EM ex-China: opening doors to different opportunities

November 2023

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About Ninety One

Ninety One is an independent, active global asset manager dedicated to delivering compelling outcomes for its clients, managing more than USD$150 billion in assets (as of 9/30/2023). Established in South Africa in 1991, as Investec Asset Management, we started with domestic investments in an emerging market. Almost three decades of organic growth later, in 2020, the firm demerged from Investec Group and became Ninety One. Today, Ninety One offers distinctive active strategies to institutions, advisors and individual investors around the world.

In the Americas, Ninety One offers a full range of investment strategies and solutions spanning equity, fixed income, multi-asset, sustainable and alternatives led by specialist teams that invest across global, emerging and frontier markets. For more than a decade, the firm has been committed to clients in the US, Canada and Latin America, developing trusted partnerships by delivering local expertise with a global platform.

Ninety One aims to make a positive difference to people and the planet while delivering long-term investment returns. We do so through a robust and comprehensive integration of sustainability analysis and research into our investment processes.

What purpose does EM ex-China serve as an asset class?

There are widely differing views among asset owners around the benefits of investing in China and whether they should allocate to China or not. The world's second largest economy represents about 30%[1] of the MSCI Emerging Market Index and is the dominant constituent. Its weight doubled in five years and, despite the current market volatility, could continue to grow. To invest in China, or not, is rapidly becoming one of the biggest decisions for asset allocators.

Investors tend to adopt one of three possible approaches: a one-stop shop approach where the China allocation decision is delegated to a core emerging market (EM) equity manager; one where China is treated as a separate asset class through a dedicated China allocation; and one that excludes China entirely from portfolios.

What does the EM ex-China universe look like today?

With the removal of China from the benchmark, the three largest markets are Taiwan, India, and South Korea, which collectively make up ~60% of the benchmark.

As such, emerging Asia remains the largest region in EM ex-China and provides exposure to Asian manufacturing, technology innovation and interesting R&D opportunities. However, its weight at 68.5% is now just under 10% lower than its weight in the traditional emerging market benchmark.

1. Index figures quoted on this page refer to 30 September 2023.

For further information on indices, please see the Important information section.

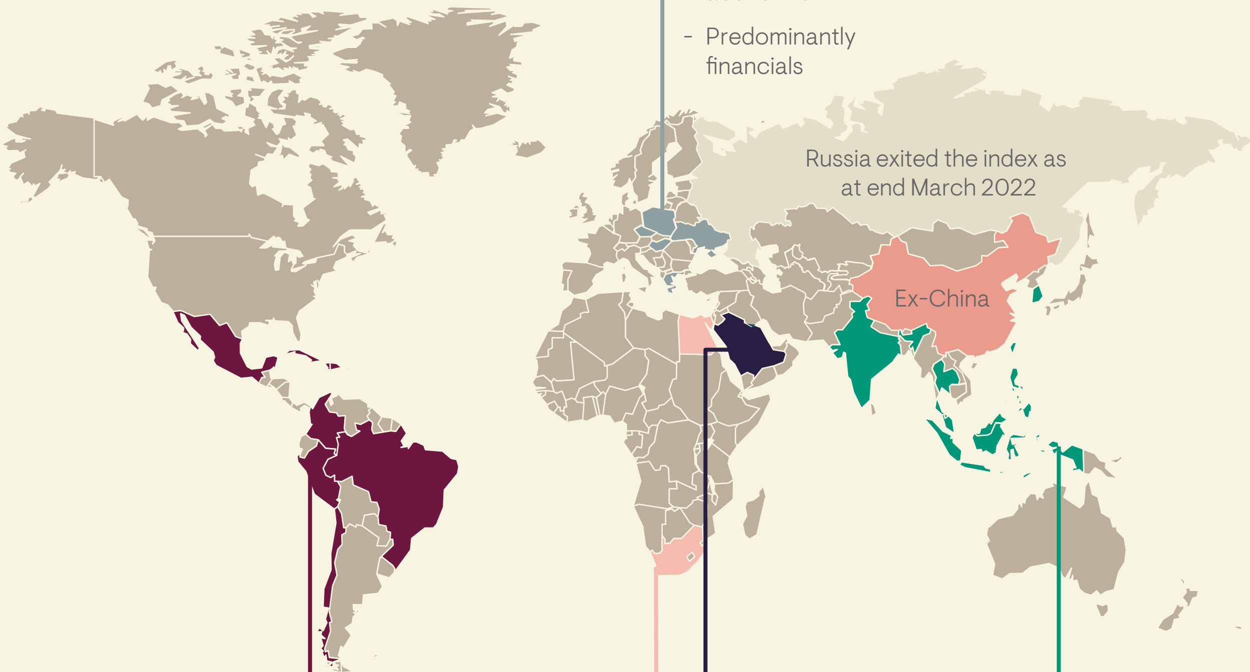
Below we illustrate the regional allocations (LHS) within the MSCI EM ex-China Index, and highlight how this allocation has either increased or decreased (RHS) relative to the traditional MSCI EM Index.

