MARCH 2021

Evolving Country Concentration in Emerging Market Indices

Opportunities for Investors

In this Insight we address the changes and concentration of the MSCI Emerging Market Index over the last decade and the implication for investors of the growing size of China within these Indices.

The last 10 years have seen some significant changes to the emerging market investment landscape, both in terms of the shifting geographical bias and the types of investors that make up the shareholder bases of many emerging market companies.

The first paradigm shift which has affected the equity universe globally has been the move by international investors into passively manage funds. In the year 2000, passive holdings accounted for just 1% of the foreign money in emerging markets (this is for publicly available funds). This rose to around 10% by 2006 and almost 37% today, worth over USD 800bn.[1] The size and weight of passive money is crucial to the evolution of emerging markets Indices as this money is obliged to automatically follow any changes or reorganisations.

Secondly, the shape of the emerging market Indices has altered dramatically over the last few years in terms of regional weightings and there have been some very large changes in country weights.

1 Rencap, as at 29 Jan 2021

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These changes have been driven by both increases in free float factors or Index inclusions for some countries, and by relative performance of economies and stock markets.

For example, in 2019 MSCI increased the inclusion ratio of China A shares from 5% to 20% in the MSCI Emerging Markets Index. These changes over time have resulted in the correlation of China with the MSCI Emerging Markets Index going from around 0.65 in 2003 to 0.9 today, as at 24 February 2021, and likely to trend further towards 1 as the China weight continues to increase.

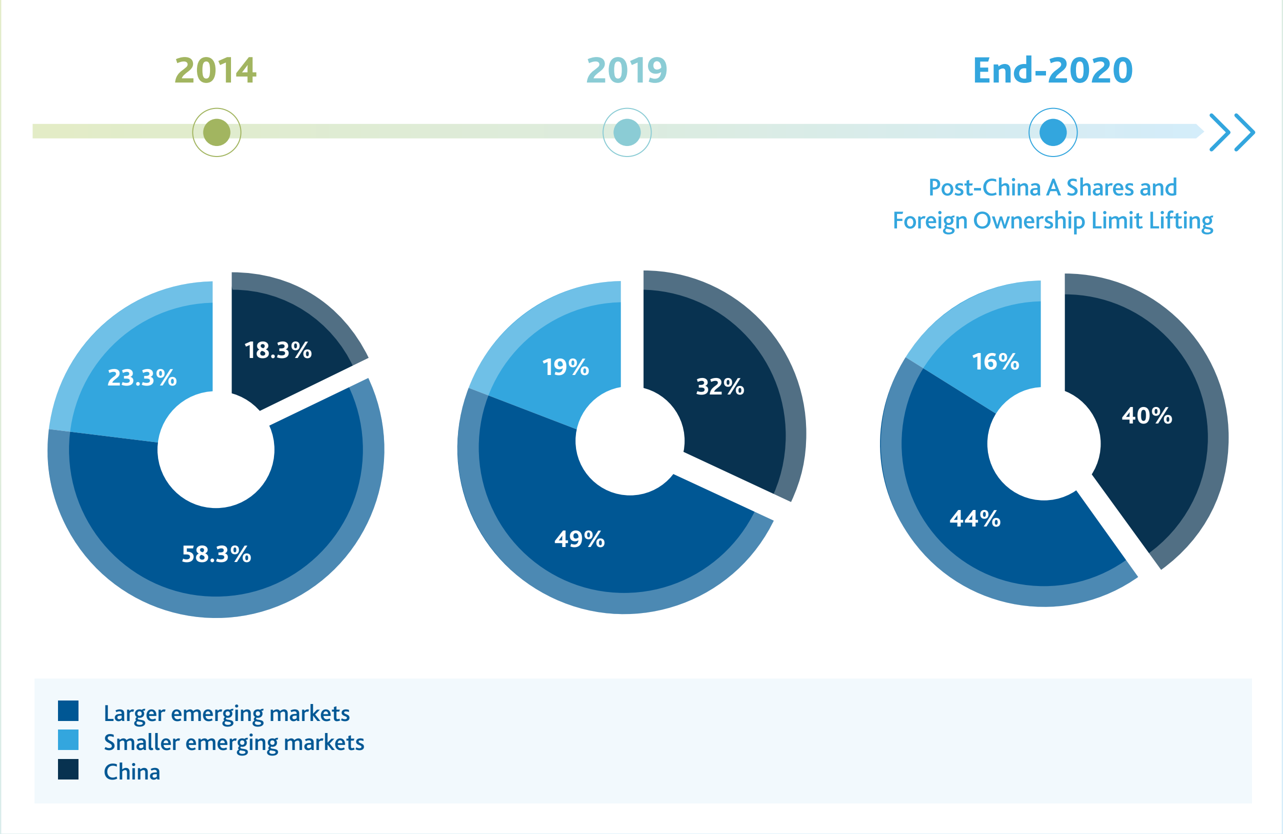
Finally, and a more recent phenomenon driven by COVID-19 and a lower global interest rate environment, local investors have become much more active in their own domestic equity markets thus somewhat changing the dynamic shorter-term drivers of many emerging equity markets.

