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Five things every emerging markets investor should know

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Emerging markets is a term used to describe economies considered to be in a transitional phase from developing to developed economies. Apart from that one common characteristic, each of the underlying countries has its own currency, economic policy and a set of companies across different sectors which makes broad comparison across markets very difficult.

The MSCI Emerging Markets Index (“MSCI EM”) is the most commonly used benchmark which solves this problem by bringing these countries and companies into a single index which adjusts for the transition from developing to developed economies over time.

This process of constant adjustment in the MSCI EM has recently resulted in one of the largest changes to the risk profile of the index since its launch. Our analysis of the two main changes (the growing weight to Chinese equities and the evolving sector composition of the index) indicates that emerging markets now offer a very different proposition to the investment opportunity in the last 10, 20 or 30 years. Based on the analysis, we have made five key observations that we believe are relevant for all investors.

What’s in an index?

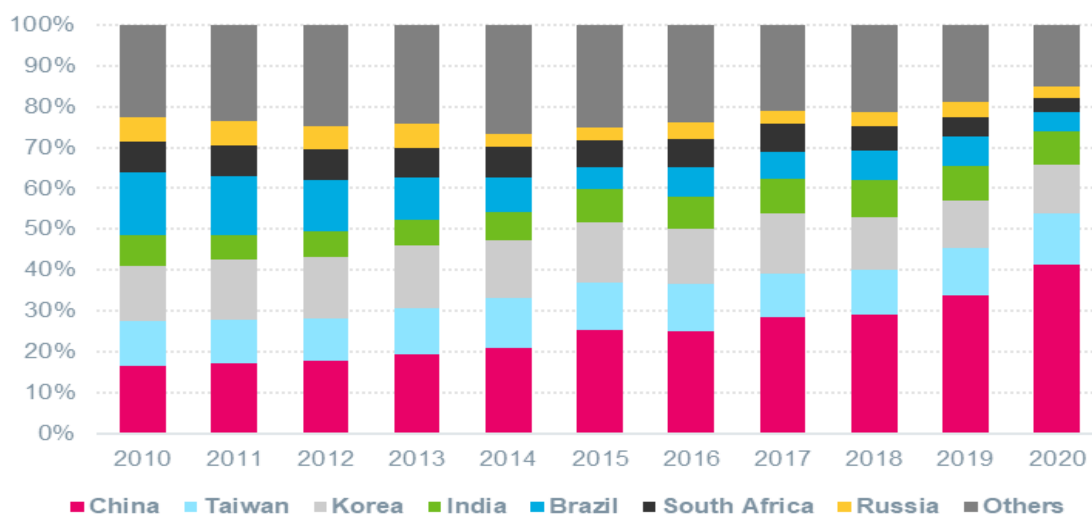
The MSCI EM index has grown from 10 countries with an equity market capitalisation of $15 billion in 1988 to 26 countries with a $6.4 trillion equity market capitalisation in 2020[1].

The emerging market economies of the 1980s and 1990s were focussed on producing cheaply and selling abroad. Over time, these economies have evolved to focus more on growing internal consumption and leapfrogging the traditional path to becoming developed markets through the use of mature economic policies and technology.

[1] Source: MSCI / Acadian

This evolution has mostly been led by China, which was first included in the index in 1996 with a weight of c.0.5%. By 2010, that weighting had grown to c.14% and today stands at c.42% - making China the most heavily weighted country in the index[2].

The Evolution of the MSCI Emerging Markets Index



China and the A shares story

The increasing weight of China is understandable given it is now the world's second largest economy by GDP and the Shanghai, Shenzhen (the two mainland stock exchanges) and Hong Kong (the offshore stock exchange) markets combined are the world's second largest equity market.

Interestingly, China's weight in the MSCI EM index is set to rise further as MSCI incorporates more China A shares into the index over the next few years[3].