Figure 1: Regional allocation ex-China

2.3% ↑c.0.7% exposure

Eastern Europe

- Russia now zero percent. Was c.5% at beginning of 2022
- Eastern Europe exposure now just above 2%
- Predominantly financials



12.5% ↑c.3.8% exposure

Latin America

- Latin America exposure increases by 4%
- Access to inflation sensitive commodity exposure
- Pension and tax reforms in Brazil are changing the macro backdrop

4.5% ↑c.1.3% exposure

Africa

- Africa exposure increases by c.1.3%
- Materials and financials are the prominent sectors followed by staples and energy

11.5% ↑c.3.4% exposure

Middle East

- Middle East exposure increases by c.3%

69.3% ↓c.9.2% exposure

Emerging Asia

- Total Asia exposure reduces by 9% (by excluding China)
- Taiwan, the region's largest equity market ex-China, grows from c.16% – 23%
- Asian manufacturing, innovation in technology and strong research and development driving growth in Korea and Taiwan
- Indian/ASEAN market features consumer facing businesses which are developing wide moats
- Banking sector in India undergoing transformative M&A
- New green deal in South Korea

Source: MSCI, Ninety One, 30 September 2023.
For further information on indices, please see the Important information section.

Is the EM ex-China asset class worth investing in?

We spent two years researching whether this is an asset class that supports a discrete allocation. We based our analysis on four criteria:

1 **Breadth:** are there enough companies to invest in?

2 **Depth:** do we want to invest in these companies?

3 **Liquidity:** can we successfully build portfolios of companies we have conviction in?

4 **Fundamentals:** how different are risk-return characteristics vs EME?

Our analysis on each of these criteria follows.

1 **Breadth:** are there enough companies to invest in?

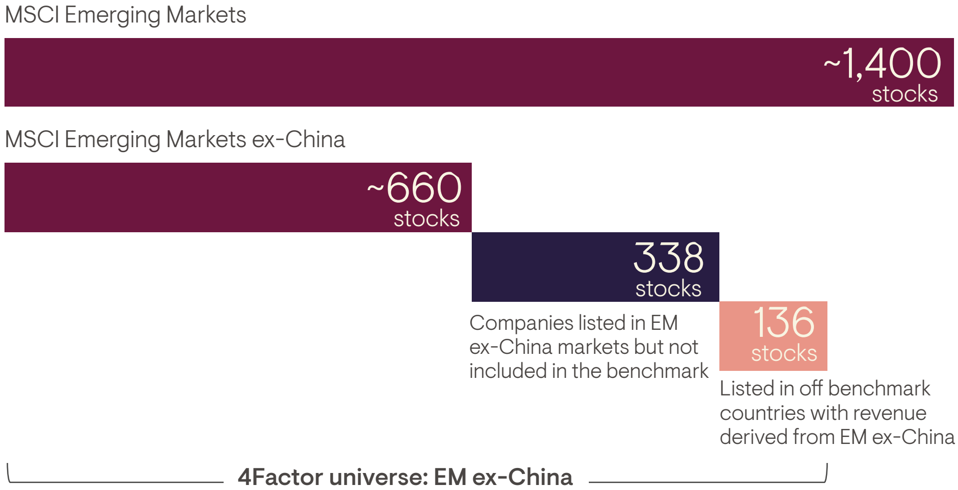
Excluding China from the emerging market (EM) universe is a significant investment decision because of its sheer weight in EM indices. The MSCI Emerging Markets Index is comprised of some 1,400 stocks, whereas the MSCI Emerging Markets ex-China Index is less than half that with ~665 stocks. Similarly, the FTSE Emerging Index includes ~2000 issuers with ~1,074 coming from China. These smaller universes could be a disincentive for investors.

