

Misleading Emerging Market Funds....

Do You Know What You Really Own in Your EM Funds?

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In 2017, emerging markets funds outperformed US markets – the biggest emerging market ETF iShares Core MSCI Emerging Markets ETF (IEMG) rose 37% while the largest US ETF SPDR S&P 500 ETF (SPY) rose 21%.¹ Why? Most news outlets and pundits reference the growth in emerging market nations like Brazil and India.... But these countries are barely represented in the Emerging Market (EM) indices. Instead, the EM index is dominated by Chinese and Asian tech stocks such as Tencent and Alibaba which have an outsized influence on this supposedly global index. Moreover, well-developed nations like South Korea and Taiwan have somehow become major components of the “emerging market” index. Even if, like me, you believe in the growth prospects of Asian technology stocks, investors and clients need to be aware of the real underlying holdings of emerging markets funds so that they can allocate their capital accordingly.

Emerging Market Indices: Asian Tech Stocks Have Higher Weighting than India and Brazil

If you have an emerging market fund, it is likely that MSCI’s EM Index drives its composition. As the company reports on its website, “MSCI is a market leader in global equity indexes and has over \$1.6 trillion in assets benchmarked to the MSCI Emerging Markets Index suite,” as of June 30, 2017.² The S&P Emerging Market index is the other primary benchmark for ETFs and mutual funds and it’s composition is similar, although it does not include South Korea³ so allocates a bit more weight to real emerging markets.

Although the MSCI Emerging Markets Index claims it is, “designed to represent the performance of large- and mid-cap securities in 24 Emerging Markets (with) more than 830 constituents,”⁴ the index is dominated by large-cap Chinese and developed market technology stocks.

The chart on the rights shows the top 10 MSCI constituents as cut and pasted from their website. These top 10 stocks constitute more than a quarter of all of Emerging Markets holdings.

The largest stock Tencent with almost 6% of the index has almost double the weighting of all Russia, which has only a 3% weighting in the MSCI index.⁵ Tencent also has almost as much of a weighting as all of Brazil which is 6.87% of the index.⁶ Tencent’s representation can be considered even more given this useful fact: Naspers, a South African telecom company which is the only non-Asian stock in the top 10, has a 30% stake in Tencent.⁷ Tencent is a Chinese technology company which owns Wechat, a popular social messaging application, as well as e-finance, gaming, and other applications.

TOP 10 CONSTITUENTS

| | Country | Float Adj Mkt Cap (USD Billions) | Index Wt. (%) | Sector |
|----------------------------|---------|--------------------------------------|------------------|--------------|
| TENCENT HOLDINGS LI (CN) | CN | 289.78 | 5.58 | Info Tech |
| SAMSUNG ELECTRONICS CO | KR | 228.74 | 4.40 | Info Tech |
| ALIBABA GROUP HLDG ADR | CN | 201.61 | 3.88 | Info Tech |
| TAIWAN SEMICONDUCTOR MFG | TW | 185.61 | 3.57 | Info Tech |
| NASPERS N | ZA | 118.47 | 2.28 | Cons Discr |
| CHINA CONSTRUCTION BK H | CN | 73.37 | 1.41 | Financials |
| BAIDU ADR | CN | 65.34 | 1.26 | Info Tech |
| CHINA MOBILE | CN | 62.33 | 1.20 | Telecom Srvc |
| ICBC H | CN | 57.34 | 1.10 | Financials |
| HON HAI PRECISION IND CO | TW | 52.00 | 1.00 | Info Tech |
| Total | | 1,334.57 | 25.68 | |
| Source: MSCI. ⁵ | | | | |

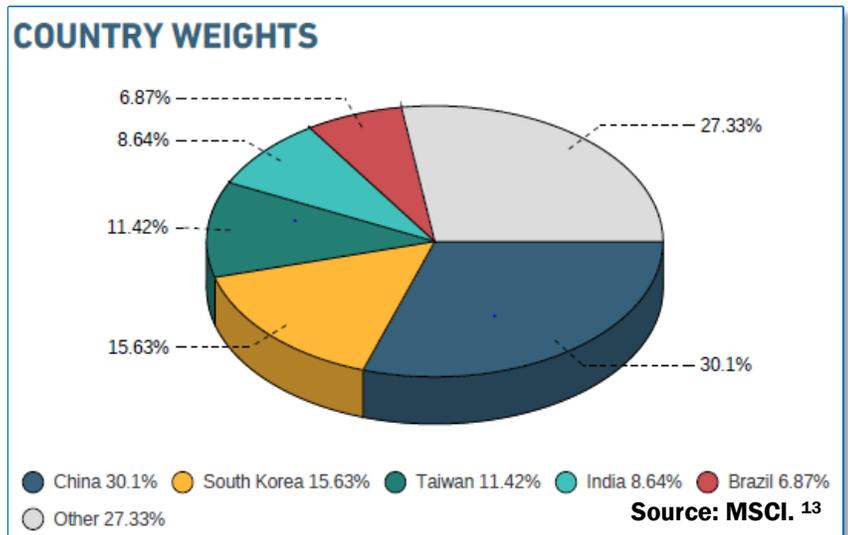
Tencent and Alibaba have a higher weighting in the MSCI index than India which is 8.64% of the MSCI Emerging Market Index.⁸ India has 1.3 billion people and is on track to become the world's fifth largest economy⁹, but MSCI gives it a smaller weighting in its EM index than two of China's tech companies.

