Why you need an Emerging Market ex China strategy

Global Emerging Market Equity Team
Eastspring Investments

20 years ago, Emerging Markets (EMs) were more diversified than they are today, with a few dominant players such as Korea, Taiwan, South Africa and a bias towards commodity sectors. Since then, there have been many shifts and rotations, leading to China's current dominance of the MSCI EM Index. Even though these once-dominant constituents have shrunk in the index weight, we still see a growing number of candidates outside of China that offer investment opportunities.

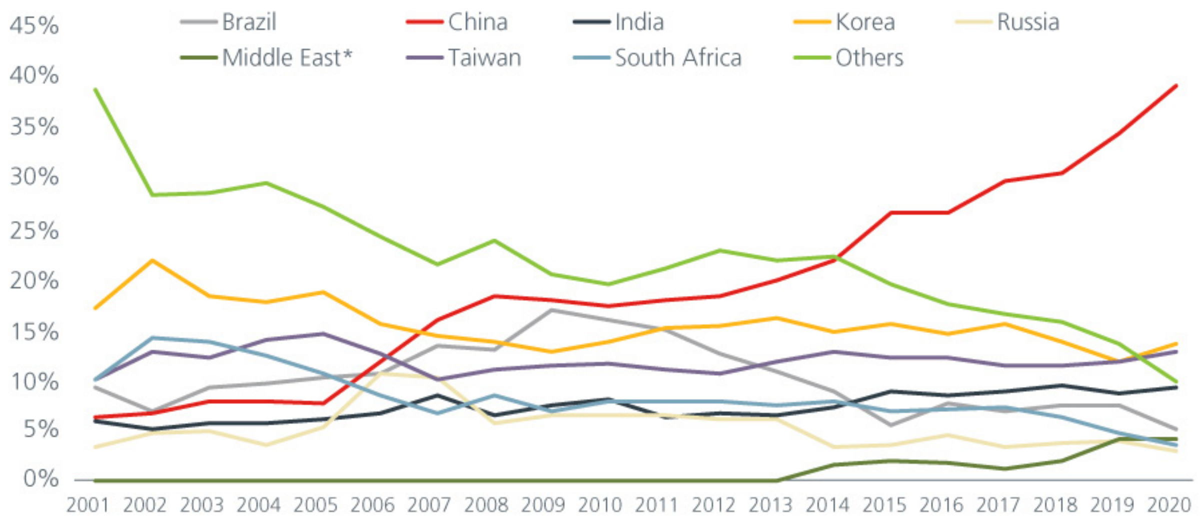
Over the last 15 years we have seen the Emerging Market equity landscape change materially both in size and shape. This is not surprising when we think about the strong economic growth emerging markets have seen over this period as well as the range of outcomes for various sectors and markets. The market capitalisation of companies across EMs have also been morphing, changing, rotating, but with one consistent theme, that of the growing dominance of Chinese equities. China represented just 5% of the MSCI EM Index 20 years ago. Today it exceeds 40% and forecast to rise to over 50% in the next few years. While China grows as a key investment destination, there remains a huge number of idiosyncratic opportunities across EMs ex China which justify a separate market allocation.

CHINA'S INDEX DOMINANCE ECLIPSES OTHER OPPORTUNITIES

China's rising share of the index has come at the expense of those dominant markets of old. See Fig 1. South Korea, for example, was the largest emerging market in 2002, briefly accounting for 20% of the index. Today, its share is nearer to just 10%. Likewise, South Africa almost reached 15% of the index in 2002 but today accounts for less than 5%.

The member countries of the MSCI EM Index have also changed over the years, with the impact of some recent additions being somewhat lost in the growing dominance of the larger countries. Saudi Arabia, the United Arab Emirates, Qatar and Kuwait are amongst the relatively recent additions, adding over 60 new stocks and USD300bn of market capitalisation to the MSCI EM Index, yet this is lost with the USD1,600bn increase in the market capitalisation of China over the last 10 years. There are many potential investment opportunities from smaller EM countries that should not be forgotten as they often fly under the radar.