This shifting landscape has raised two very important questions for emerging market investors. Firstly, investors globally are increasingly re-evaluating the appropriate allocation framework of their equity portfolios.

China's growing economic strength and improving market accessibility may transform the characteristics of the emerging market asset class further and thus its role in global portfolios.

In particular, the growing size of China within emerging market portfolios raises a question for global investors whether to establish a dedicated China allocation or continue to incorporate China as a component of their emerging market allocation.

The evolving emerging market universe – the growing dominance of China



Source: Fiera Capital, MSCI Database, 31 Dec 2020

China A shares are currently, as at 24 Feb 2021, included at only 20% of their market capitalisation weight. If this were to increase to their full free float market capitalisation weight, China's weight would rise to 49.9% of the MSCI Emerging Markets Index.

The Chinese economy continues to recover strongly from the COVID-19 shock and is now close to pre-pandemic output levels. This is quite a significant feat, given the depth of the downturn in the first quarter, and the fact that the International Monetary Fund expects other large countries to not return to pre-COVID levels until 2022.[2]

China is likely to overtake the US to become the world's largest economy by 2028, five years earlier than previously forecast, a report from CEBR states. For some time, an overarching theme of global economics has been the economic and soft power struggle between the United States and China, continues the report. "The COVID-19 pandemic and corresponding economic fallout have certainly tipped this rivalry in China's favour. China's share of the world economy has risen from just 3.6% in 2000 to 17.8% now and the country will become a "high-income economy" by 2023,'' according to the report. It is becoming clear that China's "management" of COVID-19 will boost its relative growth compared to the US and Europe in coming years.[3]

With a rapidly growing (both absolutely and relatively) and very large economy, a very active and growing equity market reinforced by a strong equity market culture, and a rapid ascent to becoming a high income economy, the likelihood is clearly that China's weighting within the emerging market Indices continues to grow. There is an inevitability about a move to becoming a standalone country. Whilst inevitable, there will be several implementational challenges, particularly the amount of passive money involved, that may delay the process for some time.