In comparison, Apple has the highest market capitalization in the US at \$870 billion but is just 3.8% of the US SPDR® S&P 500 ETF (SPY)¹⁰ and presumably has a smaller weighting in global indices.

Tencent is not even close to being China's biggest or most profitable company. Forbes considers this honor to go to Chinese Industrial and Commercial Bank (ICBC) which it ranks as the world's biggest public company.¹¹ ICBC is #9 in MSCI's EM index but has less than a sixth of the EM weighting of Tencent which Forbes ranks at #148. ICBC's revenues are five times that of Tencent at \$102 billion to \$22B.¹²

MSCI's Emerging Market Index Dominated by Advanced Economies: South Korea and Taiwan

MSCI has included South Korea and Taiwan as major components in its emerging market index even though the International Monetary Fund considers these countries to be "Advanced Economies." The IMF considers the following to be the major emerging markets: Argentina, Brazil, China, Colombia, Hungary, India, Indonesia, Latvia, Malaysia, Mexico, Philippines, Poland, Russia, South Africa, Thailand, Turkey, and Ukraine.¹⁴



South Korea has a GDP per capita of \$29,115 while that of Taiwan is \$24,000 – these are akin to that of Italy and far above the world's GDP per capita of \$10,000 which is on par with Russia, Turkey, and Brazil¹⁵ which you would think should have a higher representation in an emerging market index than these advanced economies. Brazil has a higher gross GDP than Korea and a population four times its size, but MSCI grants Brazil half of Korea's weight in its emerging market index.

Former Goldman Sachs economist Jim O'Neill popularized the term "BRIC" economies in 2001 to summarize the biggest emerging markets with the most growth potential: Brazil, Russia, India, and China. In 2013, O'Neill stated that, "the BRIC countries – Brazil, Russia, India and China – are already closely watched. The group I'm studying for this project – let's call them the MINT economies – deserve no less attention. Mexico, Indonesia, Nigeria and Turkey all have very favorable demographics for at least the next 20 years, and their economic prospects are interesting."¹⁶

Despite the growth prospects of these MINT economies with over \$3 trillion in GDP and 640 million people¹⁷, MSCI Emerging Markets decided to allocate more of their index to Tencent (5.6%) than to these four emerging nations (5.2%)¹⁸. Meanwhile, MSCI decided to allocate 2 times these countries to Taiwan, a country with 4% of MINT's population and 15% of its GDP, and 3 times to South Korea, an advanced economy with 8% of MINT's population and 43% of its GDP.¹⁹ Some believe China should be promoted to an "advanced economy" given its size but I can understand from a GDP/capita metric, it makes sense to keep it as an emerging market. I don't understand the sense of demoting South Korea and Taiwan from advanced to emerging market status and allocating 27% of the MSCI EM index to these advanced economies.

Chinese Tech Stock Opportunities and Risks

I believe in the growth potential of Chinese tech stocks and have bought some for my client's portfolios either as individual stocks or via a targeted ETF. Alibaba's price increased by 97% in 2017 while Tencent was up 113%, driving the EM index up higher – much more even than the MSCI China ETF which was only up 52%.²⁰ However, Tencent is not approved for sale in the State of Virginia – the stock is not registered in Virginia and has not complied with Blue Sky Laws. Quite a few of the other stocks in MSCI's top ten also do comply with regulatory Blue Sky Laws. Clients should be aware of the risks they are taking when investing in these Chinese internet stocks either individually or via EM funds.

Conversely, an investor may just choose to invest in Chinese internet funds or stocks if they want to get the upside in Chinese stocks without being dragged down by underperformers like Russia, which had a 0% return for the year. The KraneShares CSI China Internet ETF was up 68% for the year, double the 33% increase in emerging market fund indices. In either case, investors and clients should understand how much of their portfolio they are investing in Chinese internet stocks given their risk appetite.

| Symbol | Securities that Beat the EM Index Average change | 2017 price % |
|-------------|--|--------------|
| TCEHY | Tencent Holdings | 113% |
| BABA | Alibaba Group Holding | 97% |
| NAPRF | Naspers | 90% |
| KWEB | KraneShares CSI China Internet ETF | 68% |
| MCHI | iShares MSCI China ETF | 52% |
| EWY | iShares MSCI South Korea Capped ETF | 40% |
| BIDU | Baidu | 41% |
| TSM | Taiwan Semiconductor | 36% |
| IDCBF | Industrial And Commercial Bank | 38% |
| INDA | iShares MSCI India ETF | 35% |
| EEM | iShares MSCI Emerging Markets ETF | 34% |
| IEMG | iShares Core MSCI Emerging Markets ETF | 33% |
| FXI | iShares China Large-Cap ETF | 33% |
| SSNGY | Samsung Electronics | NA |

Source: Ycharts. Accessed December 31, 2017.

