Most Emerging Markets Indexes Are Often China Funds In Disguise

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On Friday, there was a report that the US government would consider limiting inclusion of Chinese equities on indexes managed by US firms. Without commenting on whether governments should interfere in private market activity, I'm proud to say that Life + Liberty Indexes has already provided a solution.

The Problem

The problem the US government is trying to address is that most emerging markets indexes are often China funds in disguise, that is, they have huge allocations to China. The vast majority of indexes are market capitalization weighted – this means, for international indexes, the larger the size of a country's market, the larger its allocation in the index. International indexes are commonly divided into developed markets, emerging markets, and frontier markets. China is classified as an emerging market by all index providers. Due to market capitalization weighting, China makes up 30% or more of most emerging markets indices, and its weight is growing with further addition of A-shares. The problem for investors, besides concentration risk, is that when they invest in a passive emerging markets index, they may be unintentionally directing investment dollars to markets which do not reflect their values, such as China (and Russia, Egypt, and Saudi Arabia to a smaller extent).

Our Solution

Our solution for this problem lies in our weighting methodology. Instead of market capitalization weights, the Life + Liberty Freedom 100 Emerging Markets Index (FRDM index) uses a freedom-weighted approach. The higher a country's freedom score, the higher its weight in the index. The lower its freedom score, the lower its weight. And the worst actors are excluded altogether. We use the Human Freedom Index and data set from the Fraser Institute, Cato Institute, and Friedrich Naumann foundation for freedom. The data set is the most comprehensive measure of freedom I have found. It includes 79 indicators from objective sources with a fully transparent methodology, and covers both human freedom and economic freedom factors.

As a result of its freedom-weighting approach, the FRDM index has no direct exposure to China equities. We are currently the only emerging markets index that has no China exposure without having a specific mandate to exclude it. The reason for our exclusion, lack of freedom, addresses the root problem with China’s markets. Investing in unfree markets has risks we seek to avoid, such as the lack of investor protections and rule of law, nationalization of companies, inefficiency of central planning, and arbitrary whims of autocratic regimes. Ours is a relative strategy. We do not penalize freer markets from conducting trade with excluded (less free) markets. There is no 100% free country, and there is no index that has can eliminate all indirect China exposure from other countries conducting business with China. Our goal is to provide a different exposure to emerging markets with a weighting approach that we believe makes more sense than using size of market alone. We are here to provide investors who want to promote freedom a way to do so with their investments.

There are a couple other indexes (one by MSCI) that exclude China as their objective. The FRDM index is different from these in that we are using freedom-weighting, not market capitalization weighting ex-China. China is excluded from our index currently, but it has potential for inclusion, should it become more free.

For investors who want an ACWI alternative

The US government also took issue with the federal pension plan choosing MSCI ACWI as a benchmark. The problem of China over-exposure is not as bad in global indexes because these indexes include both developed markets and emerging markets. For investors looking to exclude China from a global index such as MSCI ACWI, an alternative would be to use the MSCI ACWI ex-China index. In partnership with Alpha Architect, Life + Liberty Indexes can also provide global, developed market, and emerging market solutions.