GMO

EVENT HIGHLIGHTS

CHINA AND EMERGING MARKETS EX-CHINA

Warren Chiang and Binu George | September 23, 2021

OVERVIEW

Chinese regulatory risk has been at the forefront of recent headlines. On September 23, the GMO Emerging Markets Equity team discussed the investment implications of President Xi's dream for China. Given the uniqueness of China and its near 40% weight in emerging market indices, investors are considering standalone allocations to China and EM ex-China.

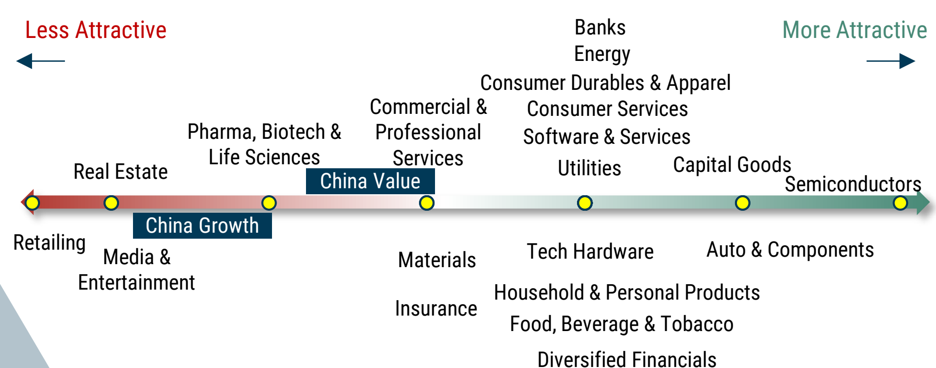
We explore this new paradigm with a focus on why we believe a top-down approach is an indispensable source of alpha in an EM ex-China mandate. As a result of our continued effort to offer solutions that meet our clients' needs, we have launched a new EM ex-China strategy which is now available to you.

> *"Conversations we've had with our clients revolve around two major themes: 1) they have too much China exposure, or 2) they realized that 'wow, there is a lot more risk in China than we thought.'*

KEY POINTS

- When we apply our top-down lens to China, we see a method to their regulatory madness. So we created an analytical framework to identify the future winners and losers of Chinese government intervention. Based on our framework, we believe that the growthy sectors (e.g., retail, real estate, and entertainment) will be more negatively impacted, while the more value-oriented sectors (e.g., semiconductors, capital goods, and autos) are positioned to benefit.

GROWTH SECTORS MORE AT RISK THAN VALUE SECTORS



Source: GMO

- Our framework also suggests that it will be the ability to align with the government's new strategic objectives, not pro- versus anti-capitalism sentiment, that will drive success. If done well, we think mid-to-small caps will flourish as mega caps are prevented from engaging in anti-competitive behaviors. If done poorly, it could sap the morale of entrepreneurs, and common prosperity may instead lead to common poverty.

Warren Chiang
Mr. Chiang is a portfolio manager for GMO's Emerging Markets Equity team and oversees quantitative research. Prior to joiningGMO in 2015, he worked at Mellon Capital Management as a Managing Director of Active Equity Strategies. Previously, he worked at the Federal Reserve Bank of San Francisco as a research associate. Mr. Chiang earned his B.A. in Economics and his MBA from the University of California Berkeley. He is a CFA charterholder.

Binu George
Mr. George is a portfolio strategist for GMO's Emerging Markets Equity team. Prior to joining GMO in 2009, he was a portfoliomanager with AXA Rosenberg. Previously, Mr. George worked in several roles encompassing research and investment strategy at Barclays Global Investors. Mr. George earned his B.Tech. in Civil Engineering from Indian Institute of Technology, Madras and his MBA in Finance from University of Rochester. He is a CFA charterholder.

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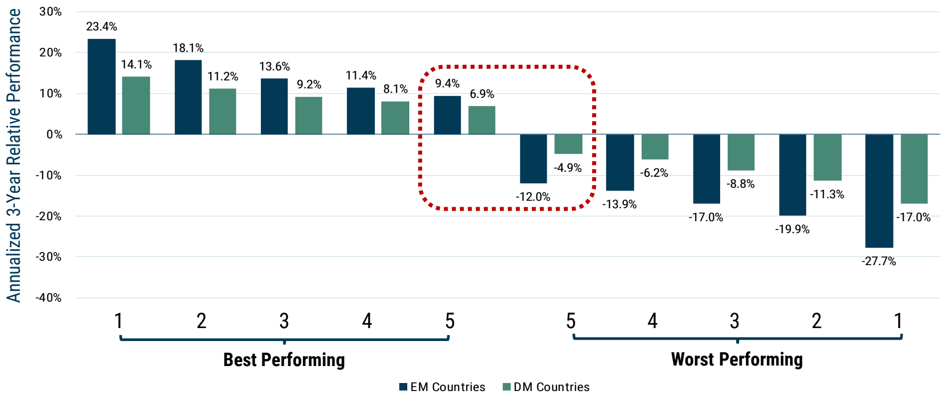
- Many of our conversations with clients have revolved around two major themes: 1) They have too much China exposure, or 2) China is a lot riskier than they thought. Investors want exposure to the elements of emerging markets that they like, but without the baggage of a 35% (or more) allocation to China.
- Local economic forces have a greater impact on individual stock prices in emerging countries than they do in developed countries. We reflect this by incorporating country and sector specific signals, and by emphasizing country and sector allocation in our process. This top-down approach becomes particularly beneficial when the stock selection dimension shrinks. A bottom-up stock selection approach that excludes China will lose about 40% of its opportunity set (i.e., the proportion of EM stocks that are Chinese). A top-down approach, on the other hand, will lose just 1 of 27 opportunities along the country dimension and nothing along the sector dimension.

THE TOP-DOWN OPPORTUNITY IS SIZABLE

Picking the right countries is important – much more so in EM than in DM



1/31/2000 - 12/31/2020 | Source: MSCI, S&P, GMO

- While investors are spoiled for choice with dedicated China strategies, they are surprisingly starved of options for EM ex-China strategies. An EM ex-China strategy is a valuable building block for investors looking to control their China allocation more precisely. We believe it will become even more important as China grows and the distinct risks and opportunities of Chinese allocations come under additional scrutiny. If you would like to learn more about emerging market strategies or our new EM ex-China solution, please reach out!

RELATED STRATEGIES

Please click on the links below to access strategies related to this event.

- Emerging Markets Strategy
- Emerging Markets ex-China Strategy

RELATED RESEARCH

Please click on the links below to access research related to this event.

- China and EM ex-China: The Yin and the Yang | by Binu George
- Emerging Markets Ex-China Strategy Product Primer