of December 31, 2023. Indices used: MSCI EM Net, MSCI EM ex-China Net. Returns are in USD.

After almost two decades of very low tracking error (and near perfect correlations – see the Figure 11 in the appendix) between the MSCI EM index and the MSCI EM ex-China index, there has been an increase in recent years, especially since the outbreak of the COVID-19 pandemic. As shown in Figure 8, the average rolling one-year tracking error between 2019 and 2023 was more than three times the average from 2001 through 2018.

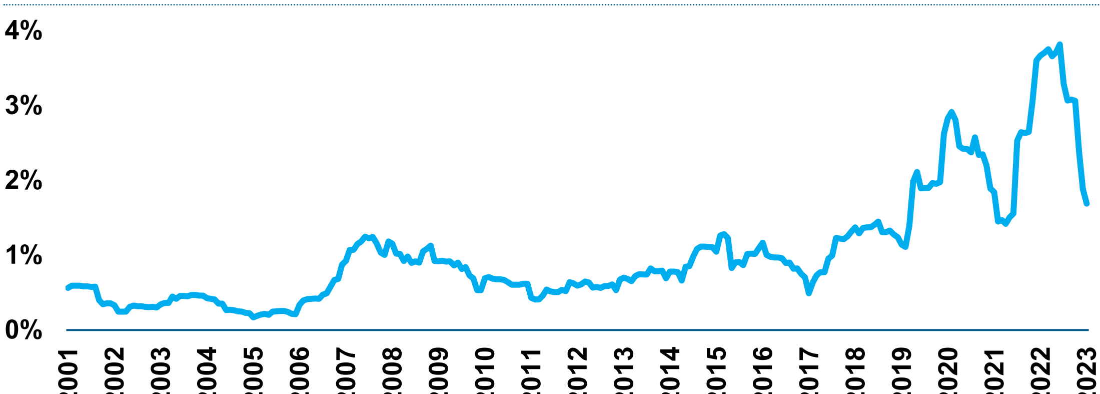

FIGURE 8
Rolling 1-Year Tracking Error for EM and EM ex-China

Source: Bloomberg and MSCI, as of December 31, 2023. Indices used: MSCI EM Net, MSCI EM ex-China Net. Returns are in USD.

Valuations

Despite divergence in their index composition and return streams, the EM and EM ex-China indices tend to exhibit very similar valuations. Since the Global Financial Crisis, pricing for the two indices has mostly moved in line with each other (see Figure 9). However, as of year-end 2023, the price-earnings ratio for EM ex-China was trading at its steepest (albeit modest) premium versus the China index since 2016.

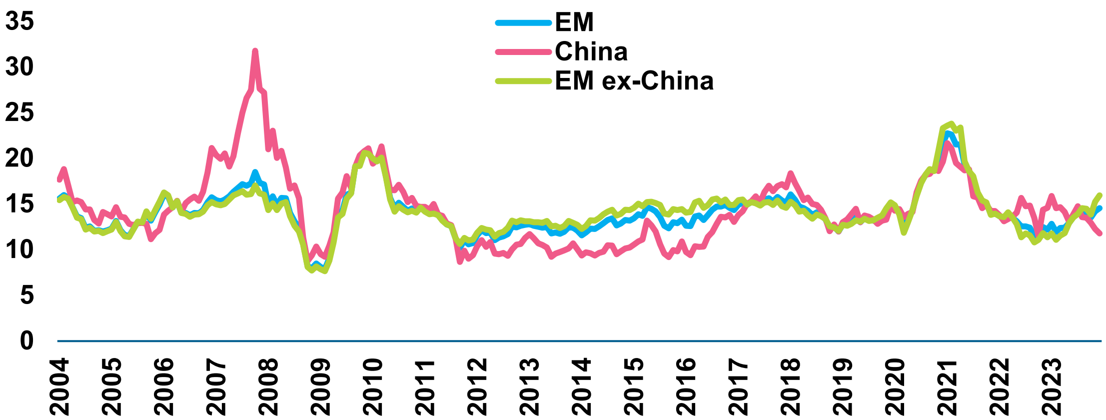

FIGURE 9
Historical Price-Earnings Ratio

Source: Bloomberg and MSCI, as of December 31, 2023. Indices used: MSCI EM, MSCI China, MSCI EM ex-China.