Both of these classification frameworks also exclude companies headquartered in emerging markets, but listed in a developed nation.

While this approach to universe construction may be appropriate for ETFs and passive investments targeted at large retail markets, we believe that for active investors this narrow view of the universe does not adequately represent the opportunity set.

One can apply a broader stock selection methodology that considers businesses that are listed in EM ex-China markets (but do not make it into the index) as well as those that may be listed in non-benchmark countries, but which derive more than 50% of their revenues from EM ex-China. One example is Portugal-listed discount food retailer Jeronimo Martins*, which earns 74% of its revenues from Poland and Colombia. As a result, our EM ex-China investible universe has been expanded to ~1,140 companies, which we believe is a truer reflection of the opportunity set.

Figure 2: 4Factor process and resourcing expands our universe of ideas



No representation is being made that any investment will or is likely to achieve profits or losses similar to those achieved in the past, or that significant losses will be avoided.
Source: MSCI, Ninety One, 30 June 2023. These internal parameters are subject to change not necessarily with prior notification.
This is not a buy, sell or hold recommendation for any particular security. *We believe this stock represents the 4Factor investment philosophy and scores highly against a 4Factor scorecard.
For further information on specific portfolio names and how the overall strategy performed, please see the Important information section and page 14 of this paper.

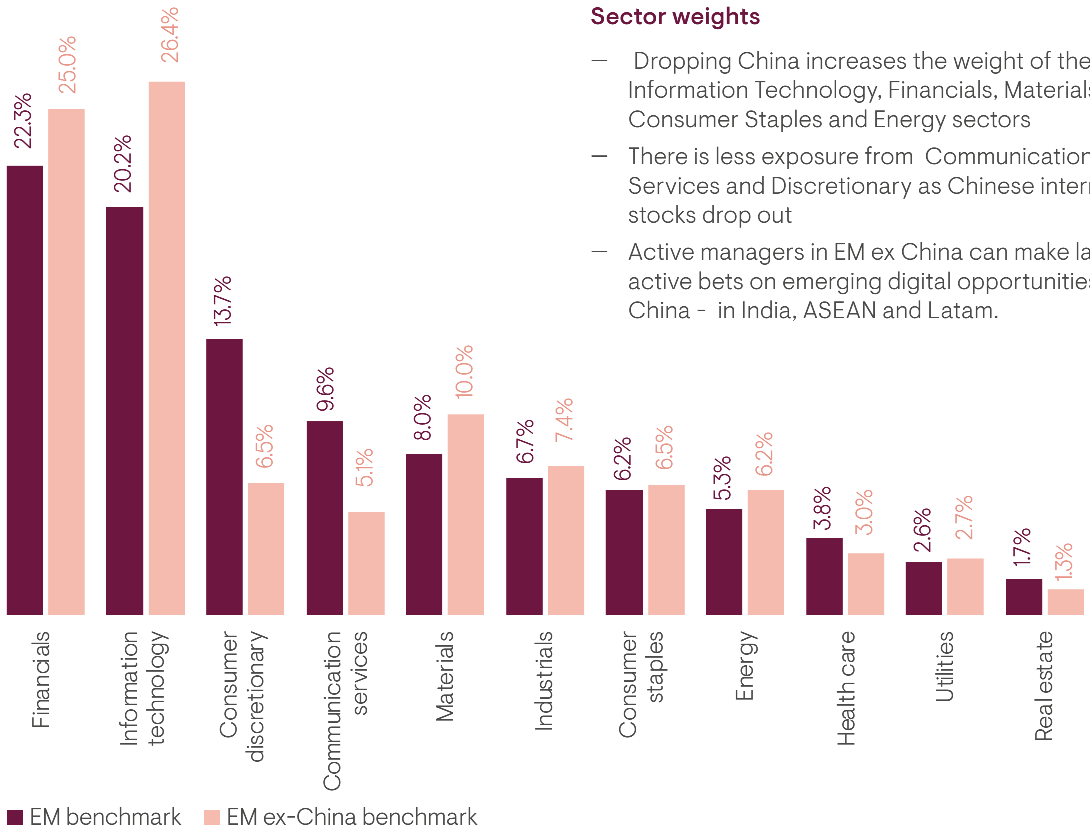
2 **Depth:** do we want to invest in these companies?

