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Emerging Markets—Beyond China

China has exhibited one of the most transformational evolutions ever seen in emerging markets (EMs), with its weight in the MSCI EM Index doubling over the past five years. But China's own dynamic and mega-cap stocks have somehow skewed EM benchmarks' performance. We believe that beyond China, EMs offer an attractive and differentiated opportunity set—one which drove our launch of our EM ex China Growth strategy. In this Q&A, Romina Graiver, partner, a portfolio specialist on our global equity team, discusses the opportunity set and process driving our strategy.

March 2023

Portfolio Specialist
Romina Graiver, Partner

Emerging Markets—Beyond China

Why did William Blair launch an EM ex China strategy?

Romina: In brief, China has become the predominant market within EM indices, and while there would likely be some setbacks over shorter time periods, the country's weighting appears poised to continue increasing over the long term amid the continued development of the equity market, growth and innovation, and further integration of China A-shares.

A natural consequence of the prominence of China's inclusion in main benchmarks, market depth, and unique characteristics is that some investors may wish to implement a dedicated strategic allocation to China, seeking to benefit from the abundant alpha opportunities China offers across sectors, market caps, and share classes. Another consequence is that the focus on the vast China opportunities may overshadow attractive investments in smaller emerging markets.

By launching our EM ex China Growth strategy, we seek to offer the potential for alpha generation across sectors, regions, and market capitalizations in the broad EM space—in Asia; Emerging Europe, Middle East and Africa (EMEA); and Latin America. This allows investors to have a deeper exposure to EM investment opportunities and complement a China allocation, including a zero allocation.

Just how big a role in EM indices does China play, and can you go into more detail about how that influenced the decision to launch an EM ex China Growth strategy?

Romina: Through its deep transformation and successful economic growth over the past decades, China has become the second-largest world economy, and Chinese companies have capitalized on changes in consumer patterns and scale and have become an engine of innovation and sustainable value creation.

A natural consequence of this is that China's weighting in the MSCI EM Index has increased from almost nonexistent in 2000 to 35% in 2022.

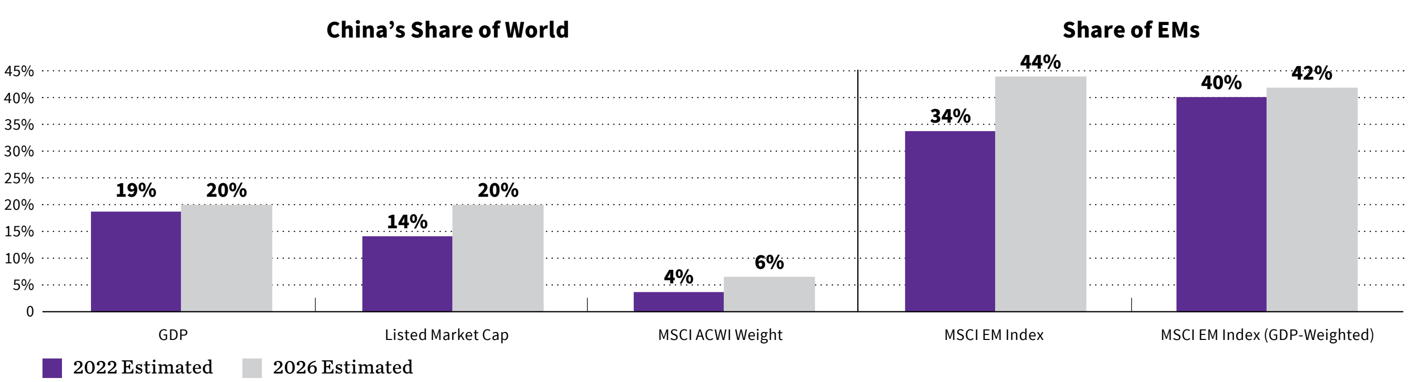
That said, China is still not even fully represented in the MSCI EM Index because the index artificially caps its domestic China A-share weighting, applying an inclusion factor of 20% to China A-shares. If this inclusion factor were 100%, China would represent closer to 45% of the index.

