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Split decision: Should investors separate China from EM equities?

Many investors are contemplating whether to separate China from the rest of their emerging market (EM) equity allocation. The case for separation is generally based on China's growing weight in broad EM benchmarks. We believe, however, that the key decision point is not China's dominance of the EM index, but the extent to which a standalone China equity allocation can be viewed as similar to an EM ex-China equity allocation. If they are, in effect, the "same thing," then the relative size of one to the other makes no practical difference.

With this in mind, we evaluated the similarity of the two allocations, using the MSCI China Index and the MSCI EM ex-China Index as proxies. Of course, no two countries/regions will ever be exactly the same, so our focus was on the degree of similarity and whether it is changing over time. We also used a variety of metrics to gauge similarity, recognizing that some may change more than others and that investors will weigh their relevance differently depending on their asset allocation approach.

In summary, we found that the case for separate China and EM ex-China allocations is:

- **Strong** if the decision is based on **factors or return drivers**
- **Growing** if the decision is based on **economic (sector) composition**
- **Supportive** if the decision is based on **co-movement metrics**
- **Inconclusive** if the decision is based on **risk and return metrics**

In this paper, we discuss these findings in detail and also touch briefly on practical considerations for those establishing separate China and EM ex-China allocations, including the challenge of a limited universe of EM ex-China strategies.

The security-selection arguments for separation

In addition to using the “similarity” lens, we think it’s worth considering the China/EM ex-China separation decision from the standpoint of security selection. Here, there are generally two arguments for carving out distinct allocations:

1. The ability to apply a broader and more consistent security-selection budget across China and EM ex-China

— Even if the two markets were substantially similar, separate allocations could still be warranted, in order to avoid the risk that bottom-up security selection leads to unbalanced or unfulfilled alpha extraction. For example, a portfolio manager running a single allocation across global emerging markets (GEM) may hold only a few stocks in China, depending on how the security-selection budget is apportioned across different regions. A standalone China allocation, on the other hand, ensures that security selection is fully and consistently applied across Chinese equities — a market that our research suggests has significant idiosyncratic alpha potential.

2. The ability to add more alpha through greater geographic focus

— We find this argument — that a separate allocation will enhance alpha potential because the portfolio management team will be focused exclusively on Chinese equities — more nuanced. A GEM portfolio management team could conceivably have more China-focused analysts than a dedicated China portfolio management team. While we’ll grant that this may not be likely, it speaks to the point that the “specialization” argument is really about resources and focus rather than the merits of separation.

Co-movement similarity

Looking across a number of metrics, including correlation and “hit rate,”¹ we found a strong coincident relationship between China and EM ex-China (FIGURE 1), which could support treating them as “the same thing.” However, we saw similarly strong relationships between other markets, and even some cases where there is greater evidence of co-movement between markets in which investors have long tended to separate their allocations (e.g., the US and Europe).

FIGURE 1

Key coincident relationships

Hit rate

	EM				
	China	ex-China	US	Japan	Europe
China	1.00	0.78	0.69	0.68	0.69
EM ex-China	0.78	1.00	0.75	0.69	0.74
US	0.69	0.75	1.00	0.70	0.80
Japan	0.68	0.69	0.70	1.00	0.74
Europe	0.69	0.74	0.80	0.74	1.00