Having a large opportunity set is an important starting point. However, the next key consideration is whether there are enough exciting potential investments to select from.

One way to address this question is to consider the differences in sector composition between EM and EM ex-China benchmarks. The major differences are reduced exposure to communication services and consumer discretionary, while China internet stocks drop out. However, it is notable that the weight in information technology is higher. This is an important distinction – over the past four years there have been several digital opportunities that have come to the market in India, South Korea and Latin America.

At a more granular level, there is also evidence of this being a rich opportunity set. From the likes of low-cost leaders such as Walmart de Mexico, to companies that make the world a better place like LG Energy Solution (EV battery manufacturer) and India's Max Healthcare (hospital operator), to'infinity machines' such as TSMC and Varun Beverages, we believe that there are some compelling opportunities available to us as stock pickers.

Figure 3: Sector allocation ex-China



Sector weights

- Dropping China increases the weight of the Information Technology, Financials, Materials, Consumer Staples and Energy sectors
- There is less exposure from Communication Services and Discretionary as Chinese internet stocks drop out
- Active managers in EM ex China can make larger active bets on emerging digital opportunities ex China - in India, ASEAN and Latam.

No representation is being made that any investment will or is likely to achieve profits or losses similar to those achieved in the past, or that significant losses will be avoided.
Source: MSCI, Ninety One, 30 September 2023.

3 **Liquidity:** can we successfully build portfolios of companies we have conviction in

Liquidity is an important consideration, as we seek to build stakes in companies where we have strong conviction. While China is the most liquid market in the EM universe, the EM ex-China universe of companies is sufficiently liquid to build conviction portfolios, with a total market capitalisation of US$4.6 trillion[2] and an average market cap of US$6.9 billion. In comparison, the MSCI Emerging Markets Index has a total market cap of US$6.6 trillion and an average market cap of US$4.7 billion.

It is also worth noting that the EM ex-China universe has a similar concentration profile to the broader EM universe (Figure 4).

Investors had similar concerns about flows and average daily trade volumes when Japan was excluded from the Asian equity indices in 2001. At that time, Japan represented 73% of the MSCI pan Asian Index[3]. However, based on the Japan case study, we can surmise that both EM ex-China and China can attract flows if the underlying fundamentals remain intact.

Figure 4: Similar concentration profiles in MSCI EM and EM ex-China universes

Emerging markets

Top 10 constituents	Market	Float adj mkt cap (US$bn)	Index wt. (%)	Sector
Taiwan Semiconductor	TW	399.14	6.12	IT
Tencent Holdings	CN	262.03	4.02	Comms Serv
Samsung Electronics	KR	242.08	3.71	IT
Alibaba	CN	179.48	2.75	Cons Disc
Reliance Industries	IN	85.97	1.32	Energy
Meituan B	CN	74.24	1.14	Cons Disc
ICICI Bank	IN	59.35	0.91	Financials
PDD Holdings A ADR	CN	58.63	0.90	Cons Disc
Infosys	IN	57.27	0.88	Financials
China Construction BK H	IN	54.27	0.83	IT
Total		**1,472.59**	**22.57**	

