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Research Paper

Carve Your Turkey, Not China

A Practical Look at Carving Out China from Broader EM

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As China's position size in the emerging markets index has grown so has interest in carving it out from a broader emerging markets (EM) allocation. In this paper, we examine the benefits and drawbacks of splitting EM into a dedicated China-only allocation and a separate EM-Ex China allocation. Ultimately, we conclude that ***investors should not carve China into a separate allocation*** at this time.

- *Removing China from a broad EM index to solve country concentration issues leaves investors with two concentrated holdings, not one. Taiwan, India and Korea make up 59 percent of the MSCI EM Ex-China Index*[1].

- *Individual country allocations are volatile and difficult to get right. The average spread between the best and worst returning EM countries is 98 percent. China's worst to best calendar year return ranges from -51 percent to +88 percent. Among the 28 emerging countries reviewed during this time, China's pole position ranked as high as first, as low as second to last and changed on average of eight places from year to year*[2].

- *There are 14 EM Ex China portfolios traded today. This compares with the approximately 700 broad EM strategies otherwise available. For the real-world investor, it leaves this conversation largely in the theoretical, rather than the practical*[3].

[1] MSCI as of October 29, 2021

[2] Fiducient Advisors, Country Selection – A Fool's Errand, August 2019

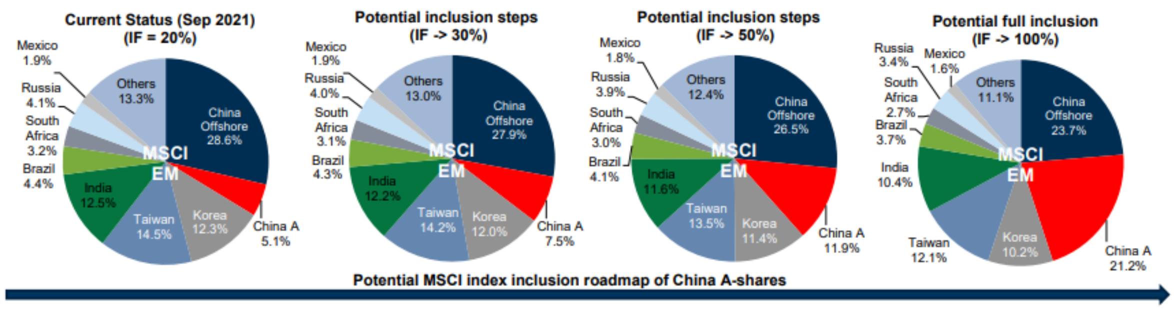
[3] Morningstar, eVestment, October 30, 2021

Breaking Down the Case for Carving Out China

1. **China is Too Large of an Allocation in the Index** – China is 34 percent[1] of the MSCI EM Index today, down from a peak of 43 percent in 2020[4]. As MSCI continues to incorporate mainland-based companies (China A shares) into the index, this will likely increase China's weight in the index back above 40 percent with the potential to become more than half the index in the future. If coupled with China's long-term "one country" mentality toward Taiwan, it is easy to see the concentration risk.

MSCI Inclusion Factor Projections of China A Shares

Holding prices constant, MSCI projects a greater than 40 percent allocation to China



Source: MSCI as of September 30, 2021

Response: This argument has merit and is perhaps the most reasonable basis for making a change. Over the past decade, annual performance of the largest 200 EM active mutual funds is approximately 90 percent correlated to the yearly returns of MSCI China Index[4]. However, carving out China to address concentration risk might not be as helpful as one might think. In the MSCI EM Ex-China Index, ***concentration in the top three countries is effectively the same.*** China, Taiwan and India make up 60 percent of the MSCI EM Index[1]. In the MSCI EM Ex-China Index Taiwan, India and Korea make up a similar weighting of 59 percent[1].

