OUTCOMES

The latest topical perspectives from PGIM Quant's investment experts

PGIM QUANTITATIVE SOLUTIONS

I'LL TAKE MY EMERGING MARKETS WITH CHINA ON THE SIDE, PLEASE

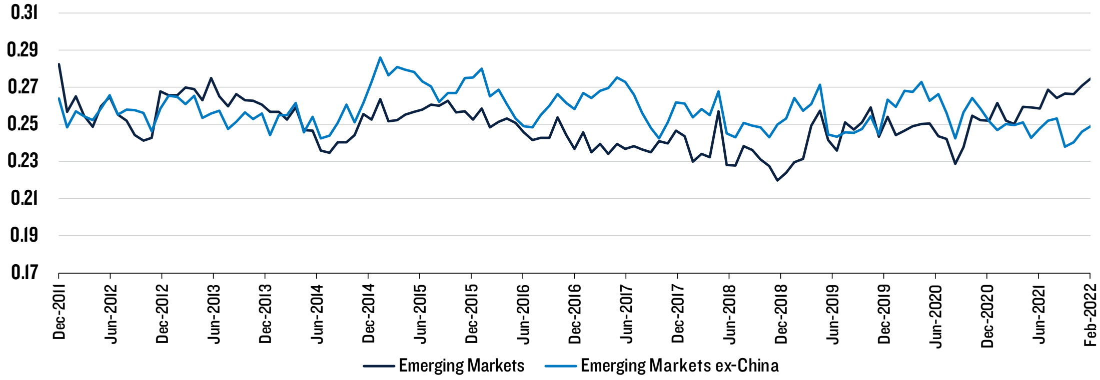
February 2023

As a key driver of global growth, ranking either first (by Purchasing Power Parity) or second (by notional Gross Domestic Product), the importance of China as a leading player on the world's economic stage is beyond dispute. It's therefore likely that asset owners could benefit from some exposure to China in their overall portfolios. The challenge for equity investors is determining the best way to get that exposure. Traditionally, emerging markets indexes were the obvious choice; their small, but growing, allocations to China reflected the country's economic appeal while providing access to an extensive set of constituents in a broad index. However, as China's influence and weighting in emerging markets indexes grow, so do the risks of a single country dominating what's meant to be a broad and diversified allocation. Recognition of the excess return benefits of the other markets in this space leads us to believe that investing in separate China-only and ex-China equity allocations through diversified and risk-controlled portfolios can truly unlock the alpha potential of emerging markets.

At the close of 2022, China's weight in the MSCI Emerging Markets Index stood at about 30%, but could increase to almost 50% if all domestic listed A-Share securities are added. The potential for growth is even greater if MSCI increases the float adjustment. There's a school of thought that 30% exposure is actually too low given the pent-up domestic demand created as a result of COVID, which is about to be unleashed, combined with today's attractive valuations of Chinese equities. But the past year has been a case study for the risks inherent in investing in China: slowing economic growth, rising government intervention, heightened regulatory scrutiny, increasing geopolitical risk, likelihood of rising COVID infections and possible resultant restrictions, and a more aggressive regional stance are key reasons to underweight China allocations. It's important to note that, regardless of the relative strength of China-based stocks right now, the standard emerging markets index allocation is dominated by China, suggesting that investors would benefit from having distinct China-only and emerging markets ex-China allocations.

An emerging markets strategy that excludes China-based securities can provide attractive alpha opportunities versus its benchmark. Utilizing a model that generates alpha through both top-down, country-industry allocation and fundamental-driven, bottom-up stock selection presents additional diversification benefits when the focus on China is removed, conferring a clear advantage in global emerging markets investing. A top-down approach that considers the intersection of country and industry alpha can capitalize on broad regional opportunities. When paired with bottom-up stock selection insights that seek to systematically and effectively identify future stock outperformance based on fundamental metrics, investors are more likely to find alpha across all countries within the emerging markets universe. In fact, our research has shown no alpha degradation between including and excluding China from the emerging markets universe.

Active Alpha Exposure for Emerging Markets Including and Excluding China



Source: PGIM Quantitative Solutions. Data as of February 28, 2022.

For Professional Investors Only. All investments involve risk, including the possible loss of capital.

But harvesting the alpha opportunity is only half the battle. Delivering risk-adjusted excess returns through disciplined and rigorous controls is just as important as the upside potential – let's keep what we earn, after all. Risk controls should be embedded in every investment decision, with a focus on direct, logical, and transparent exposure management. Add to that efficient trade execution, which could minimize trading costs while lending insights into local market microstructure and price dynamics, and an experienced and long-tenured portfolio management team seeking to minimize drawdowns in extreme market conditions, and the upside potential is palpable.

The size of China's economic opportunity has led the country to outgrow its standing as merely a component of a broad emerging markets investment allocation. A separate China allocation allows for the customization and finer control necessary to gain the benefits of investing in such a large market. Similar to stand-alone Japan allocations initiated by investors years ago, China's market dynamics and size are now distinct enough to warrant carving out an allocation that's separate from other emerging markets. Given its sheer size, China's market enjoys considerable industry diversification, particularly compared to smaller emerging markets. This more limited industry exposure of individual emerging markets means smaller countries benefit from being grouped together in a broad index to manage diversification and mitigate the risks of industry concentration. Two distinct emerging markets allocations – China-only and excluding China – give asset owners flexibility and precision, providing alpha opportunities in both areas while avoiding the single-country dominance of a blended universe.

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ABOUT PGIM QUANTITATIVE SOLUTIONS

As the quantitative and multi-asset specialist of PGIM, we combine the agility of an independently run boutique with the stability and scale of one of the world's top-15 asset managers*. For over 45 years, we have designed proprietary methods that seek to solve beyond alpha by combining the latest technology with scalable, rigorous risk controls to nimbly build and manage diversified and customized solutions that help solve clients' evolving challenges. We manage portfolios across equities, multi asset, liquid alts and retirement for a global client base with $86 billion in assets under management as of 12/31/2022.

*PGIM is the investment management business of Prudential Financial, Inc. (PFI). PFI is the 11th largest investment manager (out of 431 firms surveyed) in terms of worldwide institutional assets under management based on Pensions & Investments' Top Money Managers list published June 2022. This ranking represents institutional client assets under management by PFI as of December 31, 2021. Participation in the P&I ranking is voluntary and open to managers that have any kind of U.S. institutional tax-exempt AUM. Managers self-report their data via a survey. P&I sends the survey to previously identified managers and to any new managers asking to participate in the survey/ranking. No compensation is required to participate in the ranking.