Emerging markets ex-China

Top 10 constituents	Market	Float adj mkt cap (US$bn)	Index wt. (%)	Sector
Taiwan Semiconductor	TW	399.14	8.74	IT
Samsung Electronics	KR	242.08	5.30	IT
Reliance Industries	IN	85.97	1.88	Energy
ICICI Bank	IN	59.35	1.30	Financials
Infosys	IN	57.39	1.26	IT
HDFC Bank	IN	51.26	1.12	Financials
SK Hynix	KR	46.41	1.02	IT
Vale On	BR	45.96	1.01	Materials
Hon Hai Precision	TW	40.20	0.88	IT
Tata Consultancy	IN	38.87	0.85	IT
Total		**1,066.64**	**23.36**	

Source: FactSet, MSCI, Goldman Sachs Global Investment Research, Ninety One, 30 June 2023.
Note re market abbreviations: TW = Taiwan, CN = China, KR = South Korea, IN = India, BR = Brazil, SA = Saudi Arabia.
For further information on specific portfolio names, please see the Important information section.

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2. Market capitalisation figures as at 30 September 2023, MSCI.
3. Bloomberg, 30 September 2023.

4 What about the fundamentals: how different are risk-return characteristics vs EME?

Fundamentals for EM ex-China are attractive, and unsurprisingly very similar to that of the EM asset class.

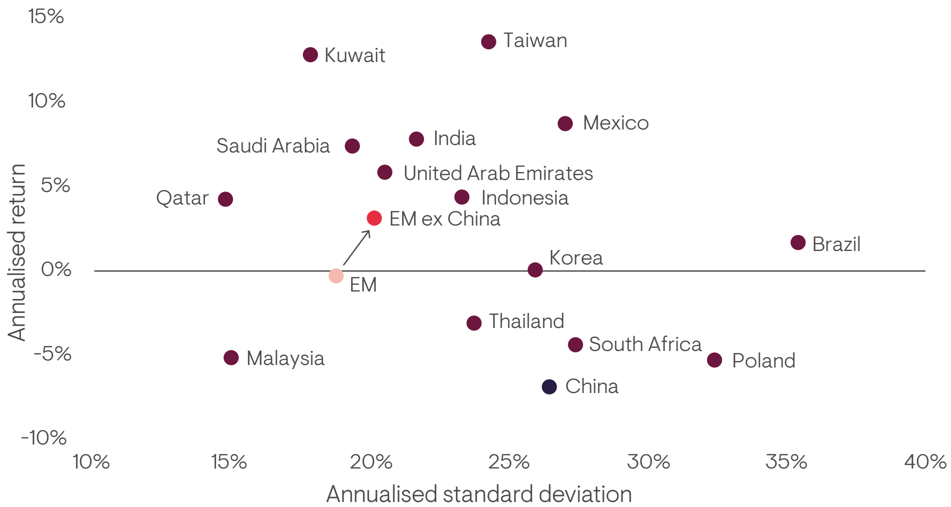
Figure 5: Comparing asset class fundamentals

Fundamentals	MSCI EM	MSCI EM ex-China	MSCI China
EPS Growth (2022-24 CAGR)	5%	1%	12%
12m PE (x)	11.6x	12.7x	9.7x
PEG (past 5 yr avg)	1.4x	1.8x	0.8x
ROE (past 5 yr avg)	12.0%	11.5%	12.4%
EPSg (past 5yr avg)	15.1%	14.4%	17.1%

Source: FactSet, MSCI, Goldman Sachs Global Investment Research, 30 September 2023. For further information on indices, please see the Important information section.

Notably, the risk-return credentials are also similar to EM. EM ex-China exhibits slightly higher risk for slightly higher returns potential.

Figure 6: EM ex-China has similar risk-return characteristics to EM



Source: FactSet, RIMES, MSCI, Morgan Stanley Research. Monthly USD total gross return data from June 2018 to May 2023. This analysis includes only top 15 largest markets in MSCI EM.

Alpha opportunities in the EM ex-China universe

As one would expect, EM ex-China markets tend to experience shorter, sharper cycles and are inherently less efficient than developed markets, driven by higher retail participation. Market efficiency refers to the degree to which market prices reflect all available, relevant information. For skilled bottom-up stock-pickers, therefore, there is more potential to generate alpha given greater dispersion in the market (the difference between the best and worst performers).

Secondly, ESG risks tend to be amplified in less mature markets, which can also be mitigated through active investment and engagement. Our 4Factor investment process seeks to take advantage of these mispriced opportunities.