EM ex-China may impact equity and debt differently

This paper has focused solely on equities; however, there may also be differences between EM and EM ex-China exposure in China's on-shore and off-shore bond markets, and these differences may be unlike those for equities. Whereas equity market index weights are based on market capitalization, index weights in bond markets tend to be issue-weighted, and in some cases, may be capped. As a result, the various emerging market bond indices are more diversified and much less concentrated in China (e.g., JP Morgan caps country weights at 10% for its the most popular indices).[7] Hence, removing China from EM debt portfolios would likely have a much smaller impact than removing it from EM equity portfolios.

7 Source: JP Morgan.

The evolution of EM ex-China funds

The landscape of EM ex-China investment strategies has seen a significant evolution in recent years, with a notable increase in the number of strategies since the onset of the COVID-19 pandemic. While some managers started talking about EM ex-China mandates when MSCI announced the inclusion of A shares in their indices,[8] actual business decisions to launch EM ex-China strategies only really manifested around 2020 and 2021. Out of the 34 EM ex-China equity strategies listed in eVestment as of April 2024, over two-thirds of those strategies have been incepted post-pandemic (i.e., post 2020),[9] indicating a shift in market dynamics and investor interest during this period. However, a concern arises as only about half of these strategies have accumulated product assets (i.e., total AUM) above the $50 million mark. This points to potential issues with vehicle availability and client concentration risk, which are important factors for investors to consider when evaluating the viability and sustainability of these strategies.

8 The MSCI began including China A shares in the MSCI EM index in June 2018.

9 Source: eVestment. Represents EM ex-China equity funds in the database on April 2, 2024.

The landscape of emerging market equity investment has seen significant shifts over the years. While China standalone accounts were highly sought after in the past (often for their alpha potential), there's been a clear pivot towards EM ex-China. However, the sentiment among EM managers suggests a readiness to adapt to client interests, indicating a potential for market dynamics to swing back if client demand increases. This flexibility reflects the ever-evolving nature of global investment strategies and the importance of client-driven approaches in asset management.

Importance of manager expertise in other EM countries

Given the different and heightened representation of other countries in the EM ex-China index, it is important to evaluate managers' track record, skill, and expertise in emerging market countries outside of China. It is especially crucial for countries such as India, Taiwan, and Korea, who together comprise more than 60% of the MSCI EM ex-China index. Managers' performance history in these regions can provide insights into their ability to navigate the unique challenges and leverage the opportunities presented by these markets. Additionally, evaluating the portfolio construction and the value added through a live track record can offer a more dynamic view of managers' stock picking and allocation capabilities. This bottom-up approach to manager selection can be helpful in identifying managers with the skills and adaptability necessary for success in the diverse and rapidly evolving landscape of both EM and EM ex-China.

Historically, emerging markets have been an area where the average active manager has often added value (see Figure 10). While it is probably fair to assume that this will likely be the case for EM ex-China, anecdotally many managers sought their highest alpha from China. There is not yet sufficient data history for the asset class to determine to what extent this has been the case.

