Emerging Market Investing: Was It a Lost Decade?

By Brendan Ahern
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A common investor narrative is that emerging market (EM) equities are “out of favor” following a decade of underperformance relative to U.S. equities. Financial advisors have had to explain to their clients for more than 10 years why they are holding an underperforming asset class. That’s more than 40 quarterly reviews defending not only an underperformer but an allocation that could have gone to outperforming U.S. stocks. For many investors, there is a point where one simply gives up. This performance narrative misses a more nuanced analysis (see figure 1).

The past decade has been challenging for traditional value managers in the United States as investors focus on growth stocks and sectors such as the FAANG (Meta, Amazon, Apple, Netflix, and Google). The preference for growth-oriented stocks is not unique to the U.S. market; this trend has played out globally including EM markets as well. Broad EM indexes began the decade overweight value sectors with minimal exposure to growth stocks and sectors.

The value overweight in EM indexes at the start of the decade stems from the absence of U.S.-listed Chinese companies. These stocks tend to be growth-oriented and include Alibaba, JD.com, Baidu, and others. U.S.-listed Chinese stocks were not added to MSCI indexes until 2015 and 2016, resulting in EM investors missing out on significant gains from the sector.

Since the Global Financial Crisis low on March 9, 2009, through December 31, 2021, the S&P 500 gained 810 percent while broad MSCI EMs returned just 259 percent. However, if we examine EM growth sectors as opposed to broader EM, they also outperformed like their U.S. equivalents. MSCI EM Technology gained 1,132 percent over the same period.

A similar story unfolds when you look at China. Broad MSCI China has performed relatively the same as EM, up 227 percent—just more than a third of the S&P 500. Yet, the MSCI China Information Technology Index is up an impressive 3,188 percent. Technology,
as a proxy for growth stocks, has done well within EM, and China tech companies have vastly outperformed (see figure 2).

Emerging market value stocks and sectors have rebounded on several occasions over the past decade (see figure 3). In 2021, Chinese internet regulation weighed on some of EM’s biggest growth names while commodity prices lifted energy and material stocks. Rising U.S. interest rates will negatively impact profitless growth technology companies globally. These value rallies are not uncommon in emerging markets, having materialized several times since 2012, which marks the beginning of EM growth’s spectacular run. The outperformance of EM value usually has been driven by inflation fears, rising yields as seen in 2013 and 2018, and extreme market stress as seen in 2015.

These value rallies have been short lived because a rationale for holding EM stocks is to align with inherently growth-oriented secular themes such as demographics, urbanization, the rise of the middle-class consumer, and digitization.

Many investors are currently underweight emerging markets despite inexpensive valuations versus developed markets. Metrics such as price to earnings (P/E), price to book (P/B), and forward P/E indicate valuations are more than one standard deviation lower for emerging markets versus developed.

Specifically, China—with its changing demographics, increased consumer spending, market size, increased international access, and differentiated performance characteristics—is attractive from a valuation and growth perspective.

RISE OF CHINA WITHIN INDEXES

The past decade highlights the value versus growth disparity, but it masks the rise of China within EM indexes. Chinese equity returns are almost twice that of broad EM over the past 10 years (see figure 4).

At the same time, China’s weight within MSCI EM is growing (see figure 5). This increased weight is driven by China’s economic rise as well as the substantial increase in the size of China’s mainland equity market, which comprises the Shanghai and Shenzhen stock exchanges.

The expansion of China’s mainland market has allowed MSCI to begin adding Shanghai and Shenzhen listed stocks to its indexes (see table 1).

China’s continued opening up is having a dramatic effect on the underlying index, and Shanghai and Shenzhen listed stocks have only had 20 percent of their potential weight added to MSCI indexes thus far. It is our expectation that continued reforms will allow MSCI to increase this weight in the years to come. Many investors are surprised to learn that Hong Kong–listed companies such as AIA Insurance, Hong Kong Exchanges, and Macau gaming stocks are not included in MSCI China but are constituents of MSCI Hong Kong. MSCI Hong Kong is part of developed markets and not EM indexes.
We believe a reclassification of MSCI Hong Kong into MSCI China could occur in the future. This would add $476 billion of market cap to MSCI China’s current $2.5 billion of market cap.

Additionally, China has been creating new stock markets, such as the Nasdaq-like STAR Market on the Shanghai Stock Exchange designed for science and tech start-ups and the recently announced third stock exchange in Beijing for small and medium-sized enterprises.

To summarize, indexes’ low weights and classification nuances have excluded some of the highest growth names, resulting in EM failing to deliver on its promise of high returns. Simultaneously, China has seen exponential growth in the number of listings as well as the diversity and sophistication of its companies and sectors. Similar to the premise that historically you could have achieved higher returns by deconstructing the standard indexes and investing in the right parts of EM, we believe you can achieve similar results by breaking out your China exposure from broader emerging markets.

**CHINA IS TOO BIG TO IGNORE**

- Second-largest economy in the world
- Second-largest equity and fixed income markets
- Underrepresented in global indexes
- Unprecedented growing consumer power

**THE SOLUTION: TREATING CHINA AS AN ASSET CLASS**

U.S. and global investors have exposure to China’s economy through U.S. and global publicly traded multinationals that operate in China. Many U.S. companies generate significant revenue and profits in China; such companies include Apple, Nike, General Motors, Caterpillar, Starbucks, and Boeing. The Federal Reserve Bank of New York estimated that U.S. publicly traded companies generated $376 billion of revenue in China in 2019. Despite this exposure, in 2017, Jonathan Shelon, chief operating officer of KraneShares, wrote that it was time to treat China equities as a standalone asset class distinct from emerging markets. Strategic allocations, such as dedicated Japanese exposure distinct from broader Asia, represent larger positions and stable weightings that are held through multiple market cycles with the goal of improving overall portfolio results. To quantify this belief, Shelon reported on extensive research and the development of the MAP framework, which describes
three main requirements for an investment opportunity to transform into an asset class (see table 2).

