Perspectives

SEPT 2020

The Changing Landscape in EM Equity

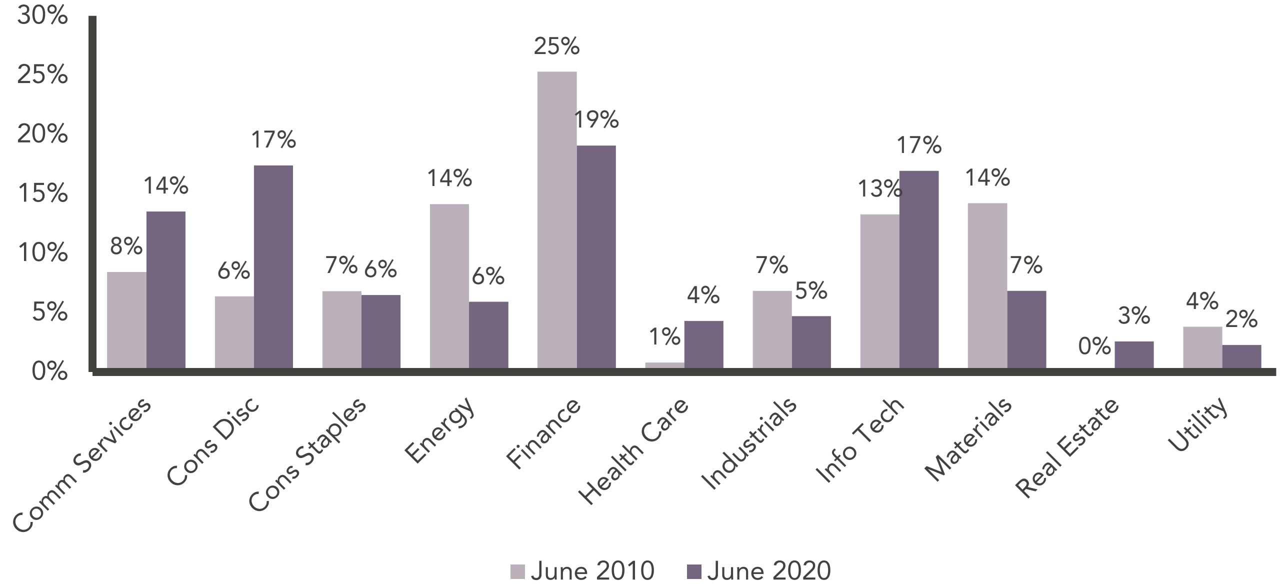
David Hernandez, CFA
Senior Research Analyst,
Non-U.S. Equities

Over the last ten years, the landscape for emerging market equities (EM) has changed. In the first decade of the century, BRIC investing was popular with an emphasis on materials and energy. Since then, the benchmark exposure to Brazil and Russia has halved, sector exposures have changed, and many new companies have entered the index. The number of stocks in the benchmark has nearly doubled, moving from 754 in 2010 to 1,385 in 2020. This newsletter will review some of the most significant changes to the EM investing arena and what that means for client portfolios.

EM: LESS ABOUT "ME" AND MORE ABOUT "IT"

In 2010, the EM Index was all about ME: materials and energy. These two sectors constituted 28% of the benchmark. Today, they account for half of that. In comparison, IT and Consumer Discretionary have nearly doubled, growing from 19% in 2010 to 34% in 2020. In September of 2018, MSCI[1] began including e-commerce companies (formerly classified as IT) under the Consumer Discretionary sector. Therefore, within discretionary there are many internet-based businesses. Alibaba — the largest stock in the index — serves as an example. Prior to 2018 it was classified within the IT sector, but it is now classified within the Consumer Discretionary sector.

Exhibit 1: MSCI EM Equity Index Sector Exposures[2]