Correlation

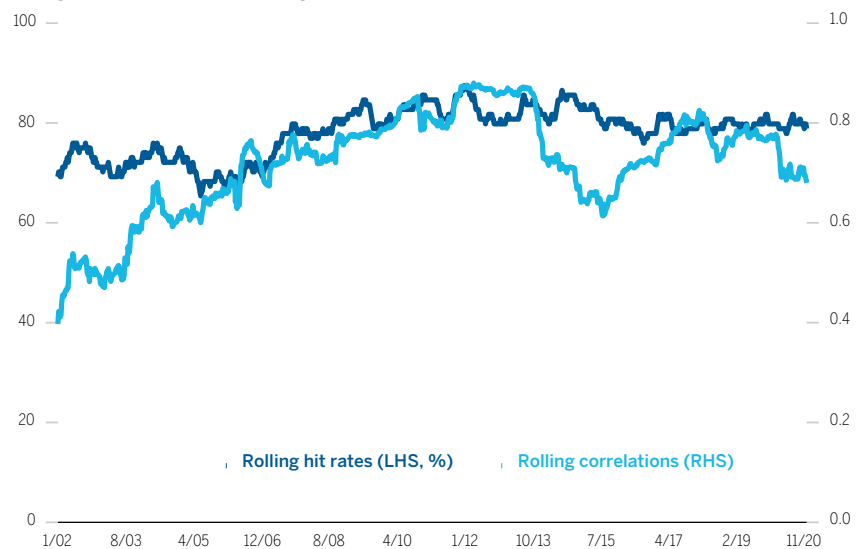
	EM				
	China	ex-China	US	Japan	Europe
China	1.00	0.69	0.49	0.51	0.51
EM ex-China	0.69	1.00	0.70	0.58	0.73
US	0.49	0.70	1.00	0.55	0.82
Japan	0.51	0.58	0.55	1.00	0.63
Europe	0.51	0.73	0.82	0.63	1.00

PAST RESULTS ARE NOT NECESSARILY INDICATIVE OF FUTURE RESULTS AND AN INVESTMENT CAN LOSE VALUE. | Sources: MSCI, Bloomberg | Chart data: 1 July 2000 – 12 March 2021

We also found that the relationship between China and EM ex-China has been inconsistent over time (FIGURE 2) — a potential argument for separation.

FIGURE 2

An up and down relationship



PAST RESULTS ARE NOT NECESSARILY INDICATIVE OF FUTURE RESULTS AND AN INVESTMENT CAN LOSE VALUE. | Sources: MSCI, Bloomberg | Rolling two years of weekly data from January 2002 to December 2020

¹Hit rate is the percentage of time the markets move in the same direction, regardless of magnitude

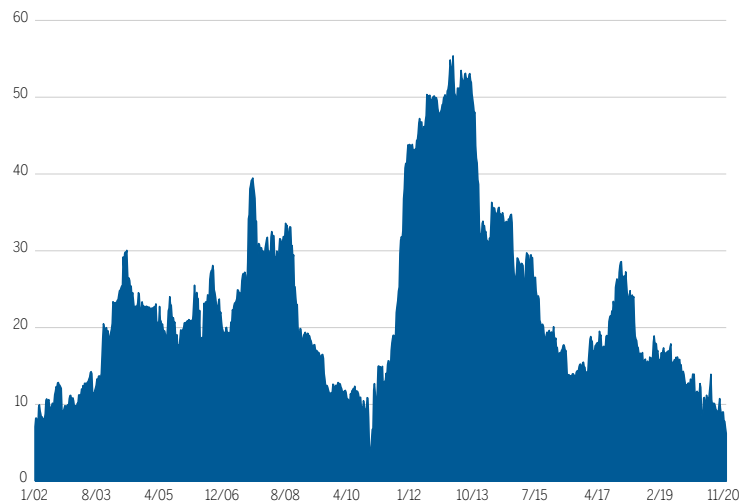
Return-driver similarity

We found a low and declining level of similarity in the two markets' return drivers, potentially supporting the case for separate allocations. **FIGURE 3** shows the output from regressing the returns of EM ex-China equities on the returns of China equities and vice versa — in other words, the changing degree to which each explains the returns of the other.² Aside from a brief increase from 2010 to 2014, the co-driver relationship was generally weak, with a notable decline in recent years (while we use R-squared data in this chart, we found a similar result using the rolling T-stat).