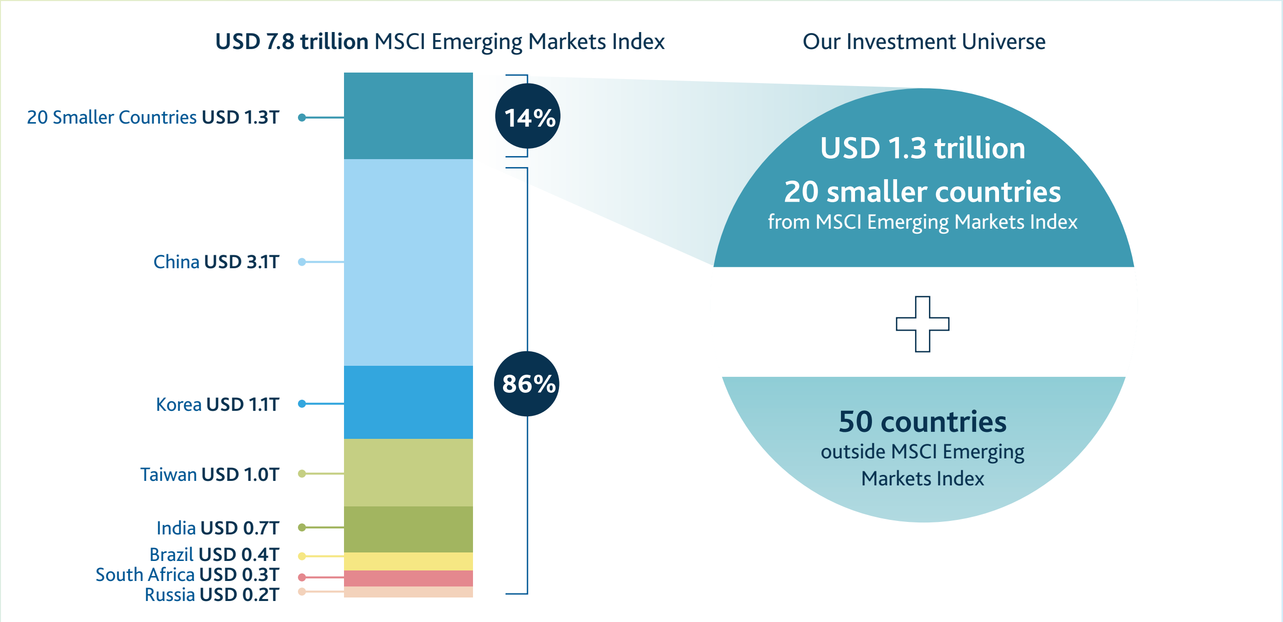
Even without China, the second question that emerging market investors need to address is the current and future concentration of global emerging market indices in very few countries.

For example, following closely behind China, India has a good chance of becoming the third largest economy in the world by 2030. India had overtaken the UK as the fifth-biggest economy in 2019 but has slipped behind it again due to the pandemic's impact. It might not take over again until 2024, but is likely to then go on to overtake Germany by around 2027 and Japan around 2030.

In addition, market concentration of individual stocks, on the rise since the 2010s in most equity markets, accelerated markedly during the recent pandemic. For example, the largest five issuers in the MSCI Emerging Markets and MSCI World Indexes reached a collective weight of 23.8% and 12.8%, as at 24 Feb 2021, respectively, significantly above the previous peaks, during the dot-com bubble.

Today's emerging market universe has become dominated by a small number of large markets, with the largest 7 countries accounting for more than 86% of the MSCI Emerging Markets Index.