China A shares are Renminbi-denominated (Chinese local currency) equity shares of China-based companies that trade on the Shanghai and Shenzhen Stock Exchanges. These shares provide access to companies that derive their earnings from China's domestic economy. The Shenzhen Stock Exchange hosts more private companies (with nearly 50% in the information technology, consumer discretionary and healthcare sectors) while the Shanghai Stock Exchange is dominated by larger, state-owned companies in more traditional sectors such as financials and industrials.

The process of integrating these companies into the MSCI EM index was started in 2018 and now over 400 large and mid-cap A share companies comprise c.4% of the index[4]. While there are some technical issues to resolve (stock settlement periods etc.) before more A shares are added, MSCI is expected to continue the inclusion process. Further inclusion could raise the weight of China A Shares from 4% of the MSCI EM today to 20% in the future, taking the total China weight in the index to nearly 50%.

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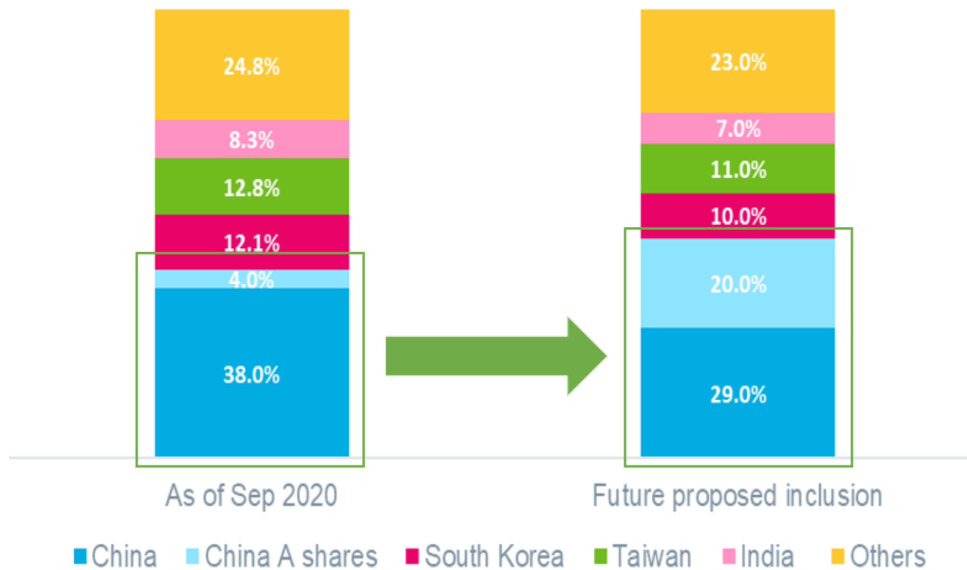
[2] Source: MSCI

[3] The initial inclusion of Chinese equities in 1996 consisted of B-shares (Domestically Listed Foreign Investment Shares) and in 2000, MSCI added Hong Kong-traded Chinese equities (Red Chips, H-shares). The process of integrating China A shares into the MSCI EM index was started in 2018.