As China's share of world gross domestic product (GDP) and listed market cap increases, so should its weight in both the MSCI All Country World Index (ACWI) and MSCI EM Index. Currently, China's share of world GDP is 19% and its share of listed market cap is 14%. These numbers are expected to rise to 20% for both. As that happens, China's weight in the MSCI ACWI and MSCI EM Index should continue to increase, as exhibit 1 illustrates.

EXHIBIT 1

How China's Index Weighting Could Increase

We believe China's weightings in the MSCI ACWI and MSCI EM Index are likely to converge with its economic exposure over the next five years.



Sources: Goldman Sachs and William Blair, as of December 31, 2022.

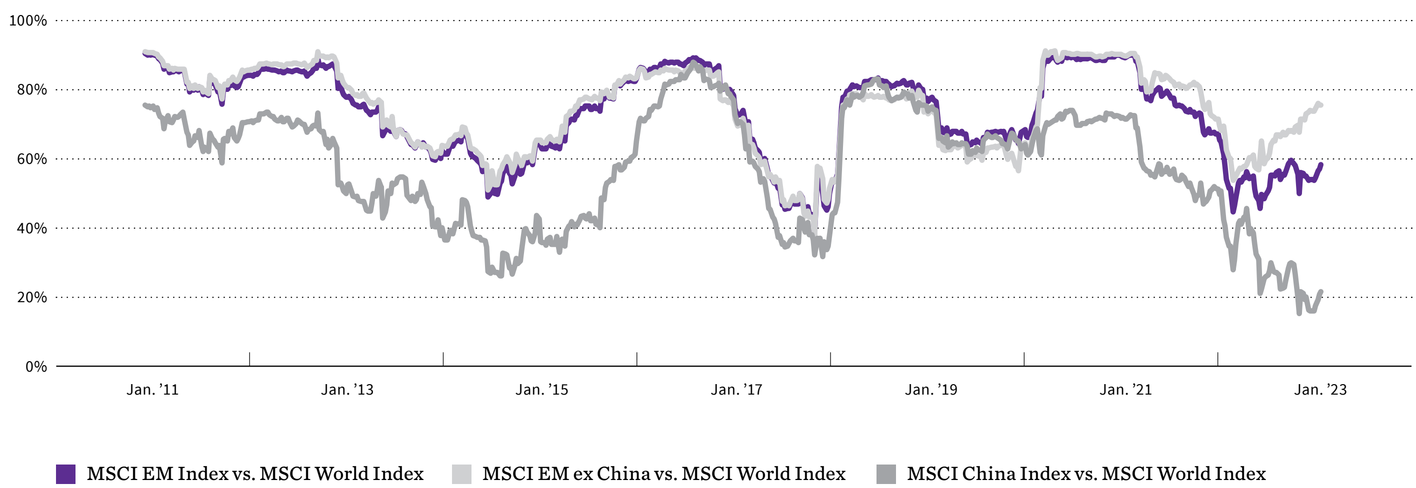
As a single country becomes such a prominent weight in the benchmark, its performance has an overwhelming impact on the entire asset class, blurring the contribution from smaller countries. As a result, it makes sense to differentiate that market from the rest of the space.

This is even more important in the case of China, as its specific macroeconomic, political, and regulatory developments have had a dominant impact on its equity market performance, and was largely desynchronized with the rest of emerging and developed markets. Exhibit 2 illustrates the decreased correlation between China and other EMs and China and the developed world.

EXHIBIT 2

Decreased Correlations Between China and Other Markets

Rolling 52-week correlations between various indices shows a decreased correlation between China and other EMs as well as China and the developed world.



Source: Goldman Sachs and William Blair, as of February 2023. **Past performance is not indicative of future returns.** Indices are unmanaged and do not incur fees or expenses. A direct investment in an unmanaged index is not possible.