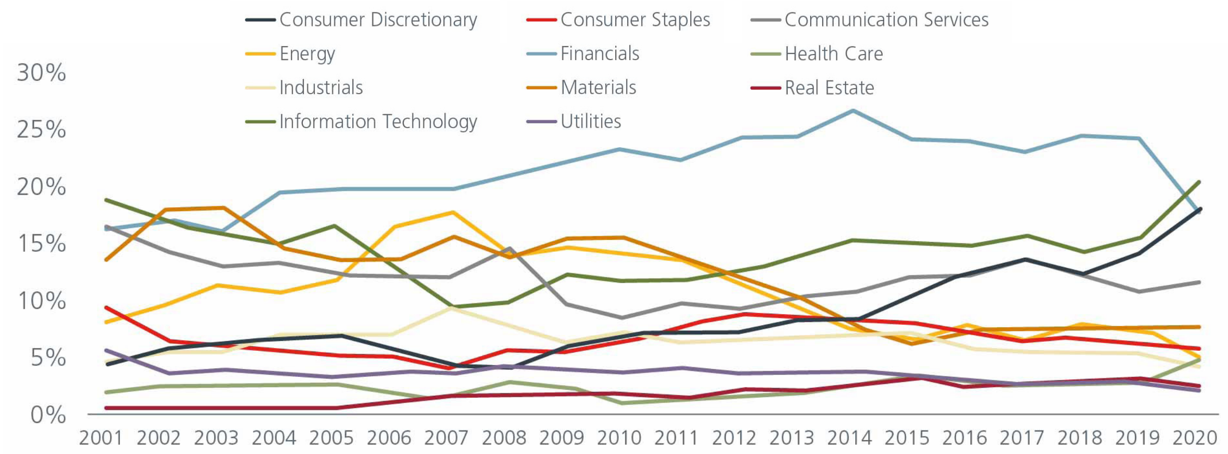
Fig 1: MSCI EM Index country weights over time



Source: Eastspring Investments and MSCI as at 31 December 2020. *Middle East includes weight of UAE, Qatar, Kuwait and Saudi Arabia.

The sector composition of the index has also changed substantially over the years and whilst MSCI's inclusion criteria may cloud the picture, some long-term trends remain clear. See Fig 2. The Financial sector was consistently the largest until its aggressive correction in 2020. While last year the Consumer Discretionary sector accelerated thanks to the growth of a few mega-cap Chinese e-commerce stocks overtaking the financial sector by year end. The Information Technology (IT) sector has continued to grow and has recently taken the crown of the largest sector in emerging markets. The true size of "tech" today is arguably understated as changes in the definitions of index constituents have moved several well-known "tech" giants to other sectors. Alibaba's transition, for example, from the IT sector to the Consumer Discretionary sector has boosted the latter's weight to become the largest sector at over 20% of the index.

Fig 2: MSCI EM Index sector weights over time



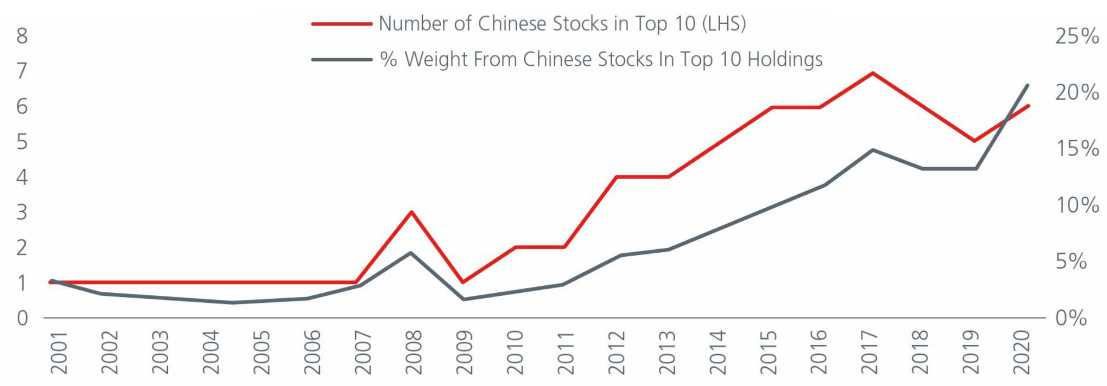
Source: Eastspring Investments and MSCI as at 31 December 2020.

Over time, the largest stocks in the MSCI EM Index have also become more and more Chinese centric. See Fig 3. In 2001, there was just one Chinese stock in the top 10 stocks accounting for about 3% of the index. Today there are 6 stocks in the top 10 stocks, alone counting for 21% of the index.

