GMO

EMERGING EQUITY INSIGHTS

CHINA AND EM EX-CHINA

The Yin and the Yang

Binu George | April 2021

EXECUTIVE SUMMARY

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 critical building block in the effort to precisely target the China allocation in EM investments. And for active managers running an EM ex-China strategy, top-down country and sector allocation is an indispensable source of alpha.

China famously has the world's second largest economy and a GDP growth rate that's still north of 6%. What's particularly enticing to an equity investor, however, is a stock market capitalization of $4 trillion, liquidity that's more than commensurate to its capitalization, over 3,000 publicly listed companies, and no dearth of themes to play. No wonder capital is rushing into dedicated China strategies to tap into these opportunities.

This has a spillover effect on investing in Emerging Markets (EM) because in addition to the above superlatives, China makes up nearly 40% of a typical EM universe. This means that those who want to invest in China-only vehicles in addition to investments in EM strategies have no choice but to take a massive bet on China.

For other investors, geopolitical concerns such as U.S.-China tensions primarily drive the desire to move away from EM strategies and towards solutions that allow for a precise control of their China allocation.

All the above highlight the need for EM ex-China strategies. They function as the yang to the yin of China-only strategies, providing a critical tool for investors to customize the China weight balance in their overall EM allocations.

Regardless of the motives behind splitting an EM mandate into China and EM ex-China, an investor will want to understand all the implications of the move and maximize the utility of each piece.

The rest of this paper examines the various implications of an EM ex-China strategy.[1] Some of the implications are more obvious – stock selection opportunities take a big hit with the loss of Chinese stocks. Others may not be as obvious – top-down investing provides a huge boost in an EM ex-China strategy. MSCI standard indexes will be used throughout as proxies for the EM and EM ex-China universes.

Impacts on Stock Selection

Stock level concentration[2] rises marginally in EM ex-China relative to EM. However, this is merely a reflection of the fact that EM has four[3] dominant firms, and a move to EM ex-China drops that number to two,[4] making them even more dominant! An easy way to see this is to study the concentration of all companies outside the top five: there is no difference between the two universes after removing the top five.[5]

So, an active manager faces a transformed version of the same uber cap question, but other than that, the two universes are the same from a stock concentration point of view.

Where the major difference lies between the two, of course, is in the number of companies. Moving from EM to EM ex-China, the investment universe drops from ~1,400 to ~700 stocks,[6] a dramatic shrinking of the opportunity set.

1
The implications for a China strategy are relatively straightforward in that the ideal strategy should identify as many differentiated themes and/or hidden stock gems as possible.

2
The Herfindahl-Hirschman Index (HHI) is typically used to quantify concentration. It is calculated by squaring the market proportion of each asset and summing the resulting numbers. This paper uses a normalized version to make it comparable across universes with different numbers. HHI at the stock level rises from .015 to .019.

3
Alibaba, Tencent, TSMC, and Samsung are each about 6%.

4
TSMC and Samsung rise in weight to be about 11% each.

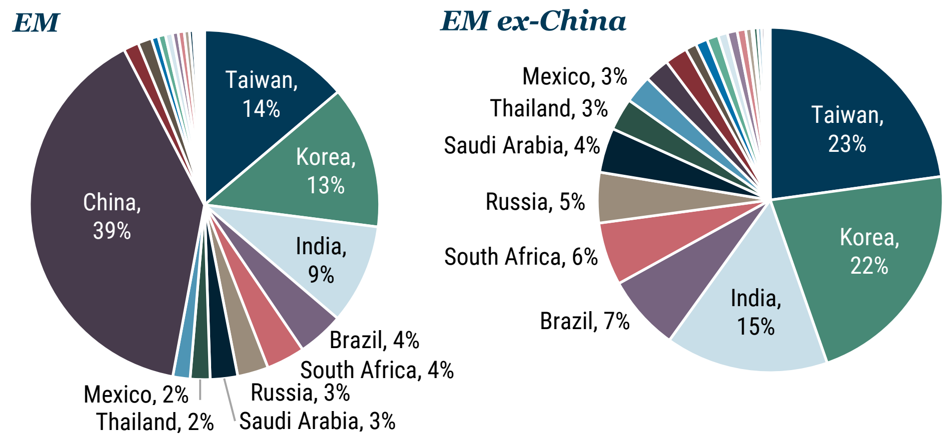
5
The HHI doesn't budge, with the figure being .003 for both EM and EM ex-China.

