China and Emerging Markets

Is Investing in China and Emerging Markets becoming riskier?

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Introduction

Emerging markets are very popular amongst UK Pension Schemes and are often included in equity portfolios as a means of increasing diversification and adding an extra source of returns. However, are investors aware of the significant exposure to China caused by investing in emerging markets?

In this note, **Dan Wood** and **Alasdair Gill** explore the recent rise of China, it's growing influence on emerging markets and the risks this poses for pension schemes.

Key findings:

1	**Allocation to Chinese equities** now makes up roughly 40% of the two most popular emerging market indices, almost two and a half times as much as 10 years ago.
2	There are **significant risks of investing in China**, including increasing regulatory intervention causing a recent rise in market volatility.
3	There are **still many arguments for investing in China** which is currently on track to become the world's largest economy.
4	**Pension schemes should be aware of the risks** involved, putting appropriate mitigations in place where possible.

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> The Chinese economy is too big to ignore, and emerging market investors are seeing increasing allocations to this Chinese stocks as they grow as part of this index. However, China also poses some unique risks and challenges to investors, and these must be considered carefully before making an allocation to this market.

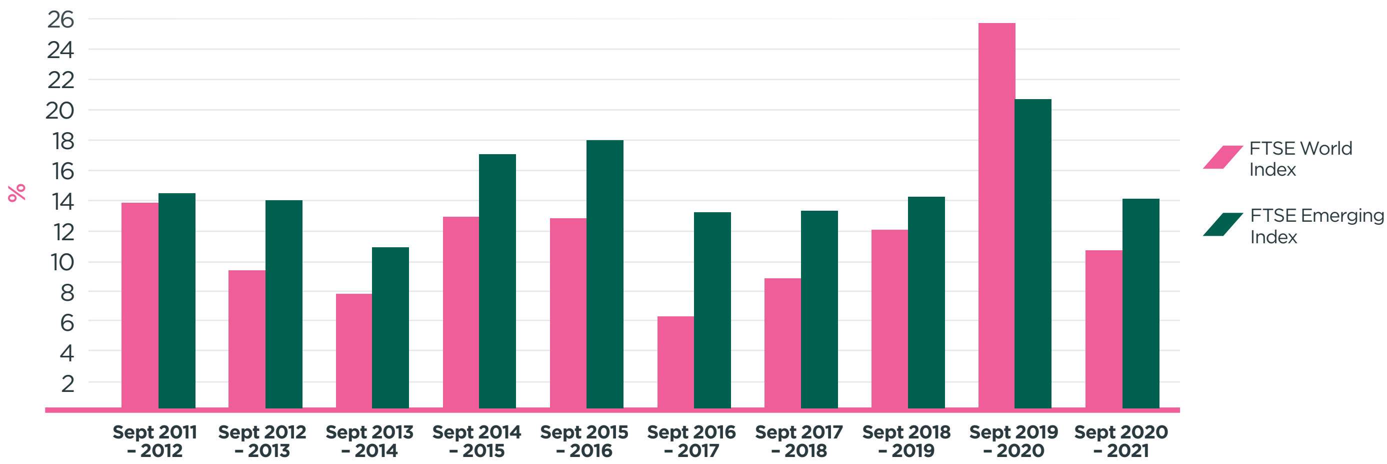
1 Overview of Emerging Markets

Emerging markets currently make up around 12% of the world's stock market by market capitalisation. They are therefore a significant part of the global equity market and have been part of pension scheme portfolios for many years, within equity portfolios and as part of diversified multi-asset funds.

Emerging markets comprise of developing nations with growing economies, who are in many cases well embedded in global supply chains, often being key manufacturers of consumer goods. In particular, an emerging market economy is one that is typically transitioning from a low income, less developed, often pre-industrial economy towards a modern, industrial economy with a higher standard of living. There are many nations that fall into this category, but some of the most notable current examples include: China, India, and Brazil[1].