CHINA'S GROWING SHARE DIMINISHES CORRELATION BENEFITS

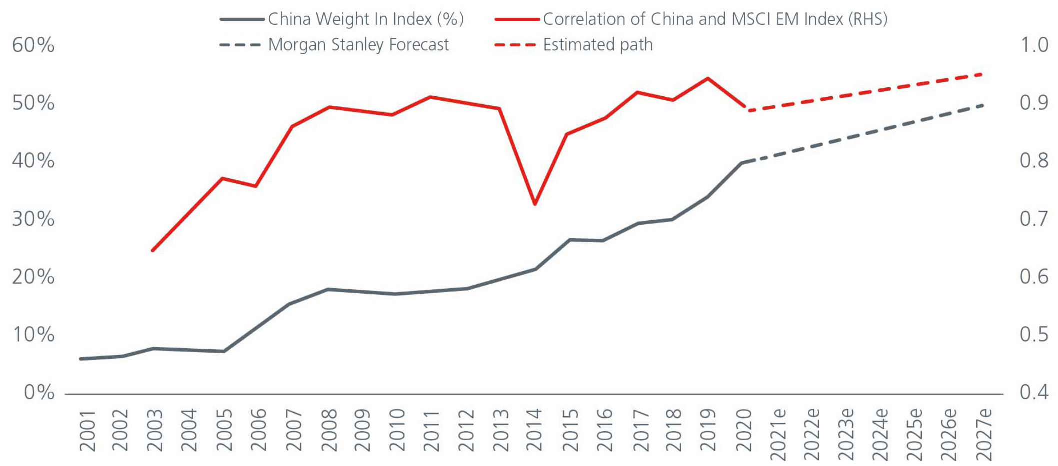
While the future for EMs is inherently uncertain, we can rely on China index inclusion data from MSCI that projects the continued growing influence of China over the coming years. This is based on forecasted inclusion factors and not taking into account the potential growth premium we have seen historically for Chinese equity markets. In this case China's share of the MSCI EM Index is set to continue growing from today at 40% to over 50% by 2027. Why should we care about this? When clients think about allocations to EMs, they often do so to capture the diverse return opportunities over time, of which China has become the primary driver. However, as China has become more dominant in the index, so has the correlation of its own return profile with the global MSCI EM Index. See Fig 4. This is directly related to its size in the index but also highlights the impact on portfolio diversification that one dominant country has. To better manage diversification and allocate to less correlated assets clients may be better placed

Fig 3: China stocks' growing dominance in MSCI EM Index



Source: Eastspring Investments and MSCI as at 31 December 2020.

Fig 4: Increasing size and correlation of China in MSCI EM Index



Source: Eastspring Investments, Morgan Stanley, forecasts and estimates subject to change without notice and no guarantee for future performance.

to instead manage a discrete allocation to China and a separate allocation to EM ex China.

With regards to China specifically, there is growing political pressure from the West, dominated by the US, and we are seeing more and more sanctions imposed on companies there. This can distort allocations and investment mandates covering Chinese assets become more complicated. This may lead to pressure to segregate the Chinese equity exposure so these issues can be managed separately.

CHINA'S MARKET CAP JUSTIFIES A DISCRETE ALLOCATION

As a single country becomes dominant in an equity Index, investors tend to move to discrete allocations to that country. This creates demand for a new regional construct to ensure the investment opportunity set does not shrink. Where single countries dominate, such as US in the MSCI World Index, investors have made discrete allocations to that market which has supported the growing popularity of the World ex US Index and EAFE (Europe, Australasia and Far East) indices. We believe that China and the MSCI EM Index is set to follow a similar path and the following high-level metrics support this argument.

Against other well-established markets such as those represented by MSCI World Index (developed markets) and MSCI Europe Index, the MSCI EM Index has a broad universe of stocks, but has become very concentrated when we look at the top 10 stocks' percentage. While the largest 5 countries in these regional MSCI indices are comparable in size, China stands out alongside the US in the MSCI World Index (as their largest country exposure). See Fig 5. Furthermore, we note that China's market capitalisation is now well above levels of Japan 10 years ago, a market which has long had discrete allocations. See Fig 6.

AN EM EX CHINA STRATEGY OFFERS MORE DIVERSIFIED OPPORTUNITIES

There are some notable differences when we compare the various metrics between MSCI EM Index and MSCI EM ex China Index[1].