Emerging Markets—Beyond China (continued)

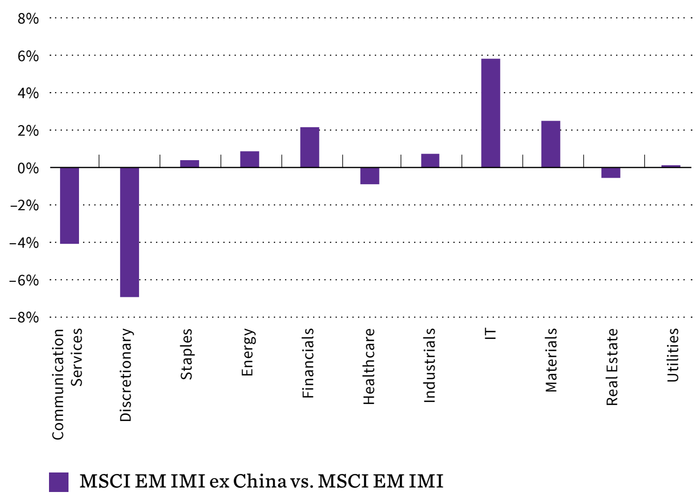
How is the EM ex China Growth opportunity set different from the broad EM opportunity set?

Romina: Ex China, EMs have much more technology (particularly semiconductor and broad hardware), materials, and financials and less consumer discretionary and communications services than the MSCI EM Investable Market Index (IMI), as exhibit 3 shows. Heavyweights in these sectors such as Tencent, Alibaba, Meituan, and JD.com are eliminated. The MSCI EM ex China Index also has a higher weighting in commodities than the MSCI China Index, as exhibit 4 shows.

EXHIBIT 3

Sector Weights Differ When China Is Excluded

Ex China, EMs have more technology, materials, and financials stocks and fewer consumer discretionary and communication services stocks.



Sources: MSCI and William Blair, as of January 2023. Shows sector weight spreads.

EXHIBIT 4

Commodity Sector Weights, China vs. Ex China Indices

Excluding China increases commodity weightings.

Sources: Factset, Goldman Sachs, MSCI, and William Blair, as of January 31, 2023. EMs ex China are represented by the MSCI EM ex China Index. China is represented by the MSCI China Index.

From a regional perspective, as would be expected, when China is excluded, there is less exposure to Asia: Asia represents almost 80% of the MSCI EM Index and 70% in the MSCI EM ex China IMI.

Eliminating China also boosts the weight of EMEA and Latin America by 5.5% and 3.8%, respectively, vs. the MSCI EM IMI.

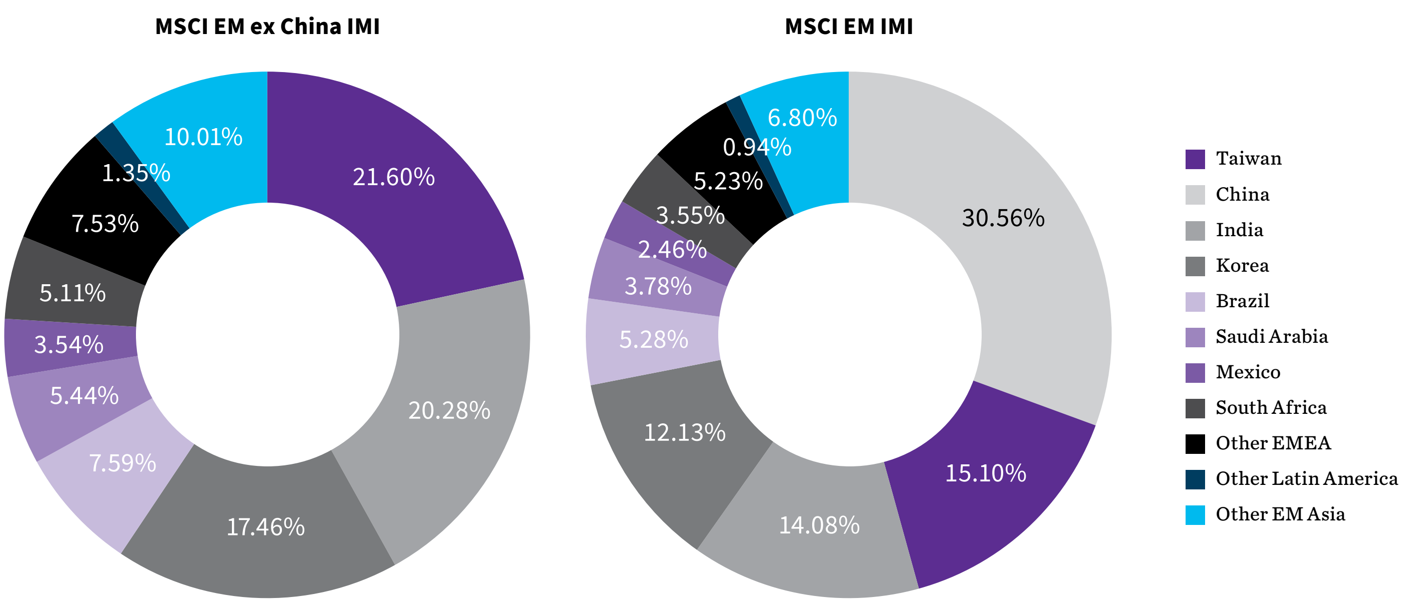
Exhibit 5 shows the country weightings in the MSCI EM IMI vs. the MSCI EM ex China IMI. Taiwan becomes the largest market in the MSCI EM ex China IMI, alongside India and Korea. But every other market, from Brazil to Mexico, gets boosted as well. This certainly provides a more balanced representation of EM countries within Asia and regions other than Asia.