Looking beyond the MSCI GEMs benchmark

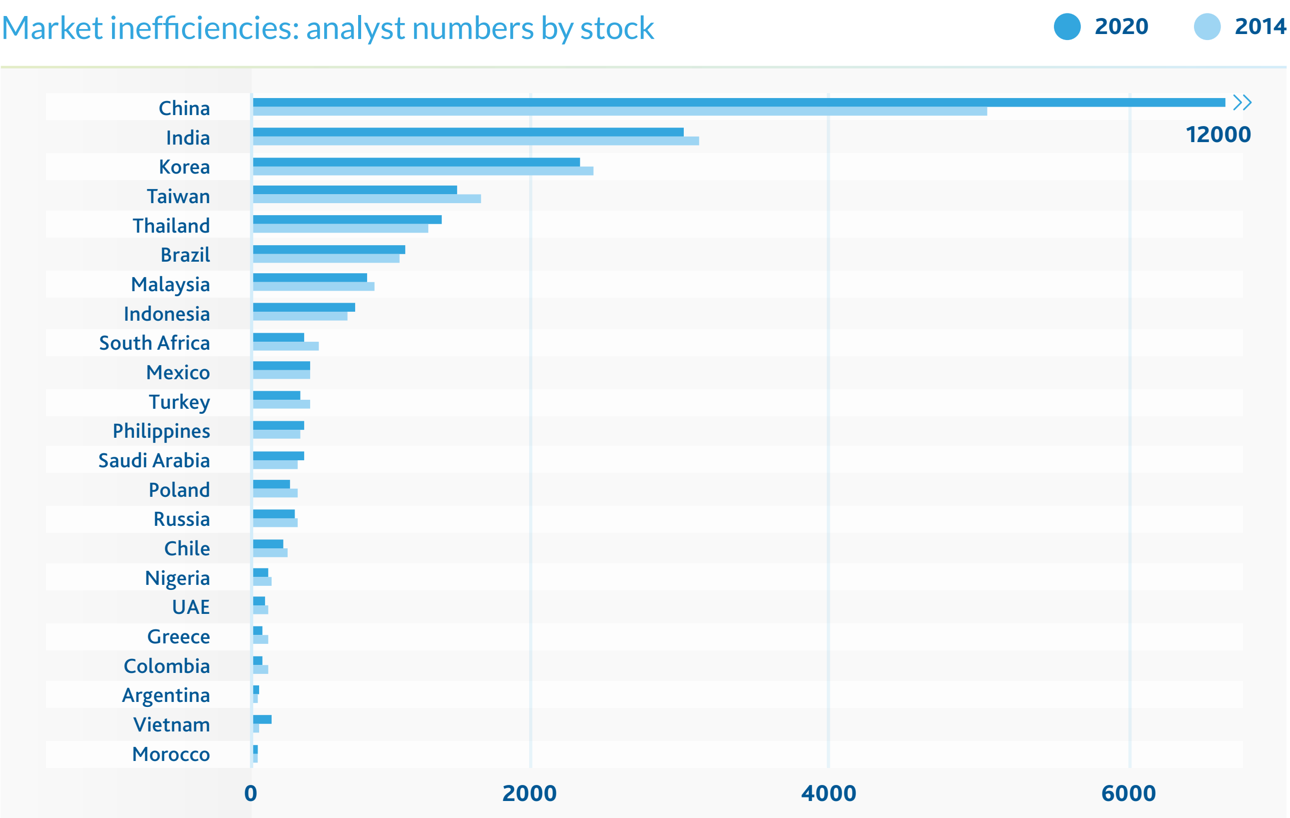


Source: Fiera Capital and Bloomberg, 31 Dec 2020 (Investible Market Capitalization of Shares in Index). All numbers presented in US dollars

2 Eastsprings Investment *Why you need an emerging market ex China strategy 31 Dec 2020*

3 CEBR *Sky News – COVID response to help China become world's biggest economy five years early 6 Jan 2021*

Market inefficiencies: analyst numbers by stock



Source: Fiera Capital, Bloomberg 31 Dec 2020.

We believe specialist global emerging market investors need to focus on these largest seven markets in order to have a chance of generating performance. This is inevitably leading to a reduction in focus on the other 19 markets that make up just 14% of the MSCI Emerging Markets Index. MIFID II pressures have multiplied this effect by reducing the focus on companies in these markets from the global investment banks representing the sell-side. The magnitude of the variations on sell-side focus can be seen in the chart below. The degree of impact on a global emerging market manager's portfolio can be demonstrated by the examples of Greece and Pakistan which are ten basis points and two basis points respectively of the MSCI Emerging Markets Index.

Combining these smaller emerging and frontier markets together, they are home to over 19,000 listed stocks and USD 1.4 trillion of market capitalisation. The alpha generating potential from inefficient stock pricing in frontier and emerging markets has been well demonstrated by our investment team over the last 10 years. Over the last few years, many of these 19 smaller emerging markets have begun to exhibit characteristics that meet our definition of frontier markets, namely markets and stocks that are "under researched and under owned."

The newly launched Smaller Emerging Markets Strategy looks beyond these 7 major markets to the smaller countries in the MSCI Emerging Markets universe, as well as all frontier markets where we believe, due to the factors above, a big alpha generating opportunity continues to exist and is growing. We pursue a very active strategy, with a strong focus on bottom up investing and top down analysis providing a negative country screen. The Strategy is benchmark agnostic with a focus on domestic growth opportunities in economies that are growing strongly due to reform processes enacted by the local administrations.

Due to the many different interested parties involved and implicated by the construction and changing of indices amongst the main index providers, it is difficult to predict the future path with high conviction. What we have attempted to demonstrate here is that asset allocating in emerging markets over the next few years is likely to lead to an optimal allocation strategy utilising specialist asset managers for China, global emerging markets ex China, and smaller emerging and frontier markets.

Dominic Bokor-Ingram,

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