Applying the 4Factor investment framework to emerging markets

We are dedicated to bottom-up investing. Our client proposition is to construct high conviction portfolios of high quality, attractively valued companies with improving operating performance that are receiving increasing investor attention. Our process relies on dedicated analysts with local knowledge and global skillsets consistently researching potential investment ideas. The 37-strong 4Factor team has 16 years' average experience. Within the team there are 13 emerging market specialists.

Our analysts assess how a company creates wealth, its capital management discipline, growth prospects, as well as its positioning and valuation relative to industry peers. They look for catalysts that can drive profitability higher, which are not fully appreciated by the market, while also identifying potential risks to future profitability. Environmental, social and governance (ESG) factors are evaluated to understand how they might impact the investment case.

Our investment process has been successful in emerging markets and has delivered relative outperformance since launching our core emerging market equity strategy in 2010.

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For further information on the investment team and investment process, please see the Important information section.

Strong relative performance over the long term

Figure 7: Strategy composite performance

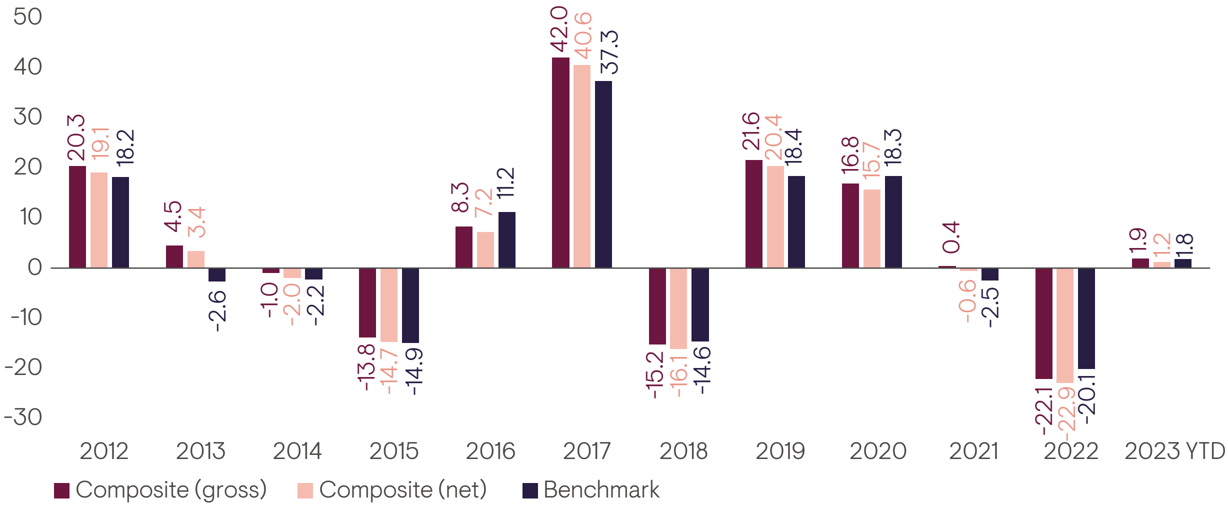

Figure 8: Emerging Markets trailing performance

	1 year	3 year p.a.	5 year p.a.	10 years p.a.	Since inception p.a.
Composite (gross)	10.2	-1.5	0.4	2.6	3.8
Composite (net)	9.1	-2.4	-0.6	1.6	2.7
Benchmark	11.7	-1.7	0.6	2.1	2.1

Past performance is not a reliable indicator of future results, losses may be made.

Source: Ninety One, 30 September 2023. Where performance is gross of fees, returns will be reduced by management fees and other expenses. Net performance is net of the highest institutional segregated portfolio management fee. Both gross and net returns are in USD, shown net of all trading expenses. Income is reinvested. 4Factor Emerging Markets Equity Strategy inception date: April 01, 2010. Benchmark: MSCI Emerging Markets NDR. Indices are shown for illustrative purposes only. For further information on indices please see the Important information section.

Does the 4Factor approach work for EM ex-China?