China is the world’s second-largest economy by gross domestic product and second-largest equity market by market capitalization (see figure 6). But, from a market-size standpoint, it is unusual because it is underrepresented in global indexes as foreign investors own just 4 percent of the mainland equity market’s total market cap.2

China’s Shanghai and Shenzhen exchanges opened in the early 1990s though they were closed to foreign investors until 2002. Over the next decade, quota programs provided limited access though with many regulatory challenges, which limited foreign investment. The advent of the Hong Kong, Shanghai, and Shenzhen Stock Connect programs in 2014 and 2015 provided access with limited regulatory oversight. This access, as well as the growing number of listings in offshore markets, has vastly increased China’s market size and availability.

Shelon’s research showed that real value can be derived from segmenting EM between China and everything else, especially for investment professionals seeking to enhance returns, reduce risk, or both. Investors will want to be explicit about their allocations to China to benefit fully from the unique attributes that this market offers.

Figure 7 shows rankings of annual performance for equity asset classes over the 20-year period from 2001 through 2021. These rankings illustrate China’s capacity to provide portfolio impact and diversification benefits. China was the best performer in six years and the worst performer in six years. In contrast, the United States, which is the least volatile, was best in five years and the worst in four years.

Summarizing return, risk, and correlation over the 20-year period, we see that China’s volatility was well rewarded, producing double-digit returns, whereas most developed countries delivered mid–single-digit results (see table 3 and figure 8). Equally impressive is that China’s correlation to just about every other category is below 0.7 (shaded blue in table 3), in both bull and bear market environments.

China’s equity market is more volatile than broad EM but has provided superior annualized returns over the past 20 years. Therefore, strategically blending

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**DEFINING AN ASSET CLASS: THE ‘MAP’ FRAMEWORK**

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<thead>
<tr>
<th>Asset Class Characteristic</th>
<th>Market Size</th>
<th>Availability</th>
<th>Portfolio Impact</th>
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<tbody>
<tr>
<td>• Asset classes need to be sizable, because most allocators prefer strategic allocations that are greater than 5 percent.</td>
<td>• A large investment category is not sufficient, because not every market is accessible or investable.</td>
<td>• Even if the market size is large and availability is high, the investment has to be differentiated compared to everything else in the portfolio.</td>
<td></td>
</tr>
<tr>
<td>• Market size is perhaps the simplest metric and indicates the significance of the opportunity.</td>
<td>• Availability ensures global investors can participate in a market and that there is sufficient capacity and volume.</td>
<td>• Otherwise, portfolios may be overexposed to a set of characteristics that already are owned somewhere else.</td>
<td></td>
</tr>
</tbody>
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**EQUITY CLASS MARKET CAP AND INDEX REPRESENTATION**

![Figure 6](chart.png)

Data from MSCI as of December 31, 2021

- Full Market Cap % of World Total
- Percentage in MSCI ACWI

1. China’s equity market represents 7 percent of the global equity market.2. Ex-China market capitalization of the Chinese equity market represents 7 percent of the global equity market.
the two markets can lower risk and maintain returns. A minimum risk EM portfolio would have 37 percent allocated to China, and a maximum efficiency portfolio would own 61 percent China with the remainder in EM excluding China. These hypothetical portfolios would have experienced less volatility (risk) and superior returns than an allocation of 100 percent EM.

Nearly five years later, Shelon’s thesis still holds true. A portfolio consisting of 40 percent China and 60 percent EM ex-China posted the highest risk-adjusted return over the updated 20-year period ending in 2021 and China was a top performer in 2019 and 2020, but EM ex-China was notably lower. However, many investors have not yet caught on. It was not a lost

**RETURN AND VOLATILITY (2001–2020)**

Index returns are for illustrative purposes only and do not represent actual fund performance. Index returns do not reflect any management fees, transaction costs, or expenses. Indexes are unmanaged and one cannot invest directly in an index. Past performance does not guarantee future results.

* Annualized volatility is the degree of variation of a trading price series over time as measured by the standard deviation of returns on a yearly basis. Standard deviation is a quantity calculated to measure the extent of deviation for a group as a whole. A low standard deviation indicates that the datapoints tend to be closer to the mean (also called the expected value) of the set, while a high standard deviation indicates that the datapoints are spread out over a wider range of values.

† Blue shaded boxes indicate correlation coefficients below 0.75.
decade in EM equities for those who allocated their money strategically. Investors saw outsized returns when they stepped away from the prescriptive broad EM framework and used one with more nuance. There are several ways to customize EM and China portfolios, including a strategic allocation that has a proper weighting to growth and treats China as its own asset class.

As China’s equity markets play an ever-expanding dominant role in EM portfolios, we believe investors need to allocate to and around China and treat Chinese equities as an asset class in their own right.

INVESTORS MUST HAVE A CHINA PARTNER

As China’s equity markets play an ever-expanding dominant role in EM portfolios, we believe investors need to allocate to and around China and treat Chinese equities as an asset class in their own right. When it comes to investing in China specifically, there are many ways to assemble a portfolio depending on goals and preferences. Some clients seek exposure with a single strategy encompassing the full market or segment, and others combine high conviction sectors and themes. A China-focused asset manager can provide exchange-traded funds and institutional strategies designed to help investors access this important and growing asset class.

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ENDNOTES


CONTINUING EDUCATION

To take the CE quiz online, go to www.investmentsandwealth.org/IWMquiz