> "EMs other than China get a big weighting boost when China is eliminated from the index."
>
> **Romina Graiver, Partner**

EXHIBIT 5

Country-Weighted Comparison of China vs. Ex China Indices

EMs other than China get a big weighting boost when China is eliminated from the index, providing a more balanced country representation.



Sources: MSCI and William Blair, as of December 2022.

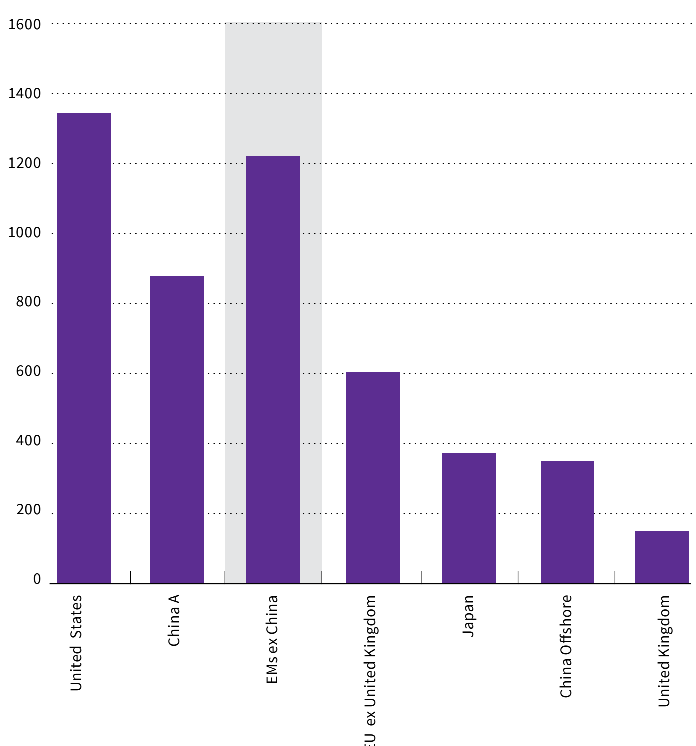
What does the investable opportunity look like when you remove China?

Romina: Even after removing China, EMs offer a deep opportunity set with more than 1,000 listed larger-cap stocks (those with at least $2 billion of market cap). More than half of those trade at least $10 million per day. That suggests that there are significant investable opportunities in EMs ex China. For comparison purposes, exhibit 6 shows the number of listed stocks with greater than $2 billion in market cap for other indices.

EXHIBIT 6

Broad Opportunity Set for EMs Ex China

Outside of China, the number of listed stocks with greater than $2 billion in market cap is compelling.



Sources: FactSet, MSCI, Bloomberg, Goldman Sachs Global Investment Research, and William Blair, as of February 3, 2023.

EXHIBIT 7

Attractive Fundamental Characteristics

EM ex China stocks have higher ROE.

	MSCI EM IMI	MSCI EM ex China IMI
Quality		
ROE	16.26	18.49
Cash Flow ROIC	16.79	18.13
Debt-to-Equity Ratio	78.15	82.16
EPS: Long-Term Growth	13.84	12.88
EPS Growth: Five-Year Historic	11.1	9.54
Reinvestment Rate	11.51	12.1
Valuation		
P/E Ratio	14.32	13.73
Dividend Yield	3.17	3.61

Sources: MSCI and William Blair, as of January 31, 2023. ROE refers to return on equity. ROIC refers to return on invested capital. P/E ratio refers to price-to-earnings ratio. EPS refers to earnings per share. Indices are unmanaged and do not incur fees or expenses. A direct investment in an unmanaged index is not possible.