| Symbol | Securities that Lagged the EM Index Average | 2017 price % change |
|--------|---|---------------------|
| EZA | iShares MSCI South Africa ETF | 30% |
| NGE | Global X MSCI Nigeria ETF | 27% |
| IEFA | iShares Core MSCI EAFE ETF | 24% |
| CICHF | China Construction Bank | 23% |
| HNHAF | Hon Hai Precision Industry | 23% |
| XCH.TO | iShares China ETF | 23% |
| EWT | iShares MSCI Taiwan Capped ETF | 22% |
| EWZ | iShares MSCI Brazil Capped ETF | 20% |
| SPY | SPDR S&P 500 ETF | 19% |
| VOO | Vanguard S&P 500 ETF | 19% |
| EIDO | iShares MSCI Indonesia ETF | 16% |
| EWX | iShares MSCI Mexico Capped ETF | 11% |
| GXG | Global X MSCI Colombia ETF | 10% |
| UAE | iShares MSCI UAE Capped ETF | 1% |
| ERUS | iShares MSCI Russia Capped ETF | 0% |

Past performance is no guarantee of future results. The table is for informative purposes only and is not a recommendation to invest in any security. Data access on December 31, 2017 at www.ycharts.com.

Given EM's outperformance, many advisors are recommending increased allocations to EM. Meanwhile, legendary scholars like Burton Malkiel argue that clients should reasonably put up to half of their allocation to emerging markets. Malkiel is an advisor to robo-advisor Wealthfront which allocates up to 28% of clients' portfolios to emerging markets.²¹ Yet, this could mean that approximately 14% of a Wealthfront investor's wealth could be put in Asian internet stocks without the client realizing this exposure and up to 25% for an investor who blindly follows Malkiel's advice.

Clients and investors should be aware of this concentration and wary that any adverse developments involving North Korea or China could have a significant downside effect on their portfolios. The Chinese government's continued intervention in its economy, markets, or currency could also have an outsized

negative effect. Even the prosaic can dampen these stocks. Emerging market stocks have been boosted by up to 10% this year given the sharp depreciation in the dollar.²² This could, of course, reverse especially if the new US tax law precipitates massive repatriation of dollars back to the US.

MSCI’s Questionable Methodology and the Implication for Investors

In its methodology, MSCI explains that it is now using float adjusted market capitalization to construct the indices.²³



Yet, one has to wonder if this is the best method to construct the index if it results in such distortions and, by many measures, does not represent the emerging markets it claims to. I advised the top emerging markets funds in London in the late 2000s and the EM index has been radically transformed while few have noticed. Even emerging markets experts like Tim Seymour of CNBC’s Fast Money states that with respect to emerging market returns, “we are not talking about single stocks. We are talking about entire indices.”²⁴ Yet this no longer seems to be true as the indices are now composed of single stocks like Tencent and are not actually a composite of national stock market indices. Instead, the EM benchmark indices are comprised of a basket of idiosyncratic securities with high percentages of free float. This indicates that emerging market indices are much less diverse than most investors believe and prone to much more volatility in the underlying holdings. MSCI has over \$3 trillion benchmarked to its All World index²⁵ and it also makes one wonder what other ETFs and funds may be misleading to clients.

Besides the concerns for individual investors, there are systemic issues. Will companies begin gaming the system to increase their float? If so, they too may rise to the top of MSCI’s index and de facto attract a good portion of the \$1.6 trillion benchmarked to MSCI EM indices. Was the 113% increase in Tencent in 2017 driven by its stock’s merits or by the self-fulfilling prophecy of having the highest weighting in the EM benchmark? If Tencent’s weighting was 6% of the MSCI Index at the start of 2017 and has since doubled, is it now more than 12% of many emerging market funds? If so, isn’t this too high a concentration for a single stock for EM funds? If they decide they need to pare down, will that cause massive selling of the high flying stocks such as Tencent and Alibaba – would that wreak havoc on the Chinese and global markets? How much have active fund managers increased risk just to match these index returns? Why has not anyone in the industry called out these discrepancies – a thirst for higher returns even if clients and individual investors have no idea what risks they are taking?

If the point of EM index and mutual fund investing is to diversify away single stock risk and approximate EM underlying growth, EM funds that are based on these benchmarks don’t seem to fit this goal. Financial advisors, robo-advisor programs, and retirement plan administrators should be aware of these discrepancies and inform and advise their clients accordingly. Caveat emptor.

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Maya is a Harvard-trained economist who leverages her two decades of top-level experience across Wall Street, the City of London, emerging markets, and advanced technology to devise investment strategies for her clients. She founded Meta Point Advisors after several years as a Financial Advisor at Merrill Lynch. Maya's clients benefit from her ability to provide savvy active management without the cumbersome costs and structure of mutual funds.

Maya's ability to abstract important concepts or "Meta Points" has differentiated her, whether writing about Russia's conversion to capitalism while at Harvard, women in business at the World Economic Forum, equity markets in London's hedge fund community, or artificial intelligence technologies for DARPA program managers. She seeks to leverage these insights to achieve superior outcomes for her clients.

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