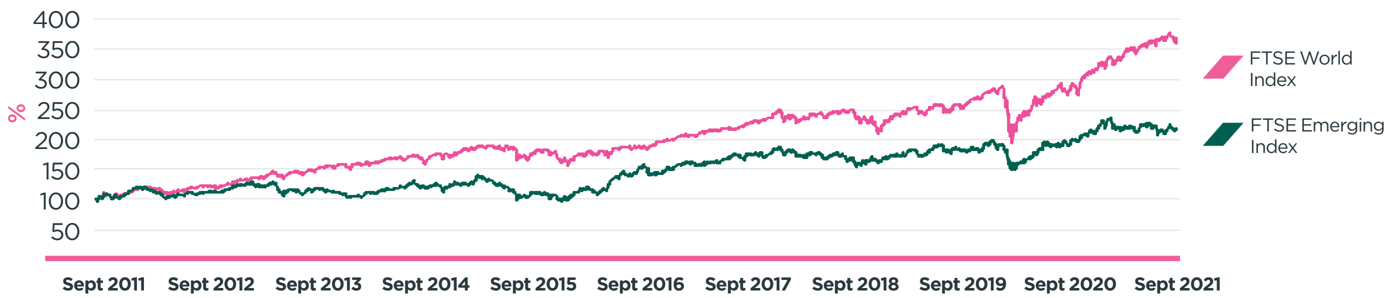
Due to the underdeveloped nature of the economies, and potential for political intervention, emerging market equities are typically characterised as higher risk and hence experience higher volatility (see chart 1). In exchange for this increase in perceived riskiness, investors expect larger returns compared to those earned from equities of more developed nations, such as the US or UK, although this has not been the case over the last 10 years (see chart 2).

Chart 1: Annualised volatility of global markets compared to emerging markets over the past 10 years



Source: Refinitiv

Chart 2: Cumulative performance of global markets compared to emerging markets over the past 10 years



Source: Refinitiv

[1] Different index providers have differing definitions of emerging markets, reflecting not only the size of the markets but also the market accessibility and the availability of investment instruments. The most notable difference between the FTSE and MSCI indices is the presence of South Korea as a large part of the MSCI emerging market index, whilst it is classified as a developed market by FTSE. Investors should ensure that they understand any nuances of the index used, particularly if investing on a passive basis.

2 What has changed? The rise of China

Whilst providing a potential source of diversification within a portfolio, investors need to be aware of any unintended risks that the allocation can give rise to. One such country specific risk has been the growing size of China in emerging market indices, and the potential for increased political intervention – this aspect is the main focus of this article.

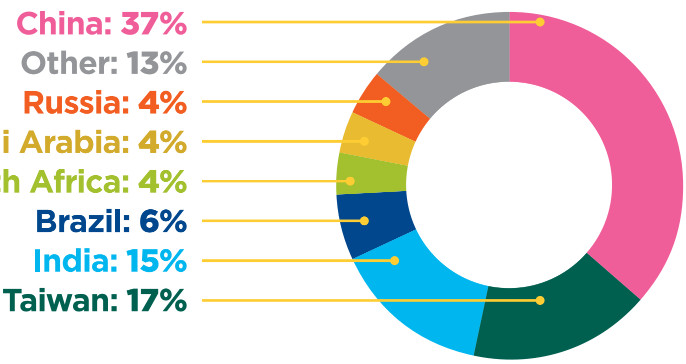
China is the second largest economy in the world based on annual Gross Domestic Product (GDP) and is consequently a major influence on the performance of emerging market indices. As of 30 September 2021, Chinese equities comprised 37.2% of the FTSE Emerging Index (and 34.0% of the MSCI Emerging Market Index).

Remarkably, China and Taiwan now account for around half of the popular MSCI Emerging Market Index, whereas 10 years ago this was around one quarter[2]. This is clearly a significant proportion and hence any movements in Chinese equities will have a material impact on these index returns.

Chart 3: Cumulative performance of the Chinese market compared to emerging markets over the past 3 years

Source: Investing.com

Chart 4: FTSE Emerging Index allocation by country (30/09/2021)



Source: FTSE Russell

> Remarkably, China and Taiwan now account for around half of the popular MSCI Emerging Markets Index, whereas 10 years ago it was only around a quarter.
>
> **Dan Wood**
> Associate – Investment

[2] **Source:** MSCI Global

3 Risks of investing in Chinese Equities

At one level, given the size and importance of its economy, it would seem natural to have a material allocation to Chinese equities within any diversified equity portfolio. However, China is not an open democracy, and so it is important for investors to understand the additional risks of investing in this market. We highlight some key ones below.

Regulatory intervention

Although the Chinese economy has experienced much liberation over recent years, there remains a long history of political intervention and capital controls on markets, individual sectors, and companies, which can not only impact the value of investments, but also the ability of investors to trade their investments[3].

A recent example of this was in July 2021 when China expanded its intervention to the online private education sector, as the Ministry of Education announced rules that prevent these companies from turning a profit, listing on stock exchanges, or seeking foreign capital from mergers and acquisitions[4]. As a result of this announcement, US-listed Chinese stocks subsequently fell by almost 15% over the following two days, the largest two day fall since the 2008 financial crisis.

Even more recent was the crackdown on the gaming industry in September, where regulations now state that those under 18 can only spend 3 hours per day online playing video games. China currently has the world's largest video gaming market with approximately 720 million gamers, roughly 18% of which are in-between the ages of 10 and 18. There is no doubt then that this is likely be detrimental to China's huge gaming and technology sectors.