First, the stock count halves from 1,397 to 683 in EM ex China which reflects the long tail of the smaller companies in the Chinese A share market, but still offers a large universe for a bottom-up stock picker.

Second, at a sector level there is more concentration in EM ex China in the IT sector, with tech hardware names like TSMC, Samsung and Infosys driving much of this exposure. There is less exposure from Consumer Discretionary as Alibaba drops out of the Index and Communication Services as China's Tencent leaves.

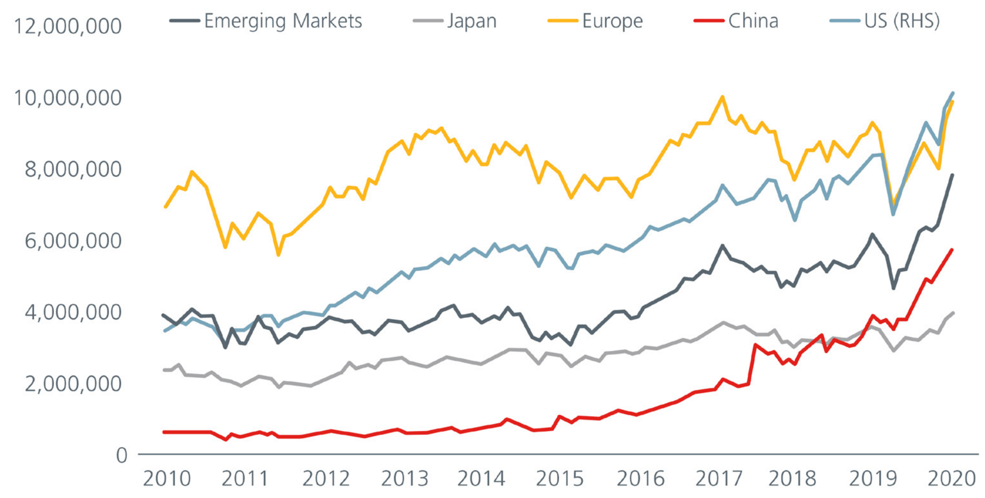
Fig 5: Profile of the MSCI Indices

MSCI Indices	Constituents		Country Weights (%) - 5 largest countries					
	Number	Top 10 total (%)	Largest	2 largest	3 largest	4 largest	5 largest	Total
EM	1,397	28.0	39.1	13.5	12.8	9.3	5.1	79.8
Europe	434	18.6	22.5	17.8	15.5	15.1	6.2	77.1
World	1,585	16.9	66.1	7.8	4.3	3.4	3.1	84.7

Source: Eastspring Investments and MSCI as at 31 December 2020.

Source: [1]As at 30 Oct 2020

Fig 6: Capitalisation of the MSCI Indices (USD mil)



Source: Eastspring Investments, Bloomberg, Refinitiv Datastream as at 31 December 2020.

At a regional level we can see that unsurprisingly EM Asia drops significantly from 80.0% to 67.1% and while it still dominates in EM ex China there is a much more exposure to the LATAM and EMEA regions as their weight increases proportionately.

Overall, we see a more diversified group of stocks from a country, sector and stock basis with a substantial number of stocks to pick from.
We believe that this universe offers a disciplined value manager many opportunities to capture alpha from over time.

A VALUE-DRIVEN EM EX CHINA STRATEGY OUTPERFORMS IN THE LONG TERM

EM ex China has a diversified country, sector and stock split with fewer dominant players and many stock specific opportunities. This market structure aligns with our experience and our disciplined bottom up value-driven approach to capture investment opportunities.

Our Value philosophy is founded on the observation that human emotions and behavioural biases

Fig 7: Profile of the MSCI EM and MSCI EM ex China Indices

	Constituents			Regional Split (%)		
	Number	Top 10 total (%)	Top 5 country weights (%)	EM Asia	EMEA	Latam
MSCI EM	1,397	28.0	79.8	80.0	12.1	7.9
MSCI EM ex China	683	27.6	72.3	67.1	19.9	13.0

	Sector Weights (%)										
	IT	Consumer Disc	Financials	Comm Svces	Materials	Consumer Staples	Energy	Healthcare	Industrials	Real Estate	Utilities
MSCI EM	20.5	18.3	18.0	11.6	7.6	5.9	5.0	4.7	4.3	2.1	2.0
MSCI EM ex China	29.3	7.5	20.8	6.2	11.1	6.8	7.2	3.6	4.2	1.1	2.1

