China’s Power in Emerging Markets Creates Headache for Global Investors

Concentration of Chinese stocks and bonds in major benchmarks sparks concern

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China’s outsize position in emerging markets has created a dilemma for many investors.

For years, as companies from the world’s second-largest economy grew rapidly and became more valuable, China came to make up more than 40% of some major international benchmarks for stocks and corporate bonds. Investment funds with similarly large allocations to Chinese assets did well in 2019 and 2020, when the country’s rise drove gains in emerging markets.

Since then, a bout of exceptionally poor performance for Chinese stocks and corporate bonds has led many investors to rethink their heavy exposure to China and how it has hurt their returns.

“It’s something that’s on everyone’s minds,” said Thomas Drissner, head of Asian credit research at Abrdn. He was referring to the need for more diversification after a surge in bond defaults among Chinese property developers—which dominated the region’s junk-bond market—caused heavy losses in 2022 for many funds.

The British asset manager recently launched an Asia high-yield bond fund that is underweight on Chinese debt. It expects to produce comparable yields by investing in green bonds and other debt and will place a small portion of its funds in investment-grade bonds.

At an American pension fund, the Maryland State Retirement and Pension System, directors and staff have been discussing whether and how to cut back the fund’s exposure to China. At a recent meeting, its board accepted a recommendation to reduce the pension fund’s overall allocation to emerging markets over the next two years to 10% of its portfolio from 14%.

The move would also reduce the fund’s China exposure to 5% from 7% at present.

“The goal is to reduce EM and China and redeploy in areas that provide overall similar portfolio returns but with less risky assets,” said Andrew Palmer, the Maryland fund’s investment chief.

Meketa Investment Group, a consulting firm that advises American pension funds, recently said in a presentation that the average U.S. public pension has 3% to 5% of its portfolio in China.

“Disentangling from China entirely is not feasible,” the presentation said.

The MSCI Emerging Markets Index lost around a quarter of its value over the past two years, with much of the decline being related to a selloff in Chinese stocks. China's weight in the widely used benchmark reached around 42% in September 2020 and was recently 33.5%, according to MSCI data. The Chinese stock declines were due to domestic regulatory crackdowns on internet companies, property developers and other fast-growing private industries, as well as Beijing's long-running zero-Covid policy, which slowed the country's economic growth.

It has been a similar story in credit markets. The J.P. Morgan Asia Credit Index, or JACI, a widely used performance yardstick that tracks investment-grade and high-yield dollar bonds with total face value of about $1 trillion, slumped 11% last year in one of its worst ever annual declines. China makes up 43% of the index because many companies from the country have dollar bonds that met the size threshold for inclusion.

"The fatal flaw in Asian bond investing has always been concentration," said Owen Gallimore, head of credit analysis for Deutsche Bank's flow-trading desk in Singapore.

JPMorgan recently proposed creating a new, enhanced version of its Asia credit index that it said would provide more diversification across countries by including bonds issued by banks and companies from Japan, Australia and New Zealand.

The new benchmark would track $1.5 trillion in bonds, and its China exposure would be below 30% as a result, according to the American bank. It said the enhanced JACI index would have done better than the old version over the past six years, in both annualized and cumulative returns. JPMorgan is planning to share the feedback it gathered with clients this month, according to people familiar with the matter.

"A smaller exposure to China means we get more diversification," said Dhiraj Bajaj, a Singapore-based portfolio manager at Lombard Odier. He added that this comes as the growth outlook for the rest of Asia is improving.

In the U.S., the Teacher Retirement System of Texas is cutting its target allocation to China by half in its multibillion-dollar emerging-markets stock portfolio. It is also modifying the performance benchmark it uses.

The organization's investment-management division said last autumn that it was reducing its China exposure given the country's outsize weight in the MSCI Emerging Markets Index, and would increase investments in Taiwan, India, South Korea and other countries. The fund held shares of Chinese banks, internet retailers, energy businesses and other companies as of January 2023, according to its public disclosures.

The Texas fund is switching to a modified gauge that is a 50:50 combination of the MSCI Emerging Markets Index and the version of it that excludes China.

"What you see is that the China allocation goes down and all the other countries go proportionally up," said Katy Hoffman, chief of staff to the fund's chief investment officer. "We just want to improve the diversification of that benchmark."

The moves by big investors to shift some assets to other Asian markets are taking place just as the clouds over Chinese stocks are clearing. Authorities in recent months lifted virtually all of their strict Covid-19 restrictions and have pivoted back to focusing on growth, raising economists' expectations for

a strong economic recovery. After hitting a multiyear low last October, the MSCI China Index has rebounded more than 30%.

“Sentiment towards China has stopped being so totally negative,” said Mark Martyrossian, a director at U.K.-based Aubrey Capital Management. His firm recently increased its China exposure in its global emerging-markets equity fund to 42% from 25% in summer 2022.

Mr. Martyrossian said he has observed many investors remaining cautious and shifting assets away from China because of political and regulatory risks. If the country ends up outperforming the broader emerging markets, “They are going to struggle to match the index,” he added.

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