Meanwhile, quality characteristics of EMs ex China are attractive, as illustrated by higher return on equity (ROE) and cash flow return on invested capital (CFROIC) for the MSCI EM ex China IMI versus the MSCI EM IMI. In addition, while the MSCI EM ex China IMI's historic earnings per share (EPS) growth has lagged the broad index including China, earnings growth expectations show a marked improvement for the MSCI EM ex China IMI and valuations are more attractive.

Not surprisingly, EM ex China companies are well represented in our quality growth investment universe (our eligibility list). Our eligibility list, as of January 2023, includes 48% EM stocks, of which 68% are EM ex China names. That gives us approximately 650 EM ex China names to draw from.

What are attractive areas in EM ex China, in your view?

Romina: EMs have experienced significant changes over the past decade. Their key drivers are now largely growth sectors, such as IT and consumer, reflecting increased innovation and income growth and contrasting with the largely dominating commodity plays of the past.

The changing face of EMs has been underpinned by a surge of innovative, digitally enabled business models in e-commerce, communications services, and fintech, to name just a few areas. This phenomenon has been a key development in China—but also outside of China.

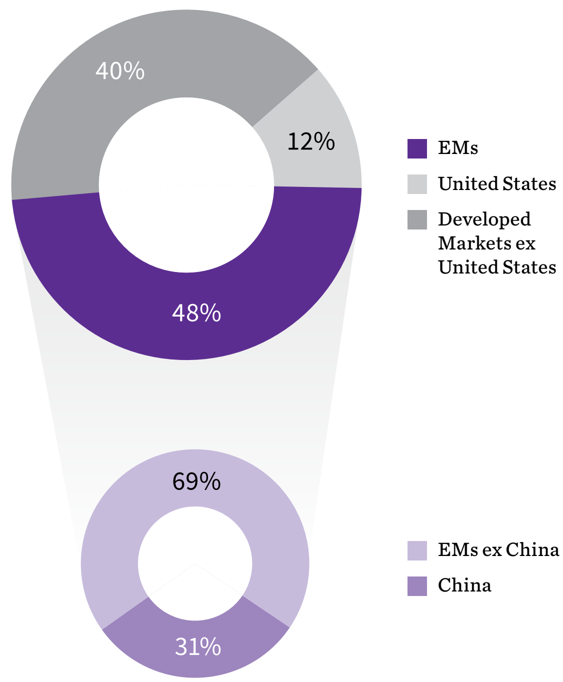
So, IT is a key theme in EMs ex China (IT and tech-related sectors account for 32% of the MSCI EM ex China IMI, close to 37% of the MSCI USA IMI, and well ahead of other developed markets, as exhibit 9 illustrates). Within IT, EM ex China has a clear leadership in semiconductors and hardware, which are export-oriented and driven by global demand. In addition, financials are also a key sector; this provides more domestic exposure.

From a geographic perspective, India is a key market in the MSCI EM ex China IMI and a very attractive opportunity set for us, as my colleague Casey Preyss described in his blog post, *5 Growth Opportunities in India*.

EXHIBIT 8

William Blair Global Team Eligibility List

EM ex China accounts for 33% of our global eligibility list.