FIGURE 3

Measuring the rolling co-driver relationship

Rolling explained variation (R^2)

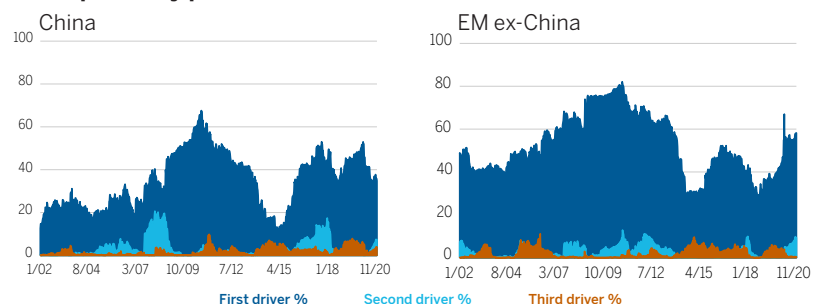


PAST RESULTS ARE NOT NECESSARILY INDICATIVE OF FUTURE RESULTS AND AN INVESTMENT CAN LOSE VALUE. | Sources: MSCI, Bloomberg | Rolling two years of weekly data from January 2002 to December 2020

We also looked at the role of common external drivers in explaining the returns of the two markets. We used principal component analysis (PCA)³ to estimate three drivers or “PCA vectors” from the returns of non-EM/non-China equity markets (Japan, Europe, and the US). Then we used those PCA vectors as proxies for the external drivers, regressing them against China and EM ex-China returns, respectively. The analysis (**Figure 4**) suggests these common external factors are more important for EM ex-China (explaining two-thirds of the variation in returns) than for China (explaining one-third of the variation in returns).

FIGURE 4

The explanatory power of common external drivers



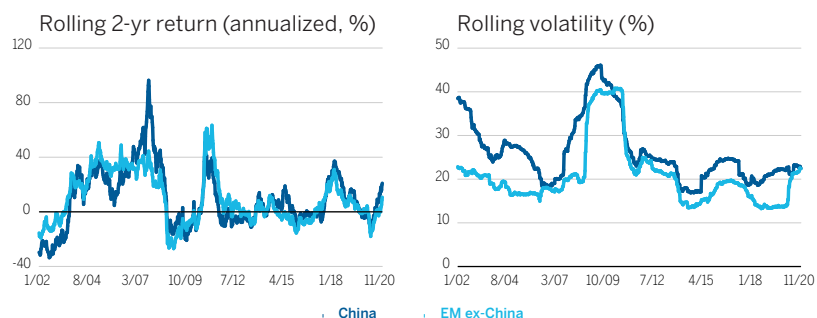
²To remove the broad equity dynamic, this analysis used returns in excess of global equities | ³PCA is a statistical technique in which none of the drivers are predefined but are instead discerned from the raw data over some rolling window, with the result that the drivers can and do change over time

Risk and return similarity

While the risk and return characteristics of the two markets have changed significantly over time, they have tended to change similarly in each, likely making it too early to separate the two on this basis. For example, **FIGURE 5** shows rolling two-year returns and volatility of the markets over time. Both markets experienced a decline in volatility, while returns generally settled into a somewhat narrower band. We also found broad but similar changes in the two markets when we looked at historical return and volatility distribution data.