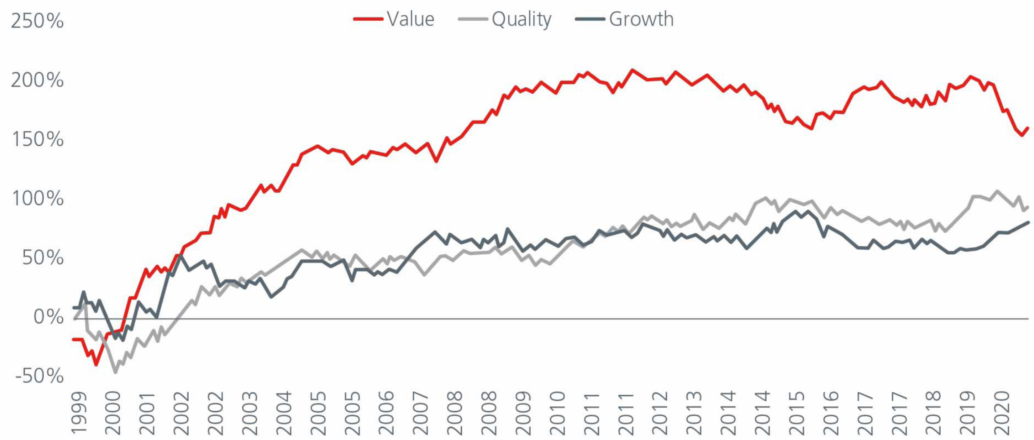
Source: Eastspring Investments and MSCI as at 31 December 2020.

distort investment decision making, leading to investors overpaying for the promise of growth and perception of quality, focusing on the recent past and extrapolating into the near future. This creates mispricing across equity markets which we seek to exploit in a systematic way. Supporting our philosophy, when we look at equity market history, we can see that Value has outperformed Quality and Growth in EM ex China over the long term. See Fig 8.

While we see absolute valuation support for investing in this region today and many clear valuation opportunities over the long term, we are also seeing a unique opportunity today for EMs ex China. Post GFC, investors have avoided value names and instead preferred high-quality stocks and those with short-term earnings potential. This trend was exacerbated in 2020 due to COVID 19 and has created an extreme valuation dispersion within EM ex China between cheap stocks and expensive stocks. See Fig 9. This represents a unique opportunity for disciplined value investors to capture future outperformance.

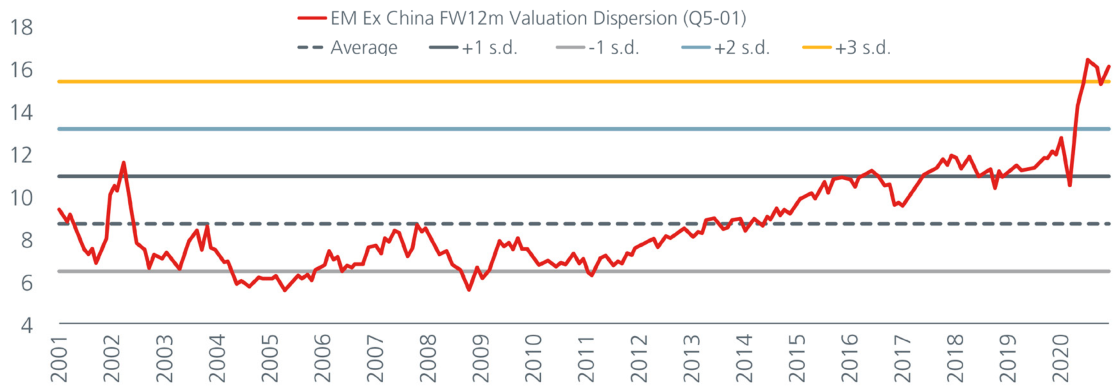
In short, today we see many valuation opportunities across emerging markets, but more exciting is the extreme valuation dispersion we see between cheap and expensive EM ex China stocks which offers us many stock picking opportunities to outperform from here.

Fig 8: Style performance of the EM ex China strategy



Source: Eastspring Investments as at 31 December 2020.

Fig 9: EM ex China valuation dispersion at extremes



Source: Eastspring Investments as at 31 December 2020.

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