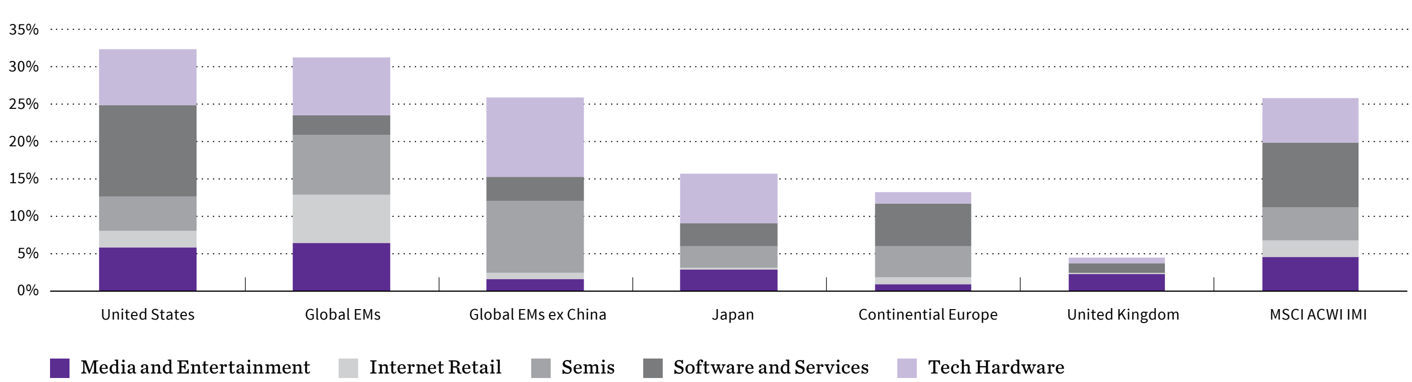


Source: William Blair, as of January 2023. The 33% refers to 69% of 48%.

EXHIBIT 9

Tech Market Share by Region Favors EMs

The changing face of EMs has been underpinned by a surge in innovative, digitally enabled business models combined with technological leadership in hardware and semiconductors.



Source: William Blair, as of January 2023. Regional breakdown based on the MSCI ACWI IMI.

Let's talk about the EM ex China Growth strategy. What is the origin of this strategy and its design?

Romina: Given the market and index developments; conversations with clients and consultants; and an analysis of our expertise, track record, and opportunity set, we decided to launch our EM ex China Growth strategy in 2021. We first launched a private fund vehicle with seed money and sometime later launched a mutual fund in collaboration with an existing client in our broad EM Growth strategy.

The design of the strategy is similar to our long-standing flagship EM Growth strategy. That strategy offers broad exposure to high-quality growth names across EMs (including frontier markets) and sectors, and has a constant exposure to small-cap stocks. We believe this breadth provides broad sources of alpha, and is a differentiating feature of our EM ex China Growth strategy.

In addition to having a similar design as our EM Growth strategy, our EM ex China Growth strategy is managed by the same portfolio managers as the EM Growth strategy: Todd McClone, CFA, partner; Casey Preyss, CFA, partner; and Vivian Lin Thurston, CFA, partner, which further ensures consistency across these strategies.

Besides the China allocation, the main difference between our EM Growth strategy and our EM ex China Growth strategy is the number of holdings (typically 120 to 175 in EM Growth versus 80 to 130 in EM ex China Growth) and the maximum sector weighting (40% for EM Growth and 50% for EM ex China Growth). This is designed to reflect the opportunity set and larger IT weighting in the MSCI EM ex China IMI.

Naturally, the overlap between our EM ex China Growth and EM Growth strategies is typically high—greater than 90% as of January 2023. It is important to highlight that our EM ex China Growth strategy is actively managed by the team as a standalone strategy (meaning it is not an automatic carveout from our EM Growth strategy) and it continuously reflects what the team believes are the most attractive investment opportunities in EMs outside of China. In managing the strategy, the team leverages the full breadth of the team's platform, including attractive investment opportunities that are part of our EM Small Cap Growth strategy. Individual stock weightings are the result from conviction on fundamental thesis and portfolio fit as well as stock liquidity and, to some extent, weightings in the MSCI EM ex China IMI.

Sector, country, and market-cap positioning are generally consistent with our EM Growth strategy, with the most noticeable difference being a higher weighting in financials and IT and a lower weighting in consumers and industrials.

Style exposure in our EM ex China Growth strategy is consistent with all other EM strategies managed by the team. They typically display higher-quality characteristics and stronger growth than their respective benchmarks. These attractive fundamental metrics typically result in higher P/E multiples.

Is there any kind of negative screening for a company that may be domiciled in, say, India but derives a large component of its revenue from sales into China?

Romina: We don't look at geographic revenue to define eligibility (or non-eligibility) for this strategy. Our EM ex China Growth strategy does not invest in companies that have their principal offices in the People's Republic of China (PRC). Mainland China, Hong Kong, and Macau are included in the definition of PRC.