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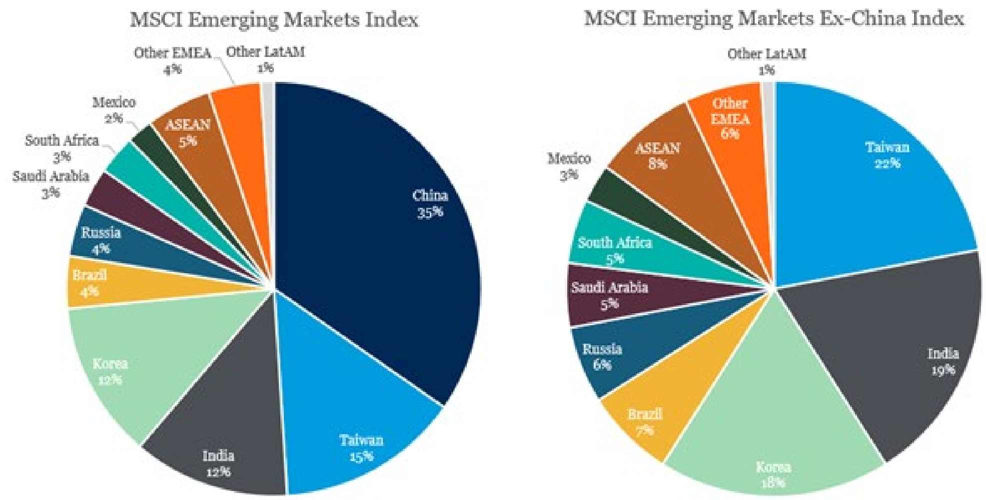
[1] MSCI as of October 29, 2021
[4] Goldman Sachs EM ex-China as a separate equity asset class

MSCI EM Benchmark Weightings

Country concentration is not alleviated by simply carving out China from the broad EM index



Additionally, ***single security concentration worsens slightly.*** A more material weighting to Taiwan Semiconductor and the top 10 constituents of each index continue to make up approximately 25 percent of the index.

MSCI Emerging Markets	
Top 10 Constituents	**Weight**
Taiwan Semiconductor	6.58%
Tencent Holdings	4.48%
Alibaba Group	4.00%
Samsung Electronics	3.59%
Meituan	1.76%
Reliance Industries	1.22%
Infosys	0.96%
JD.com	0.86%
Housing Development Finance	0.82%
China Construction Bank	0.82%
	25.09%

MSCI Emerging Markets Ex China	
Top 10 Constituents	**Weight**
Taiwan Semiconductor	10.08%
Samsung Electronics	5.50%
Reliance Industries	1.86%
Infosys	1.46%
Housing Development Finance	1.26%
Gazprom	1.13%
ICICI Bank	1.06%
Sberbank Rossii	1.04%
VALE	0.97%
Mediatek	0.96%
	25.32%

Source: MSCI as of October 29, 2021

Finally, ***sector concentration rises with even more exposure toward Technology and Financials in the Ex-China Index as both sectors rise seven and three percentage points, respectively.*** While concerns around China concentration may be removed after the country is carved out, new and perhaps unanticipated concentrations begin to arise.

MSCI Emerging Markets	
Sectors	**Weight**
Information Technology	20.65%
Financials	19.64%
Consumer Discretionary	15.55%
Communication Services	10.64%
Materials	8.52%
Consumer Staples	5.82%
Energy	5.78%
Industrials	4.73%
Health Care	4.56%
Utilities	2.16%
Real Estate	1.99%