[4] Source: MSCI

China A share inclusion in the MSCI EM Index



Source: MSCI / Fidelity as of 30 Sep 2020

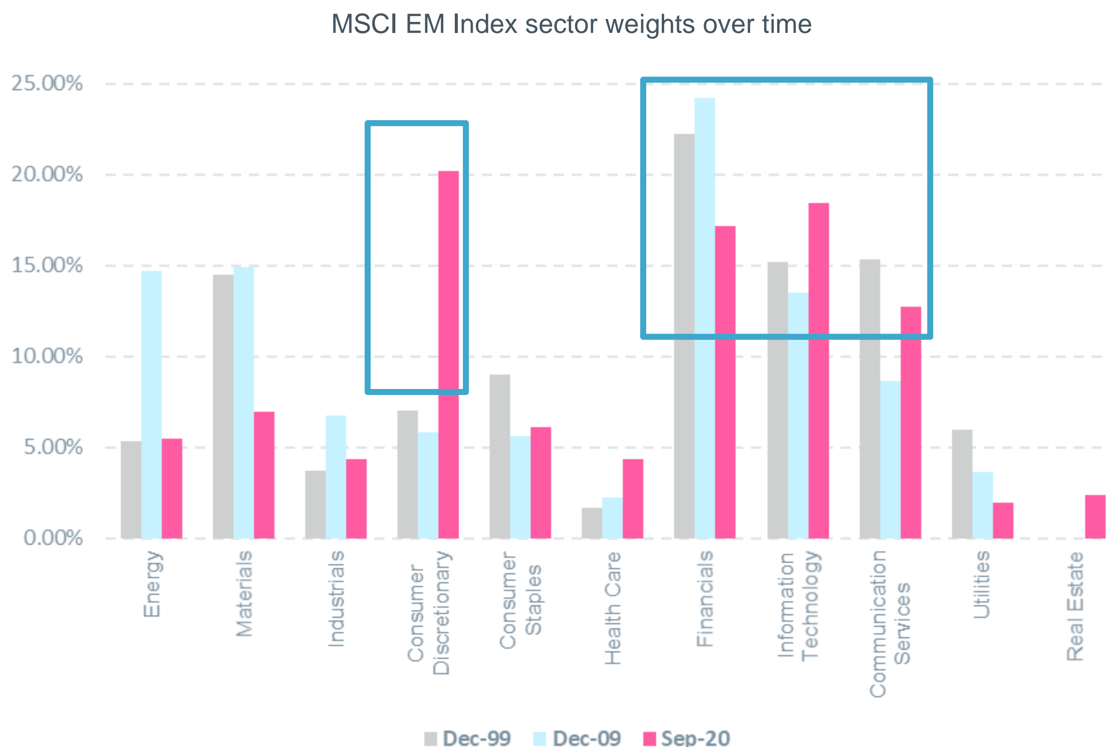
As of 30 September 2020, China represents c42% of the MSCI EM index and along with Taiwan (12.8%), South Korea (12.1%) and India (8.3%), these four markets represent c.75% of the index, with 22 other countries accounting for the remaining c.25%[4].

This is quite a change from the days when the BRICs (Brazil, Russia, India and China) were expected to become the largest emerging market economies and highlights that the index is now heavily dominated by Asian companies.

It also highlights that the country diversification of the MSCI EM is now more in line with the MSCI World Index (used to benchmark developed markets) which is heavily dominated by USA (67% of the index) and where three countries (USA, Japan and the UK) represent c.79% of the index. With both indices, our key observation is that the index is more likely to be impacted by country-specific factors in the largest constituents (China and USA respectively) than any of the other markets, reducing the country diversification benefits of investing in an index fund.

[4] Source: MSCI

How has the sector composition evolved over time?



Source: MSCI as of 30 Sep 2020

The emerging market economies of 30 years ago were a mixed collection of commodity exporters and low-cost manufacturers. As shown in the chart above, the MSCI EM index is now mostly comprised of companies in the Information Technology, consumer discretionary, financials and communication services sectors (combined weight of 67%), all of which are driven by domestic consumption or high value-add exports.

Conversely, the commodity or infrastructure-driven sectors such as the energy, materials, industrials and utilities sectors have become much less important drivers of performance.

What may come as a surprise is that several emerging market companies have seized the lead in innovation and are leapfrogging developed market companies in areas such as e-commerce, digital payments, social media platforms, renewable energy and electric vehicles. Examples such as Alibaba (shopping and financial payments platform), TikTok (social media platform), Taiwan Semiconductor (global leader in integrated circuits), Samsung Electronics (electronics manufacturer) and Infosys (IT consulting) are but some of the names that showcase the global leadership of emerging market companies in 'new economy' sectors.