Whilst there are economic reasons behind these shifts in policy, it is also motived by the State's desire to ensure that companies are more aligned with its political and social beliefs.

Climate change and the move to more sustainable investing

China currently emits 30% of the world's total fossil fuel carbon dioxide, making it the largest CO2 emitter in the world. Despite its pledge to reach net-zero carbon emissions by 2060, China continues to rely on fossil fuels for 70% of its electricity generation and are also among the largest foreign investors in new fossil fuel projects.

As the world and the investors within it move towards a greener future, will this lack of progress create a negative sentiment around the Chinese market?

The ethical and social dimension

There are a host of ethical and social issues currently creating international tensions between China and many western nations in particular. For example, the alleged suppression of ethnic groups, such as the Uyghurs in Xinjiang, has attracted considerable attention and led to clothing retailer H&M stating it would no longer source cotton from the region. Working conditions and other alleged human rights violations, such as child labour, can also be a feature, although this matter is not only confined to China.

3 As a result, there are different ways of investing in Chinese equities: via 'A' shares – quoted in Shanghai or Shenzen stock markets for domestic investors and 'Qualified Foreign Institutional Investors', 'B' shares, more widely available shares quoted in foreign currencies, and 'H' shares – Hong Kong quoted shares (in HK Dollars). Overseas investors can also invest in American Depository Receipts (ADRs), dollar denominated instruments issued by US banks to replicate a holding of an overseas stock.

4 **Source:** From Mao to Deng and now to Xi' viewpoint from Thanos Papasavvas, CFA.

4 Is there a still a case for investing in China and emerging markets?

As mentioned earlier, investments in emerging markets provide a source of diversification away from traditional developed economies and have the potential to deliver higher longer-term returns, given the higher volatility. Below, we summarise the 'bull' case for investing in emerging markets, with a particular focus on Chinese equities:

- **China is on track** to becoming the world's largest economy. The Belt and Road initiative, among others, is one example of how their global influence is set to continue to increase. This is China's global infrastructure development strategy to invest in nearly 70 countries and international organisations with the purpose of better connecting China to the world.
- **China's economy** is becoming more and more consumer-led and offers attractive investment opportunities in a large, liquid, and accessible market.
- **The Chinese Communist Party** shows no sign of relinquishing power. Therefore, they will use all the tools available to them to ensure that economic growth continues. Policy makers have kept a relatively tight grip on fiscal and monetary policy during the past 18 months compared to the other major economies. Consequently they have significant reserves of liquid and marketable assets to utilise and put to work should there be a shift to the downside for the economy[5].
- **China and other emerging market countries** are often well integrated into global supply chains and so are likely to benefit from global growth, as well as potentially benefiting from a more quickly growing domestic economy.

How to mitigate the risk of investing in China

If a pension scheme would like exposure to emerging market equities, but wants to mitigate potential concentration and political risks, then there are a few ways that this can be achieved:

- **If investing in emerging market equities,** ensure this is part of a broadly diversified equity portfolio.
- **If investing in passive emerging market index,** review the index being used and ensure you are comfortable with any country and sector risks in the context of your overall exposure – other indices are available that allow you to reduce the single country exposure (e.g. combining an ex. China index with a Chinese equity index fund). An alternative is to use an index that combines developed and emerging equities or investing in emerging market equities as part of a more diversified multi-asset portfolio.
- **If the concern is on the Environmental, Social and Governance issues,** consider a more a sustainably focused equity fund, again potentially investing across developed and emerging markets.
- **Consider allocations to other emerging market asset classes,** such as emerging market debt via a multi sector credit portfolio or a global investment grade corporate bond portfolio.

[5] **Source:** From Mao to Deng and now to Xi' viewpoint from Thanos Papasavvas, CFA.

Conclusion

This paper has highlighted the growth of China in emerging market equity indices, and some of the risks faced by pension schemes when investing in this market. In particular:

- **Emerging markets equities** have been used for many years in institutional portfolios for diversification purposes, and the case for emerging market equities remains strong, but investors must be aware of the risks involved.
- **China has become the biggest single country in most emerging market indices** (up to 40% in some cases) over the last few years, creating potential for significant concentration risk where not appropriately balanced within the overall portfolio. Hence it is important for investors to understand the particular nuances of investing in this market.
- **Political interference in the Chinese economy is on the rise,** and whilst this is not new to emerging market countries, it has led to some volatility in the Chinese equity market and future risks for shareholders in high profile Chinese domiciled businesses.

We recommend that pension schemes with material equity holdings should review their allocation to Chinese equities, and assess whether they have sufficient risk mitigants to allow for their current level of exposure.

If you would like to find out more on China and Emerging Markets or would like to understand how best to mitigate the risks of investing in these markets please contact Alasdair Gill or Dan Wood:

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