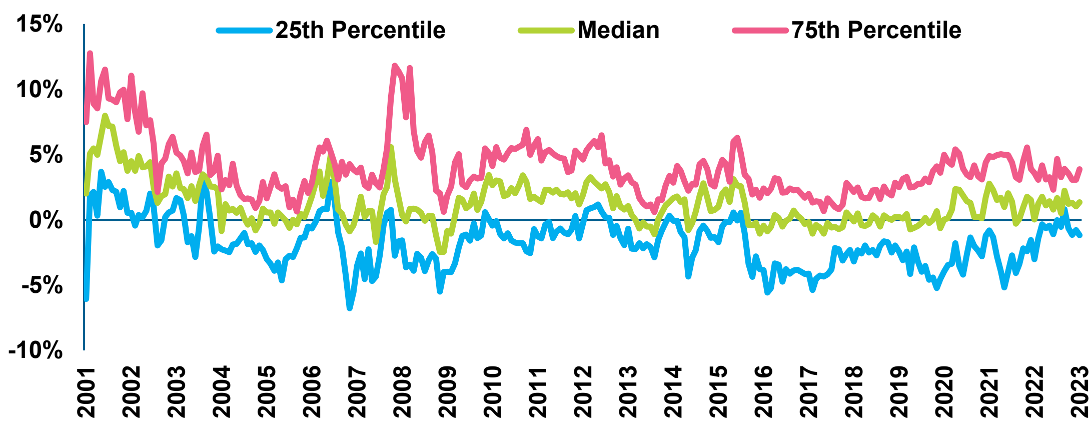

FIGURE 10
Rolling Outperformance of Active Emerging Market Equity Managers

Source: eVestment. Data as of December 31, 2023. Represents rolling 12-month geometric excess returns versus the MSCI EM index, gross of fees. See Meketa's "Manager Alpha" Whitepaper for more information on these calculations.

Fees

Given the operational complexities of setting up segregated accounts in all EM countries, pooled vehicles are often the preferred choice for any emerging markets mandate. The nascent stage of the EM ex-China space means there are fewer investment vehicles available. However, this presents an opportunity for investors willing to seed investments, potentially benefiting from preferential early investor terms and conditions. Given the early stage in the business development cycle of these strategies, EM ex-China fee proposals tend to be more attractive relative to the more established emerging market equity counterparts. Managers are often very willing to offer fee discounts to get live track records started with outside money and have particular strategy vehicles be up and running to attract further allocations.

Caveat emptor

The options discussed in this paper relate to reducing an investor's direct exposure to China, and ostensibly the associated China risk. However, even if an investor were to go to the extreme and completely divest from China, it would not wholly eliminate the risk that China poses. This is because China represents a systemic risk, given its place in global supply chains and revenues for many companies. Hence disentangling a portfolio entirely from this risk is not feasible for anyone invested in global capital markets. Investors for whom a primary concern is the level of systemic risk should consider building a defensive structure with risk mitigating strategies that hedge against systemic risks, including China.

Conclusion

Recent geopolitical events, regulatory changes, and policy shifts are leading investors to reevaluate their exposure to China. As market-friendly policies wane, Chinese Communist Party ideology and nationalism gain prominence. The risk of conflict between China and the US, especially over Taiwan, seems to be increasing. Headlines frequently highlight China's struggles with debt, demographics, and deflation. Given this pessimism, some investors are questioning what the appropriate allocation is to China and emerging markets as a whole, fueling interest in separating China from emerging markets exposure.

Removing China from the broader emerging markets group has several significant implications. India takes over as the largest country weight, closely followed by Taiwan and then South Korea. However, the EM ex-China index is only slightly less regionally concentrated in Asia than the broader EM index. The most significant sector differences are an increase in the information technology sector and a decrease in the consumer discretionary sector. The composition of the top ten largest companies would shift, becoming somewhat more concentrated. Importantly, the share of corporate revenues for which China accounts drops from 48% to 7% in the EM ex-China index.

The investment strategy landscape in emerging markets is characterized by a rapid proliferation of new strategies, a high level of responsiveness to client demands, and a cautious approach to financial commitments. Investors and fund managers alike must navigate these dynamics carefully, considering the implications of market volatility, regulatory environments, and the strategic allocation of assets. The interplay between client interests, market readiness, and financial prudence will continue to shape the evolution of investment strategies in the foreseeable future.