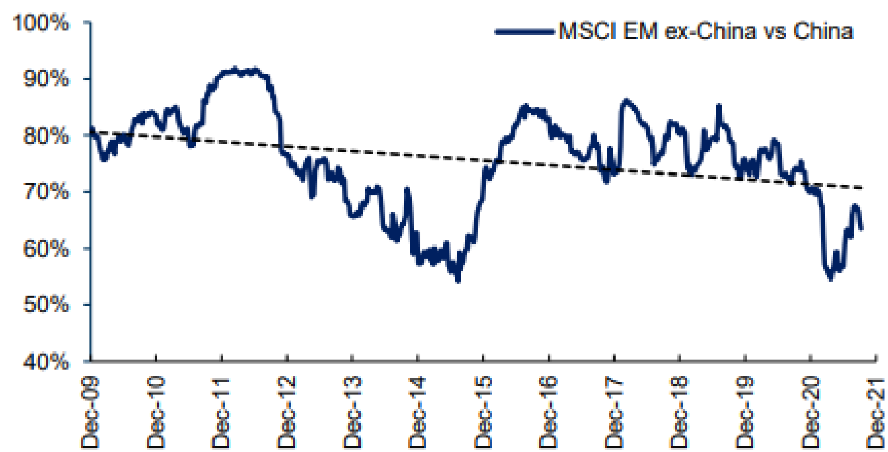
MSCI Emerging Markets Ex China		Difference
Sectors	**Weight**	
Information Technology	28.02%	7.37%
Financials	22.93%	3.29%
Consumer Discretionary	6.14%	-9.41%
Communication Services	6.77%	-3.87%
Materials	11.43%	2.91%
Consumer Staples	6.17%	0.35%
Energy	8.05%	2.27%
Industrials	4.54%	-0.19%
Health Care	2.98%	-1.58%
Utilities	2.06%	-0.10%
Real Estate	0.92%	-1.07%

Source: MSCI as of October 29, 2021

2. **Portfolio Diversification** – A review of EM in the 1990's and early 2000's typically revealed that EM often traded directionally with commodity prices, then it evolved to China leading EM. Now, some believe China is asynchronous from other EM countries seemingly operating on its own. Therefore, carving out China and treating it like its own asset class, much like the U.S., would improve portfolio outcomes with better diversification.

MSCI China Rolling 52-Week Correlation vs EM Ex-China

China's relationship with EM Ex-China has varied over time, but has fallen recently



Source: FactSet, MSCI, Goldman Sachs Global Investment Research

Response: Owning an asset based solely on diversification is a road littered with many investing mistakes. Low correlation (read: a diversifying asset) can just as easily come from an asset declining in value when many others rise. While low correlation is an attractive attribute it is just the first step. An investor also needs to have a positive view on return and a risk profile that they are willing to accept.

Secondly, other important groupings of assets can have a similar effect on portfolio construction. For example, carving out a sector such as Information Technology would have a similar mathematical effect on diversification given its lower correlation to broad markets. However, few would advocate for such an approach.

Lastly, the notion that diversification is only attained when it is carved out as an asset class is false. Investors in broad EM portfolios will receive the benefits of diversification, should there be one, just like an investor in a dedicated China mandate. Holding all else constant, the only way to change the level of diversification to the overall portfolio would be to change the weight allocated to the asset. ***There is nothing magical about a standalone risk exposure***.

3. **China is the Second Largest Economy** – As the world's second largest economy, and on its way to being number one, China deserves its own attention and focus in portfolios.

   Response: By market cap, Japan is the world's second largest equity market, financials are the world's second largest sector and Microsoft is the world's second largest stock[1]. None of these reasons serve as a reasonable rationale for why any of them should be carved out and treated differently. Moreover, nothing prevents China from being part of a broad allocation to EM and commanding the attention of either an active manager or a passive index.