Emerging markets as a group have been filing more global patents than USA and Japan (two highly innovative economies) since 2005. China alone is home to many companies with global leadership in renewable energy production, 5G cellular network equipment and electric vehicles - technologies which are expected to form the bedrock of future societies.

We note that the technological expertise is not evenly split amongst emerging market countries, with information technology being the largest sector weight in Asia whereas financials and commodity driven sectors are more common in EMEA (Europe, Middle East and Africa) and South America. This partially explains the growing weight to Asia in the index, and the rapid growth of technology companies in Asia is only likely to increase the weight differential further.

Five things every emerging markets investor should know

The emerging markets of today offer a very different proposition to the investment opportunity in the last 10, 20 or 30 years. This leads us to make five key observations relevant to all investors:

1. **Comparisons with the past are less meaningful**

   Given the changes to the index at both the country and sector level, evaluating historical index behaviour to guide expectations for the future has become less meaningful. In particular, the large correlation to the commodities cycle is no longer relevant given the reduced exposure to commodity and infrastructure driven sectors in the index. Furthermore, the largest countries in the MSCI EM index now run current account surpluses (e.g. China, South Korea and Taiwan), whereas in the 1980s and 1990s the largest countries generally ran deficits (e.g. Brazil, Malaysia, and Mexico). This makes comparisons of currency volatility and reliance on foreign capital to grow (trends of the past) less meaningful.

2. **The index is now more concentrated**

   Not only more concentrated in China, but also in the top 10 stocks. In 1998, the top 10 stocks accounted for c.16.7% of the index which has now risen to c.31%, despite the total number of stocks increasing from 958 in 1998 to 1151 today.

   If the weight to China continues to rise with the incorporation of more China A shares, this could create a dilemma for some investors who either feel the asset class is no longer sufficiently diversified or those that may want to have greater control of their China exposure.

   We are broadly comfortable with most investors maintaining the current allocation to emerging markets, noting that China's weight is still far below that of the equivalent weight to USA in the MSCI World Index. The alternative solution would be to opt for separate EM ex-China (or EM ex-Asia) and China (EM Asia) funds and set the weight to each allocation as desired. However, at the current time, this is a less practical solution as there are only a handful of managers who provide EM ex-China (or EM ex-Asia) equity funds.

3. **Emerging market benchmarks are constantly evolving**

   Since the MSCI EM index was launched in 1988, there have been several reclassifications with some countries promoted to developed markets and others demoted to frontier markets.

   We believe the recent evolution is a trend that is unlikely to reverse anytime soon given the faster growing demographics of Asian economies (such as China and India) and the shift from export-led to consumption-led growth.

   While it is difficult to predict when China, Taiwan or South Korea (which is already classified as developed in FTSE Russell indices but not MSCI) may be promoted to the MSCI World index and which countries may replace them, the one certainty is that the investment exposures in the MSCI EM index will again change significantly at a future point in time when these promotions occur.

4. **Broad generalisations about emerging markets fundamentals are inaccurate**

   This is not a surprise to us as few investors would group the economies of the USA, Japan and the UK (the three largest countries in the MSCI World Index) together for economic analysis. However, emerging markets have been commonly treated as a homogenous group in the past when commodity driven sectors had a larger weighting. We believe that due to the ongoing trend toward more domestically driven economies, economic fundamentals by country are becoming more dispersed, making broad generalisations about the asset class inaccurate.

5. **Emerging market equities offer an attractive long-term investment**

We believe an allocation to emerging market equities is attractive as a strategic long-term investment. Emerging markets, led by China, have demonstrated that they are an important engine of incremental global economic growth. The longer-term trends like urbanization and growing incomes combined with the recent trends of global leadership in technology-led sectors make the investment proposition more attractive than in the past.

We recognise that a one size fits all approach is not suited to emerging market allocations. We suggest that the size and investment management style (active or passive fund) decisions should take into account other factors such as current market valuations, political risk, currency risk, ESG risks, the timing of the allocation and how comfortable investors are with the growing weight to China.

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