Appendix

Recent differences in return behavior

Returns and volatility between the EM and EM ex-China indices have exhibited an increased divergence from each other since 2020 (see Figures 11 and 12). Likewise, the correlation between the two has dropped from a near perfect correlation, though it still remains quite high (see Figure 13).

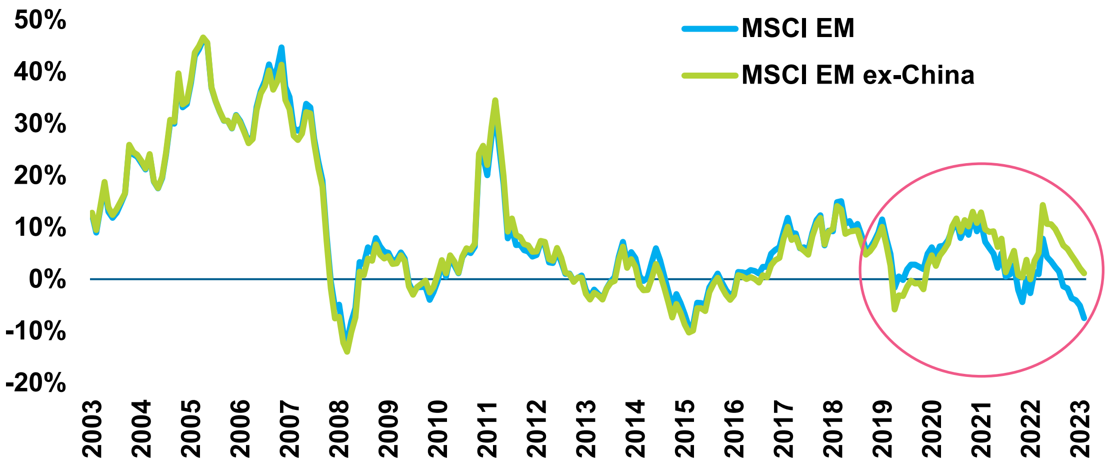

FIGURE 11
Rolling 3-Year Returns

Source: Bloomberg, as of December 31, 2023. Indices used: MSCI EM, MSCI EM ex-China.

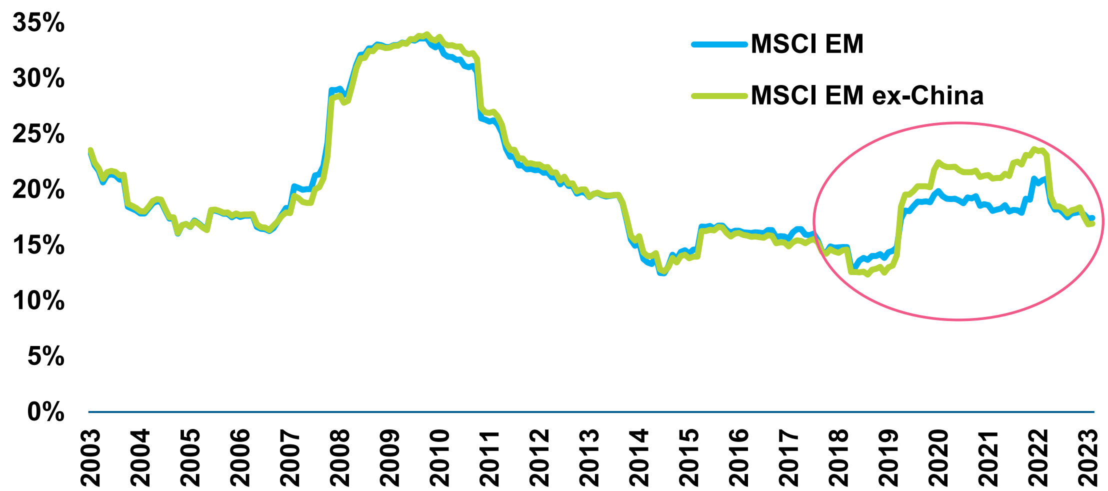

FIGURE 12
Rolling 3-Year Volatility

Source: Bloomberg, as of December 31, 2023. Indices used: MSCI EM, MSCI EM ex-China.