FIGURE 5

Return and volatility characteristics of China and EM ex-China



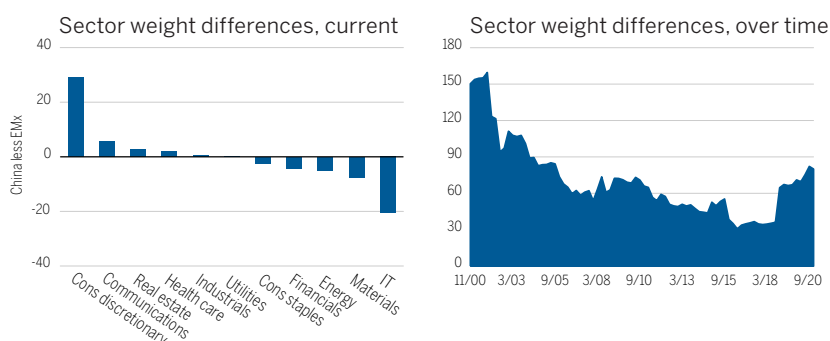
PAST RESULTS ARE NOT NECESSARILY INDICATIVE OF FUTURE RESULTS AND AN INVESTMENT CAN LOSE VALUE. | Sources: MSCI, Bloomberg | Rolling two years of weekly data from January 2002 to December 2020

Sector and factor composition similarity

FIGURE 6 shows the current differences in the sector composition of the China and EM ex-China indices (left chart) and the summed absolute differences in sector weights over time (right chart). After a lengthy period of decline in the sector weight differences, the two markets have started to diverge in recent years. For now, though, the differences remain historically small.

FIGURE 6

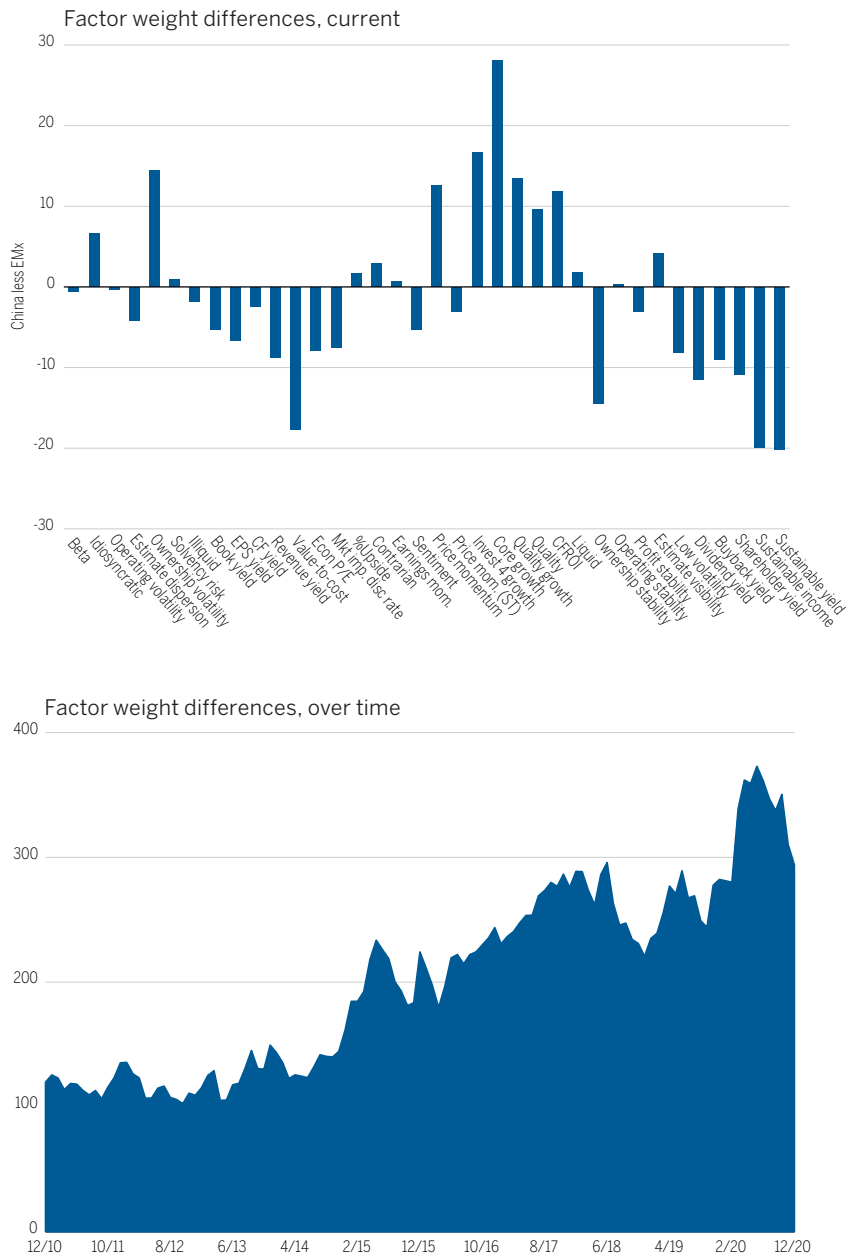
Early signs of divergence in sector composition



