Demerging China from emerging markets

Some investment professionals are calling for China to be removed from the main emerging markets indices.

The MSCI Emerging Markets Index is the leading emerging markets (EM) index, with over 1,400 constituents covering 26 countries. The value of investment capital either tracking or benchmarked against it measures in the trillions of dollars, a following that means any changes to the index have potentially wide implications. Likewise, large adjustments could be particularly disruptive as many investment managers would have to buy and sell shares to mirror the revised structure of the index.

This problem raised its head a few years ago as MSCI decided to increase the weighting of China in the index. Although the country remains under-represented in the index, it already accounts for nearly 35% (as at the end of October 2021). The next largest constituent country, ironically Taiwan, counts for 14.7%.

China’s weighting in the index has doubled over the last five years, although at present much of this is through Chinese companies, such as Alibaba, whose shares are listed outside China. In time, China could account for over 40% of the index.

Recently, Goldman Sachs, the major US investment bank, published a paper examining whether the time had arrived to separate China from the EM index it was coming to dominate. The authors of the paper argued that China deserved to stand alone for a variety of reasons, including:

- It has the second largest global equity market after the US, worth $18 trillion with nearly 6,000 listed stocks.
- It dominates the EM index and is already has the largest single country weighting in the index’s history.
- China is a country subject to “idiosyncratic factors”. This is the bankers’ careful way of saying that the country of President Xi Jinping has a different geopolitical stance from many other EM countries and, of late, a somewhat unpredictable regulatory policy.

The paper has provoked much comment and served as a useful reminder of two facts for individual investors in the UK:

- China is too big a market to ignore; and
- If you are investing in index-tracking funds, it pays to understand what the underlying constituents are.

The value of your investment and any income from it can go down as well as up and you may not get back the full amount you invested. Past performance is not a reliable indicator of future performance. Investing in shares should be regarded as a long-term investment and should fit in with your overall attitude to risk and financial circumstances.

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