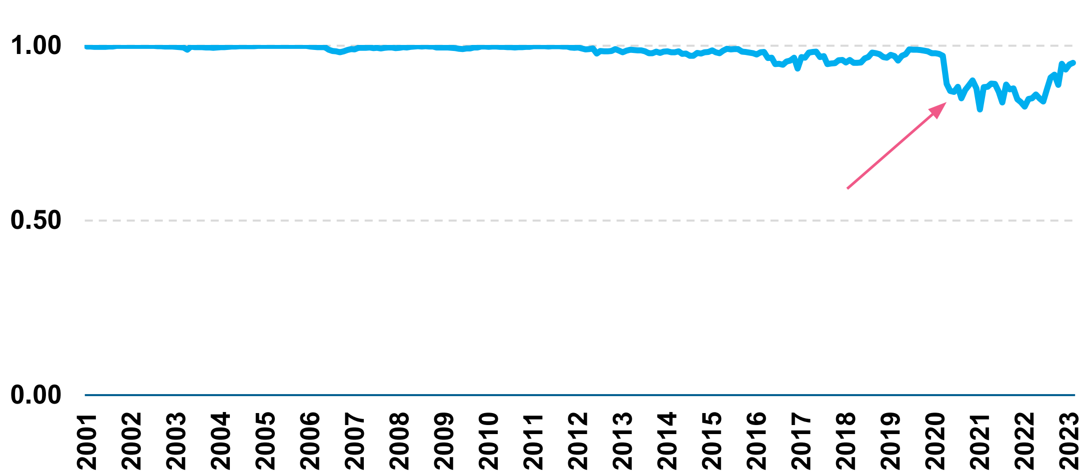

FIGURE 13
Rolling 1-Year Correlation between the MSCI EM Index and the MSCI EM ex-China Index

Source: Bloomberg, as of December 31, 2023. Indices used: MSCI EM, MSCI EM ex-China.

Country and sector allocations at peak China

China represented over 43% of the EM index at its peak in 2020, more than three times the weight of the next closest country (see Figure 14). As a result, the EM index was heavily concentrated in consumer discretionary and communication services companies (see Figure 15).

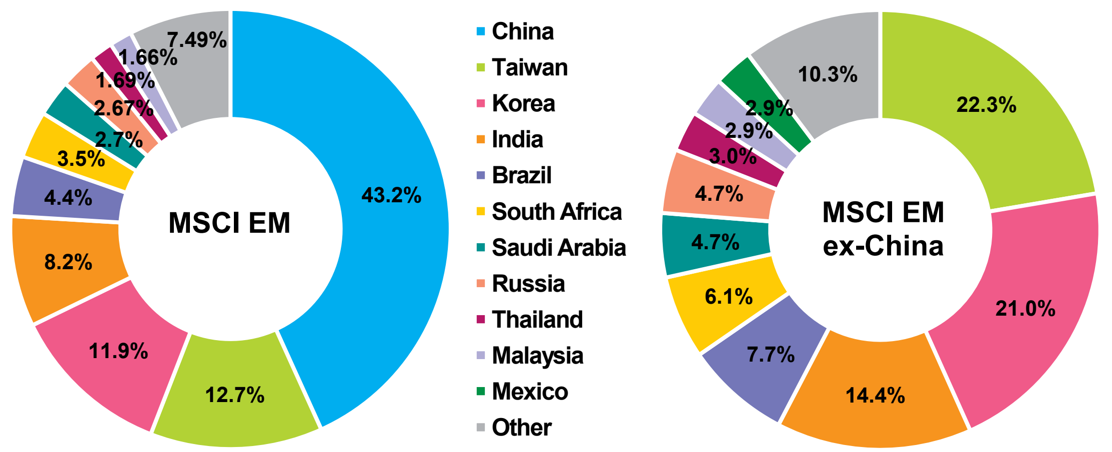

FIGURE 14
Country Breakdown at Height of China's Country Representation at the Peak

Source: FactSet and MSCI, as of October 31, 2020. Countries included in "other" are: Indonesia, Philippines, Qatar, Poland, United Arab Emirates, Chile, Turkey, Peru, Hungary, Colombia, Argentina, Greece, Egypt, Czech Republic, Pakistan, and Kuwait.