PAST RESULTS ARE NOT NECESSARILY INDICATIVE OF FUTURE RESULTS AND AN INVESTMENT CAN LOSE VALUE. | Sources: MSCI, Bloomberg | Left chart data is as of December 2020. Right chart data is quarterly from Q402 to Q420

From a factor standpoint, however, the markets have been diverging for some time now. **Figure 7**, based on our team's proprietary factors, shows quite large differences in current factor weights (top chart) and a clear trend of growing factor weight differences over time (bottom chart).

FIGURE 7

Strong divergence in factor composition

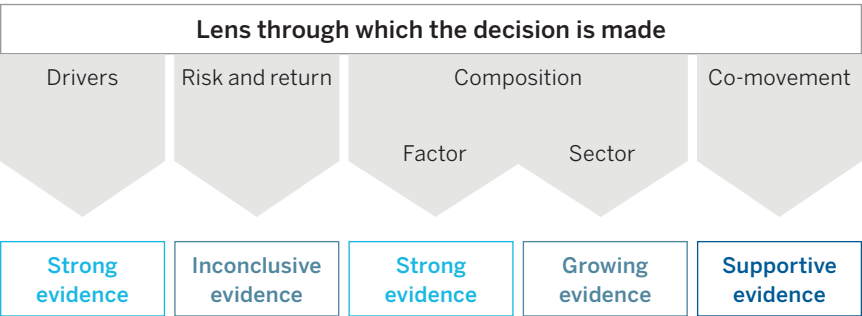
PAST RESULTS ARE NOT NECESSARILY INDICATIVE OF FUTURE RESULTS AND AN INVESTMENT CAN LOSE VALUE. | Source: Wellington Management | Top chart data is as of December 2020. Bottom chart data is quarterly from December 2010 to December 2020

Research summary and practical considerations

We believe the decision to separate China from the rest of EM in an equity portfolio should be based on the investor's view about whether the two allocations are similar or not. This view will depend on the lens being used. **FIGURE 8** highlights the results for the set of lenses we selected. To summarize, we found strong evidence for separate allocations if the decision is based on return drivers or factors; growing evidence if the decision is based on sector composition; supportive evidence if the decision is based on co-movement, though this is a personal choice as other regions with similar co-movement metrics are often separated; and inconclusive evidence if the decision is based on realized risk and return.

Turning to practicalities, one challenge for investors who opt for separate allocations is the limited universe of EM ex-China strategies. While this may improve in the future, investors currently are restricted largely to either passive implementation or active strategies with a relatively short track record. We believe one potential solution is to pair a broad GEM equity allocation with a satellite China allocation. This approach not only preserves the ability to access a large universe of active GEM strategies (versus a smaller universe of EM ex-China strategies), but it also allows for a larger allocation to China than that implied by the GEM index. And, in fact, based on our research into the optimal size of a China allocation (which we would be happy to share upon request), we believe investors should consider a larger-than-benchmark exposure. ■

FIGURE 8
Should China and EM ex-China be separate allocations?



Read more on China and EM allocations

- [“Allocating to China — a deeper dive by asset class”](#)
- [“A is for allocation: The rationale for increasing exposure to China”](#)
- [“EMs: With great challenges come great opportunities”](#)



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