6
This calculation of ~700 Chinese stocks is based on the MSCI standard index series. A comprehensive approach that includes China A-shares, B-shares, H-shares, P-chips, Red-chips, and foreign listed equities would find the number of Chinese stocks to be over 3,000.

Country Implications

Country concentration in an ex-China universe obviously shifts dramatically, presenting opportunities for an active manager. As Exhibit 1 shows, China absorbs almost 40% of the capital in the MSCI EM Index, nearly triple the allocation to Taiwan, the next highest. Removing China from the index bumps allocations to Taiwan and Korea up, but each is still far from China's share in the EM index with 23% and 22%, respectively.[7]

EXHIBIT 1: COUNTRY COMPOSITION MSCI EM INDEX VS MSCI EM EX-CHINA



As of 2/28/2021 | Source: MSCI, GMO

From an active manager's perspective, EM ex-China is a bit more conducive to exploiting country allocation skills because smaller countries have a higher weight, giving the manager more leeway to underweight[8] them. If, for example, the manager chooses 5% as a significant bet, the number of countries that can be underweighted by 5% or more rises from 4 to 5 with EM ex-China. Using 1% as a guide, the number rises from 12 to 14. This is a very encouraging finding when compared to the story with stock selection, which saw the opportunity set being cut in half. This will be addressed in more detail later in the paper in the section on top-down investing.

Sector Differences

Sector concentration rises[9] with a move to an EM ex-China portfolio. This is largely a byproduct of the transfer in weight from China to Korea and Taiwan. China is well represented across multiple sectors whereas Korea and Taiwan especially are more concentrated in IT. IT continues as the largest sector, but its weight rises to roughly 31% in EM ex-China, a significant increase from its weight of 21% in the EM index.

From an active manager's perspective, though, the sectoral shift is a minor positive for allocation decision opportunities. Using 5% as a significant bet, the number of sectors that can be underweighted by 5% or more rises from 6 to 7. There is no impact if 1% is used as a guide as even the smallest sector is above 1%. (Note that there are 11 sectors as opposed to 26 to 27 countries in our universes.)

7 The HHI drops to 0.104 in EM ex-China from 0.176 for EM.

8 This is not an issue for long/short managers.

9 HHI across sectors jumps from .055 for EM to .089 for EM ex-China.

Style and Characteristics Differences

Because China has good representation in both traditionally "Value" (banks, commodities, SOEs) and "Growth" (tech, consumer, health care) segments, removing it does not materially affect the style or characteristics of the universe. A quick look at standard valuation metrics and measures of quality does not suggest a significant shift toward more value, growth, or quality.

An active manager, in other words, does not face a diminution in his or her ability to add alpha because of an investment style.

Liquidity and Capacity Considerations

Any evaluation of a universe should include a study of liquidity and capacity. Caution is merited here. China, it turns out, accounts for approximately 40% by number of stocks and by weight, but even more by liquidity. This is because faster-moving retail traders in China have ensured a high level of liquidity and volume for local companies. An ex-China universe, by our calculations, will lose about 50% to 60% of the liquidity of EM.

The implications are clear: managers focusing on this alternative universe need to be extra careful about liquidity in their investments, particularly in companies in the mid and small cap range. From a capacity perspective, an ex-China product might eat up about twice the capacity of an EM product, assuming one follows the same investment process. Capacity estimates for the entire suite of EM products need to factor this into their calculations.

China-only or a Regional Mandate?