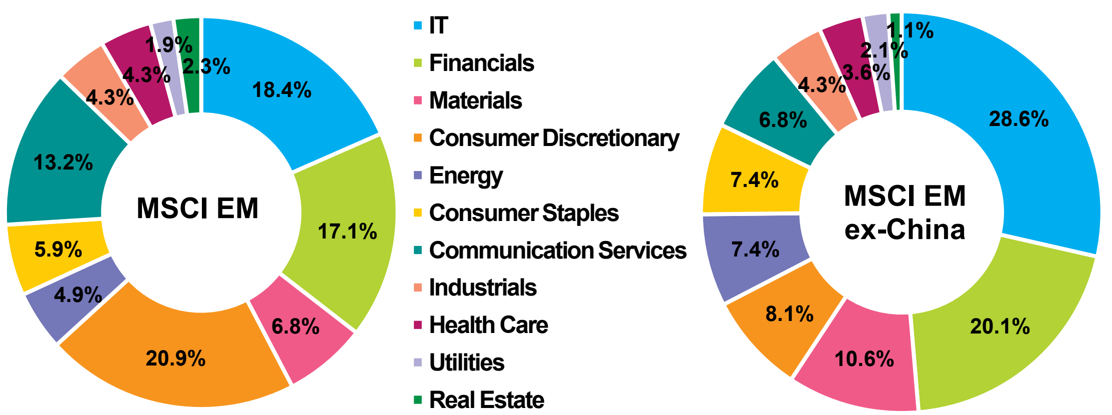

FIGURE 15
Breakdown at Height of China's Country Representation at the Peak

Source: FactSet and MSCI, as of October 31, 2020.

China exposure in EM debt

The most commonly used local currency EM debt benchmarks from JP Morgan all cap individual country exposure at 10%. For example, the JP Morgan Government Bond Index-Emerging Markets Global Diversified Index ("GBI-EM GD")[10] has a more diversified and evenly distributed among Latin American and Asian countries, six of which – including China – each constitute roughly 10% of the benchmark (see Figure 16). This is quite different than the regional allocations for EM equities.

On the hard currency EM debt side, the most commonly used JP Morgan indices are even more diversified by country than the local currency indices. The largest country in the JPM EMBI Global Diversified index is only ~5%, with China comprising 4% of the index (see Figure 16).

[10] The JP Morgan GBI-EM GD primarily measures local currency denominated, fixed rate, government debt issued in emerging markets.