How do you think about Taiwan?

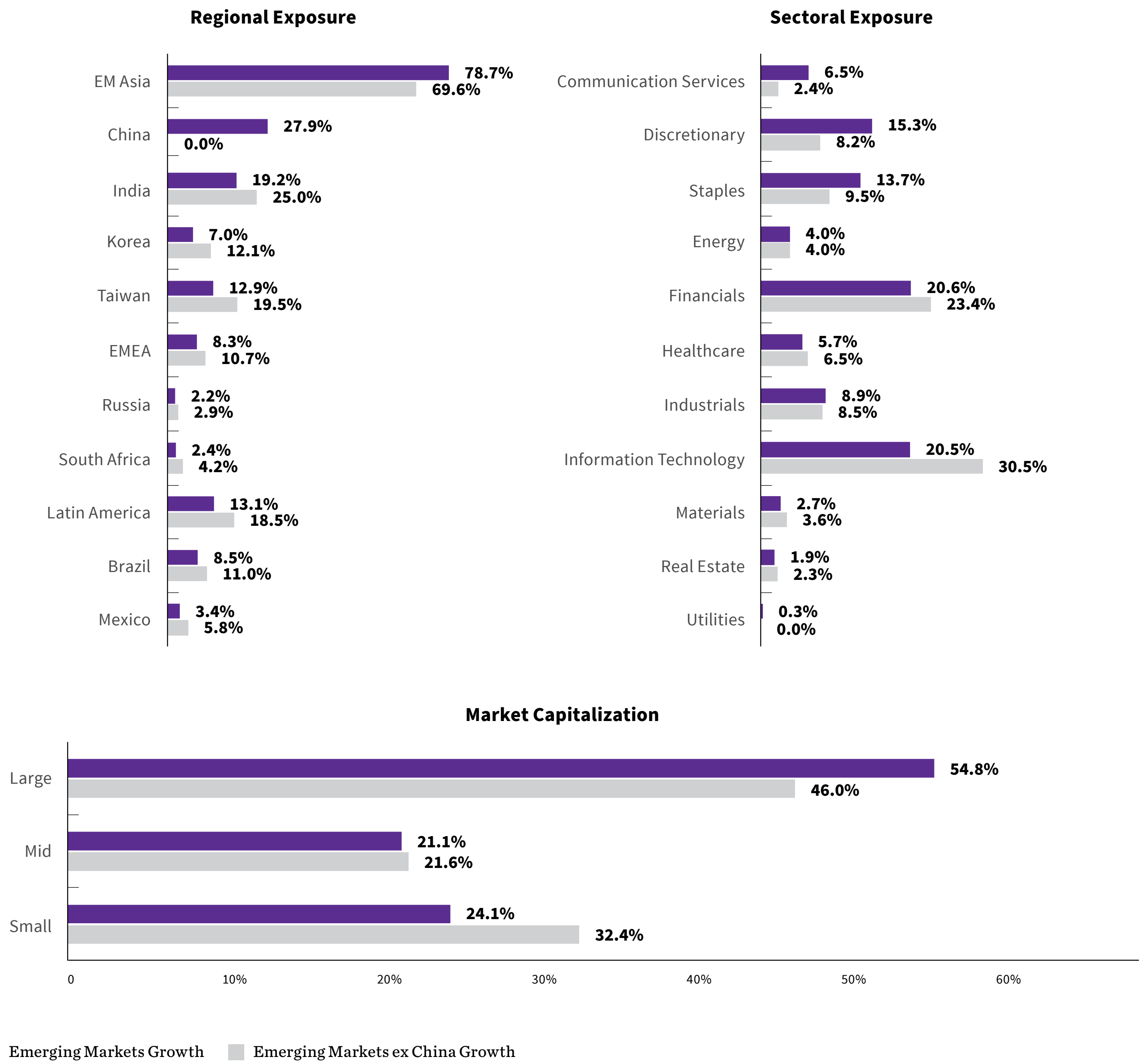
Romina: That's a fair question. In terms of the portfolio, we aim to offer a strategy that can complement a China allocation without missing any component of EMs. Taiwan is a large market, representing 21% of the MSCI EM ex China IMI, and it is also part of our EM ex China Growth strategy.