Grouping works best when the components within the groups have high correlations to each other and low correlations to members of the other groups. A natural question with a "China-only" strategy is whether it should include other countries such as Korea and Taiwan. These two countries are similar to China in their above-average exposure to the consumer tech space and their leverage to global growth. They also have strong trade links with China and are geographically proximate. Countering the above supports for inclusion is the fact that China has a massive domestic market whereas Korea and Taiwan are far more export-oriented. Furthermore, while China's economy is huge, incomes on a per capita basis are a fraction of those in Korea and Taiwan.[10]

As investors, we can measure the net effect of all the above through a study of correlations. Correlations of China with Korea and Taiwan have fluctuated around 0.7. Correlations of China with other major countries are generally lower, but still range from 0.4 to 0.6. At the very least, this suggests that there isn't an incontrovertible case for an active manager to include Korea and Taiwan in his or her China mandate.

The Case for Top-down Is Even Stronger in EM ex-China than in EM

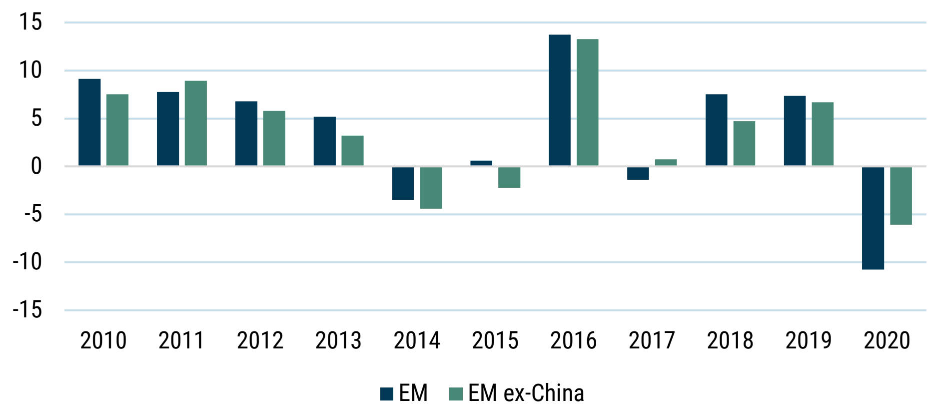
The ability to add alpha through top-down country or sector allocation decisions is a clear advantage in EM investing. Emerging markets have demonstrated on many occasions that local economic forces have more impact on individual stock prices than they do in developed countries. At GMO, we reflect this belief in our EM equity portfolios by incorporating country and sector specific signals in our models and by giving country and sector allocation a greater weight than stock selection in our process.

10 Per capita GDP in 2019 was $10,000 for China vs. $31,000 for Korea and $26,000 for Taiwan.

And this becomes particularly beneficial when the stock selection dimension shrinks. Neither quantitative nor fundamental stock pickers will welcome a drop of 40% in the size of their opportunity set. A top-down approach, on the other hand, will lose just 1 of 27 on the country dimension and nothing along the sector dimension.

We use simulations to illustrate this. All the GMO EM equity portfolios typically allocate around 60% of their weight to country and sector allocation and around 40% to stock selection. Removing Chinese stocks should impact our EM portfolios by about 40% (proportion of EM stocks that are Chinese) of about 40% (weight of stock selection in our process), i.e., by roughly 16%. We should therefore expect an EM ex-China simulation to closely match an EM simulation. And that's exactly what we find. The incorporation of top-down allocation allows us to transform an opportunity set hit of ~40% to a far more manageable decrease of ~16%. Exhibit 2 presents the similarity in annual alphas (versus their respective benchmarks) across the two simulations of our quantitative value strategy.

EXHIBIT 2: GMO VALUE PORTFOLIO SIMULATED ALPHA BY YEAR



As of 12/31/2020 | Source: GMO

Conclusion

An EM ex-China product is increasingly a required building block for investors as China gets larger and brings the distinct risks and opportunities of Chinese allocations under additional scrutiny by allocators.

The switch from an EM to an EM ex-China universe dramatically reduces the opportunity set for stock selection but barely impacts the opportunities for country or sector allocation. Getting the country call right is always desirable, but its power is magnified when the other alpha opportunities falter. Investors are therefore strongly advised to include top-down allocations as part of their repertoire in an EM ex-China strategy.

Binu George

Mr. George is a portfolio strategist for GMO's Emerging Markets Equity team. Prior to joining GMO in 2009, he was a portfolio manager 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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