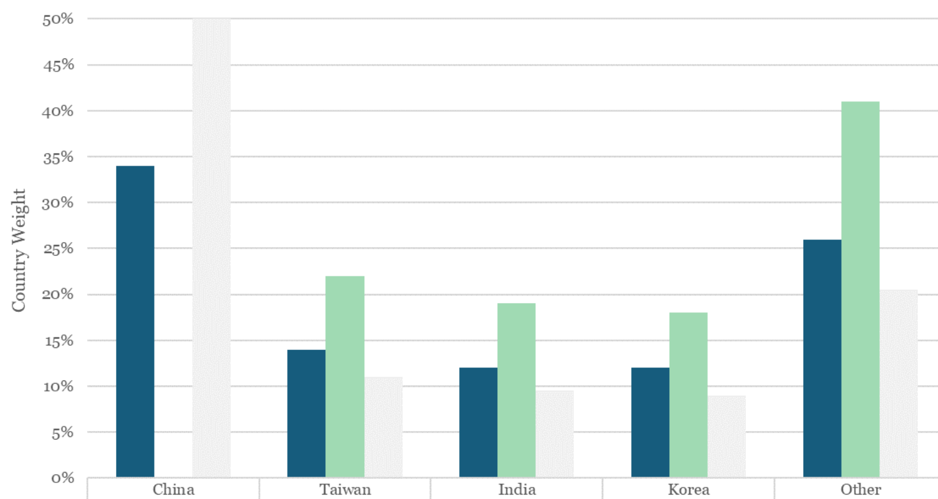
Additional Considerations

- **Countries Are Volatile** – The volatility of country returns is rarely discussed because it is hidden in broadly diversified portfolios. However, we believe an investor should think seriously about their risk appetite before targeting country allocations. According to our research paper, *Country Selection – A Fool's Errand*, the ***average spread between the best and worst returning EM countries is 98 percent***[2]. ***China's worst to best calendar year returns range from -51 percent to +88 percent, nearly a 139 percentage point spread***[1]***! Among the 28 emerging countries examined during this period, China's pole position ranked as high as first, as low as second to last and changed an average of eight places from year to year***[2]**.** Selecting the right country, at the right time, at the right size and having the ability to hold on for the ride is difficult to say the least.

[1] MSCI as of October 29, 2021
[2] Fiducient Advisors, Country Selection – A Fool's Errand, August 2019

- **Impractical Implementation** – ***There are 14 EM Ex-China portfolios traded today***. This compares to approximately 700 broad EM strategies otherwise available[3]. While this number is likely to rise if interest grows for EM Ex-China, it still proves to be a prohibitively small universe from which to select. ***For the real-world investor, it leaves this conversation largely in the theoretical, rather than the practical.***

- **Need a China Allocation Mousetrap** – Once the decision has been made to carve out China, an investor must decide what the appropriate allocation is for the country. If one believes in the wisdom of the markets and uses the current weighting of the MSCI EM Index, we have just created a more complicated version of what we had before. Perhaps an arbitrary weighting of say 50/50 to China and Ex-China? This decision will materially affect total country and sector positioning and the corresponding risks and returns. On average over the last five calendar years the MSCI EM Index and the MSCI EM Ex-China Index have differed by four percent per year[1]. Lastly, as stated above regarding country volatility and our paper, *Country Selection – A Fool's Errand*, timing allocations to counties is a difficult, if not a futile exercise[2].



	China	Taiwan	India	Korea	Other
MSCI EM	34%	14%	12%	12%	26%
MSCI EM ex-China	0%	22%	19%	18%	41%
50% China / 50% Ex China	50.0%	11.0%	9.5%	9.0%	21%

Source: MSCI as of October 29, 2021

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We continue to believe that China is an important and meaningful market in which our clients' investments can benefit from and should remain as part of a broadly diversified portfolio. For those who share our view of the opportunity for active management in the space, broad portfolios provide investment managers with the widest opportunity set from which to invest. Those who would rather gain exposure passively will also benefit from a more diverse set of counties, sectors and holdings offering greater diversification and likely at a lower cost given the generally higher cost associated with more nuanced investments.

For more information, please reach out to any of the professionals at Fiducient Advisors.

About the Author

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Brad joined Fiducient Advisors in 2012. He is chair of the firm's Investment Committee and a member of the firm's Discretionary Committee, Research Forum, Capital Markets Team and Mission-Aligned Investing Committee. In 2019, Brad was name named a "Rising Star" in City Wire's annual Professional Buyer publication for his contributions in the investment manager research industry. Prior to joining the firm, Brad worked in various research capacities at Citigroup and Wells Fargo in New York. He received a BA in Finance and Minor in Economics from The University of Colorado and is a CFA® charterholder and member of the CFA Society of Chicago and CFA Institute. Additionally, he is active with Greenhouse Scholars, a nonprofit providing financial and personal support to under resourced college students. In his free time, Brad loves cooking and spending time with his wife and young sons.