We launched our dedicated 4Factor EM ex-China strategy in December 2021. Prior to launching, we sought to understand whether we would be successful in delivering alpha in EM ex-China. One way to help answer this question is to analyse an ex-China carve-out of our core Emerging Markets Equity (EME) strategy which we have been managing since 2010, while noting that this is only indicative given that i) we construct the EM ex-China strategy distinctly from the ground up to optimise the opportunity set, and ii) when analysing the ex-China carve-out, we acknowledge there is no specific objective to outperform an ex-China benchmark, and if there had been this objective, it would likely have influenced portfolio allocation decisions along the way.

However, as we consistently apply the same 4Factor process to both EM universes, the two portfolios have a 69% overlap (in their ex-China positions) allowing us to glean three key insights from analysing the carve-out.

Firstly, the performance of the carve-out has been positive, as seen in Figure 9 below, outperforming the benchmark on both a gross and net of fees basis, since inception in 2010.

Secondly, we dissected country-level performance for our broader EM strategy. Notably, over two-thirds of our alpha came from ex-China while China represented the remaining 31%. It is important to note that China's weight in the EM index today is ~30%, suggesting that our alpha generation is commensurate with the weight of the country within the benchmark.

Finally, we looked at the contribution from off-benchmark positions. This is a relevant indicator given how we construct the broader EM ex-China universe for our process. The EM core strategy has an average weight of 5.7% off benchmark over the past 12 years. These positions generated just over 8% of the strategy's overall alpha profile, which suggests that we are rewarded when considering off benchmark positions.

Figure 9: EM ex-China carve-out performance since EME inception

	1 year	5 years p.a.	10 years p.a.	Since inception
Strategy (gross)	17.2	2.4	2.7	3.7
Strategy (net)	16.0	1.4	1.6	2.6
Benchmark	14.7	3.0	2.7	2.6
Relative (net)	1.4	-1.7	-1.1	0.1

Past performance does not predict future returns; losses may be made.
Performance does not represent actual trading and may not reflect the impact that material economic and market factors might have had on decision-making if actually managing client money.

Figure 9 source: Ninety One, 30 September 2023, Where performance is gross of fees, returns will be reduced by management fees and other expenses. Net performance is net of the highest institutional segregated portfolio management fee. Both gross and net returns are in USD, shown net of all trading expenses. Income is reinvested. Carve-out represents the Ninety One Emerging Markets Equity (EME) composite excluding China holdings since inception: 01 April 2010. The performance results of the total portfolio are available on request. Benchmark: MSCI Emerging Markets ex-China NDR.

How is the 4Factor EM ex-China strategy performing?

Our dedicated EM ex-China strategy launched, into tumultuous market conditions, in December 2021. After 12 months of operation, performance has been encouraging on a relative basis, as the following table shows.

Figure 10: EM ex-China: Excess return since inception to end-Sept 23

	1 year	Since inception
Strategy (gross)	14.9	-6.7
Strategy (net)	13.8	-7.7
Benchmark	14.7	-8.4
Relative (net)	-0.9	0.7

Past performance does not predict future returns; losses may be made.

Source: Ninety One, 30 September 2023. Where performance is gross of fees, returns will be reduced by management fees and other expenses. Net performance is net of the highest institutional segregated portfolio management fee.Both gross and net returns are in USD, shown net of all trading expenses. Income is reinvested. 4Factor Emerging Markets Equity ex China inception date: 1-Jan-22. The above returns relate to a child portfolio within the Emerging Markets Equity Strategy, were not attained by any client and are for illustrative purposes only. Additional and supporting information is available upon request. Benchmark: MSCI Emerging Markets ex-China NDR.

Conclusion

An asset allocation decision to emerging markets can be made in several flavours. Whether looking to express a positive, negative, or ambivalent view on China, the irrefutable fact is that China now represents over 30% of the MSCI Emerging Markets Index. It is this outsized dominance that has consequences for both portfolio managers and asset allocators. This lends itself to investigating the opportunity set in EM ex-China. Ninety One's 4Factor team has applied significant research to this question and as discussed in the preceding pages, believes that the available universe of stocks is deep, broad and, liquid and opens doors to different opportunities.

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