Also, Taiwan, like South Korea, has a differentiated profile and dynamics. It's export-oriented, with a global leading edge in semiconductor and IT more generally and it is closer in many ways to a developed market than an EM. This provides interesting opportunities and potential diversification benefits within the EM universe.

EXHIBIT 10

Portfolio Positioning

The sector, regional, and market-cap breakdown of our EM ex China Growth strategy compared to EM Growth strategy shows how the strategies differ.



Sources: William Blair, as of January 31, 2023. The data shown above is based on each strategy's representative portfolio. Region and sector distribution are calculated in Eagle based on Global Industry Classification Sectors (GICS). Small-cap is defined as $0 to $5 billion, mid-cap as $5 billion to $20 billion, and large-cap greater than $20 billion. Cash is excluded. For informational purposes only and not intended as investment advice. Holdings are subject to change at any time.

From a cyclical perspective, we see clear signs of a trough in the semiconductor cycle; with peak inventories, we expect that trough valuations may lead the way to sustained earnings and stock price recovery.

In terms of the geopolitical outlook for Taiwan given heightened tensions with China, we think the near-term risk of an escalation into a direct conflict between China and Taiwan is low but not zero. My colleague, Vivian Lin Thurston, talks about Taiwan more in a recent blog post, *China: 5 Questions*. Rather than repeat her, I refer readers there.

How are you addressing environmental, social, and governance (ESG) considerations in the new strategy?

Romina: ESG is integrated the same way it is for all of our global equity strategies. Our focus is on financial materiality based on our proprietary materiality framework for each industry. We also prioritize engagement, which we believe is particularly important in EMs and with smaller companies. The team has significant expertise researching and engaging with senior management and board members of small- and mid-cap companies at earlier stages of the corporate lifecycle. As we engage with these companies, especially in EMs, we have a greater appreciation for the impact we can have as corporate governance practices are still evolving (and so are local governance codes), and many companies have yet to formalize their sustainability priorities and goals. This necessitates a pragmatic approach to our analysis and engagement methods.

> "Our EM ex China Growth strategy allows investors to have a deeper exposure to EM investment opportunities and complement a China allocation, including a zero allocation."
>
> **Romina Graiver, Partner**

Will the strategy appeal to more ESG-motivated investors who see China as having a poor record in regard to ESG?

Romina: That's a good question. Certainly, by excluding China, you're not getting the geopolitical or ESG risks that surround China. But we're not demonizing China. There are many similar issues across EMs. Investing in EMs carries its own ESG risk, and we believe the solution is to choose a manager with a clear lens into ESG considerations. It's about how we select companies. And, as I noted above, ESG is integrated into our EM ex China Growth strategy with a pragmatic approach, understanding the geographic and corporate lifecycle nuances and focus on materiality.

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The **MSCI All Country World Index (ACWI)** and the **MSCI All Country World Index (ACWI) Investable Market Index (IMI)** capture large- and mid-cap representation across 23 developed markets and 24 EMs. The latter is broader, with a larger number of securities. The **MSCI China Index** captures large- and mid-cap representation across China A shares, H shares, B shares, Red chips, and P chips. The **MSCI Emerging Markets (EM) Index** captures large- and mid-cap representation across 24 EMs. The **MSCI Emerging Markets (EM) ex China Index** captures large- and mid-cap representation across 23 of 24 EM countries excluding China. The **MSCI Emerging Markets (EM) Investable Market Index (IMI)** captures large-, mid- and small-cap representation across 27 EMs; the **MSCI EM ex China Investable Market Index (IMI)** excludes China. The **MSCI USA Investable Market Index (IMI)** is designed to measure the performance of the large-, mid-, and small-cap segments of the U.S. market. The **MSCI World Index** captures large- and mid-cap representation across 23 developed markets.

Cash flow return on invested capital (ROIC) is a measure of how effectively a company generates cash flow based on capital investment. **EPS: long-term growth** represents the weighted average of forecasted growth in earnings expected to be experienced by stocks over the next three to five years. **EPS growth: five-year historic** reflects the weighted average earnings per share growth for stocks over the past five years. **P/E ratio** is the ratio of a stock's current price to its per-share earnings over the past year.

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