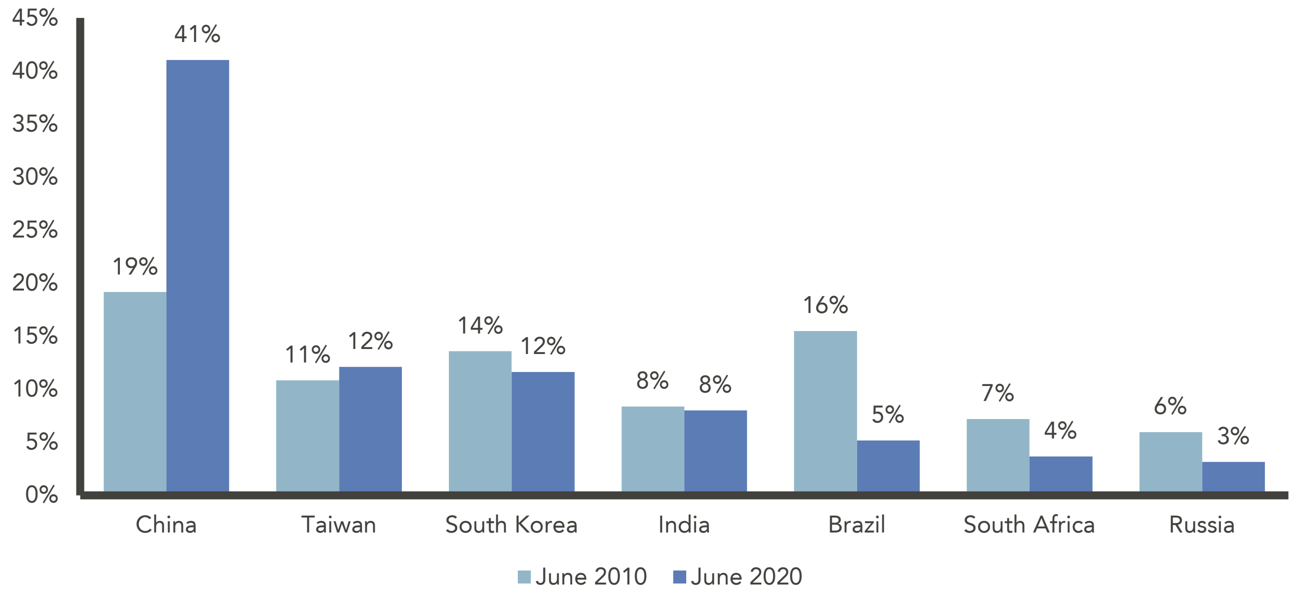


Source: Bloomberg

CHINA DOUBLES ITS SIZE

In December 2015, MSCI added Alibaba, Baidu, and several other overseas-listed Chinese shares to the EM Index. Previously, MSCI only included Chinese companies listed in Hong Kong. Many of these companies were internet and consumer oriented, more reflective of the new investment opportunity set within China. In 2018, MSCI took further inclusive steps when it added 239 A-share stocks. In 2019, the index provider added another 234 A-share stocks moving the inclusion factor[3] from 5% to 20%. For further information on the A-share inclusion, reference our previous newsletter, "MSCI Plans to Increase A-Share Exposure." As a result, China has become a larger part of the benchmark, growing from 19% in 2010 to 41% in 2020.

Exhibit 2: MSCI EM Equity Index Top Country Exposures



Source: Bloomberg

The increased exposure to China, consumer, and technology stocks has led to some dramatic changes to the top five companies in the MSCI EM Index. Two energy companies, Gazprom and Petroleo, have been replaced with Chinese mega-caps Alibaba and Tencent. These two stocks alone represent a 13.4% weight in the benchmark. The top five have moved from 9.2% of the index in 2010 to 22.9%. This is slightly higher than the S&P 500's top five (21.7%). Similar to the U.S. benchmark, the EM top five is comprised of IT, Consumer Discretionary, and Communication Services.

Exhibit 3: MSCI EM Equity Index Top Five Stocks

2010	Company	Benchmark Weight	2020	Company	Benchmark Weight
	Samsung	2.4%		Alibaba	7.0%
	China Mobile	2.0%		Tencent	6.4%
	Gazprom	1.7%		TSMC	4.5%
	Petroleo	1.6%		Samsung	3.6%
	TSMC	1.6%		Naspers	1.4%
	Top 5	9.2%		Top 5	22.9%

Source: Bloomberg as of June 2020

CONCLUSION & IMPACT ON PORTFOLIOS

Over the last ten years the investment landscape has changed for EM equities. The asset class has become less reliant on commodity prices and we see this as a positive. Investors can benefit from the larger investment opportunity set which includes companies that are capitalizing on technology trends that played out in the U.S. E-commerce, online payment processing, and social platform businesses serve as examples.

Many of these new opportunities have emerged in China, the second largest economy in the world. Some investors are concerned with the country's 41% allocation to the index. However, taking a broader view, China is still only 5.1% of the global equity benchmark, third to Japan (6.6%) and the U.S. (58.7%). Therefore, we believe the 41% is reasonable.

We do see the concentration at the top of the benchmark as a risk for investors. Compared to ten years ago, a handful of companies now have a much bigger influence on the index returns. Active management can mitigate this risk given the large investment universe. However, strong performance from the top stocks can serve as a headwind, something we have seen occur in recent years. Ultimately, emerging market equities will continue to serve as a common constituent in investor portfolios, but it is important to understand how the asset class has evolved over the last decade and how that will impact risk and return profiles in future years.

NOTES

[1] MSCI is the MSCI Emerging Markets Equity Index provider.
[2] The Real Estate sector was added in 2016. Previously a large portion of these stocks were in the Financials sector.
[3] Represents the proportion of the FIF-adjusted market capitalization of China A-shares included in the pro forma MSCI China Index.

PREPARED BY MARQUETTE ASSOCIATES

180 North LaSalle St, Ste 3500, Chicago, Illinois 60601
CHICAGO BALTIMORE MILWAUKEE PHILADELPHIA ST. LOUIS

PHONE 312-527-5500
WEB MarquetteAssociates.com

The sources of information used in this report are believed to be reliable. Marquette Associates, Inc. has not independently verified all of the information and its accuracy cannot be guaranteed. Opinions, estimates, projections and comments on financial market trends constitute our judgment and are subject to change without notice. References to specific securities are for illustrative purposes only and do not constitute recommendations. Past performance does not guarantee future results.

Marquette is an independent investment adviser registered under the Investment Advisers Act of 1940, as amended. Registration does not imply a certain level of skill or training. More information about Marquette including our investment strategies, fees and objectives can be found in our ADV Part 2, which is available upon request.

About Marquette Associates

Marquette Associates is an independent investment consulting firm that guides institutional investment programs with a focused client service approach and careful research. Marquette has served a single mission since 1986 – enable institutions to become more effective investment stewards. Marquette is a completely independent and 100% employee-owned consultancy founded with the sole purpose of advising institutions.
For more information, please visit www.marquetteassociates.com.