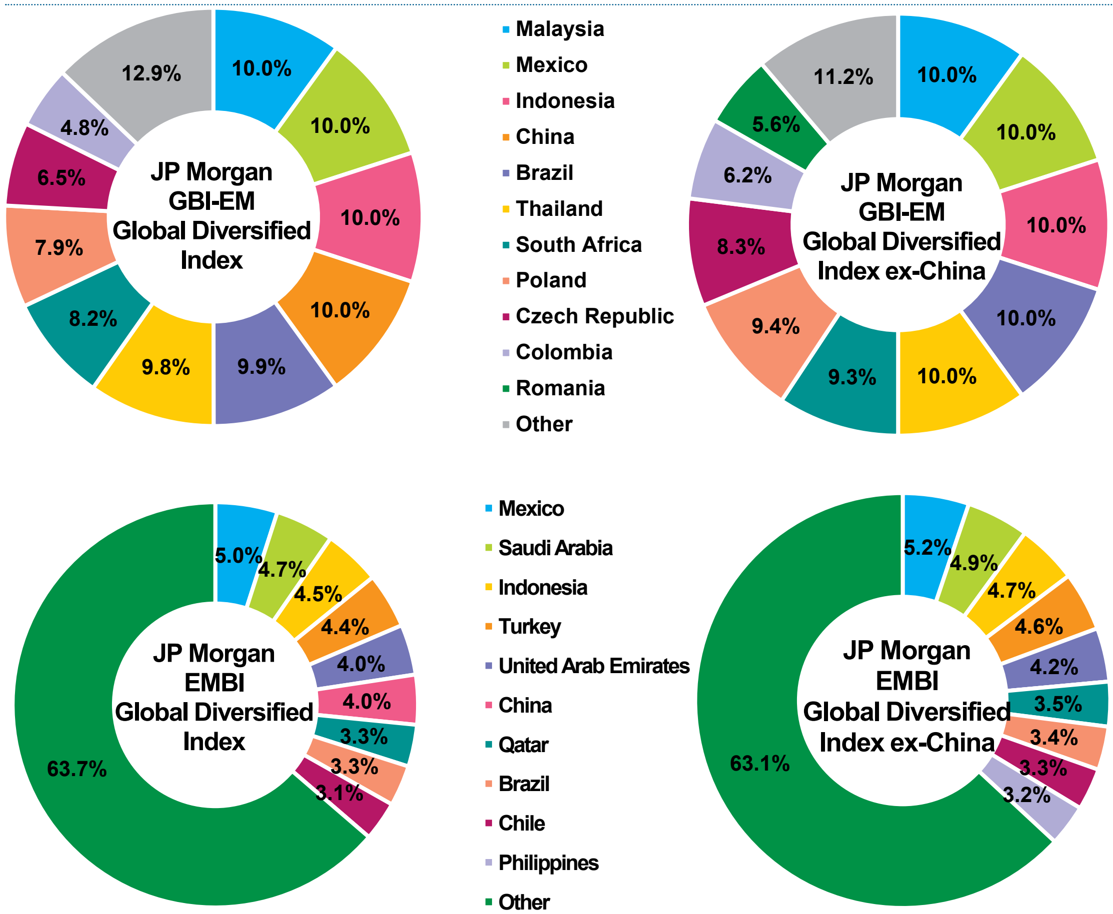

FIGURE 16

Market Value by Country for Emerging Market Debt

Source: JP Morgan, as of March 31, 2024. Given the index's methodology, the max weight of any country in the index cannot be greater than 10%.

Disclaimers

This document is for general information and educational purposes only, and must not be considered investment advice or a recommendation that the reader is to engage in, or refrain from taking, a particular investment-related course of action. Any such advice or recommendation must be tailored to your situation and objectives. You should consult all available information, investment, legal, tax and accounting professionals, before making or executing any investment strategy. You must exercise your own independent judgment when making any investment decision.

All information contained in this document is provided “as is,” without any representations or warranties of any kind. We disclaim all express and implied warranties including those with respect to accuracy, completeness, timeliness, or fitness for a particular purpose. We assume no responsibility for any losses, whether direct, indirect, special or consequential, which arise out of the use of this presentation.

All investments involve risk. There can be no guarantee that the strategies, tactics, and methods discussed in this document will be successful.

Data contained in this document may be obtained from a variety of sources and may be subject to change. We disclaim any and all liability for such data, including without limitation, any express or implied representations or warranties for information or errors contained in, or omissions from, the information. We shall not be liable for any loss or liability suffered by you resulting from the provision to you of such data or your use or reliance in any way thereon.

Nothing in this document should be interpreted to state or imply that past results are an indication of future performance. Investing involves substantial risk. It is highly unlikely that the past will repeat itself. Selecting an advisor, fund, or strategy based solely on past returns is a poor investment strategy. Past performance does not guarantee future results.