India Allocation Soars in Emerging-Markets Strategies

Driven by strong performance and market shifts, emerging-markets funds increase their India exposure, albeit with caution.

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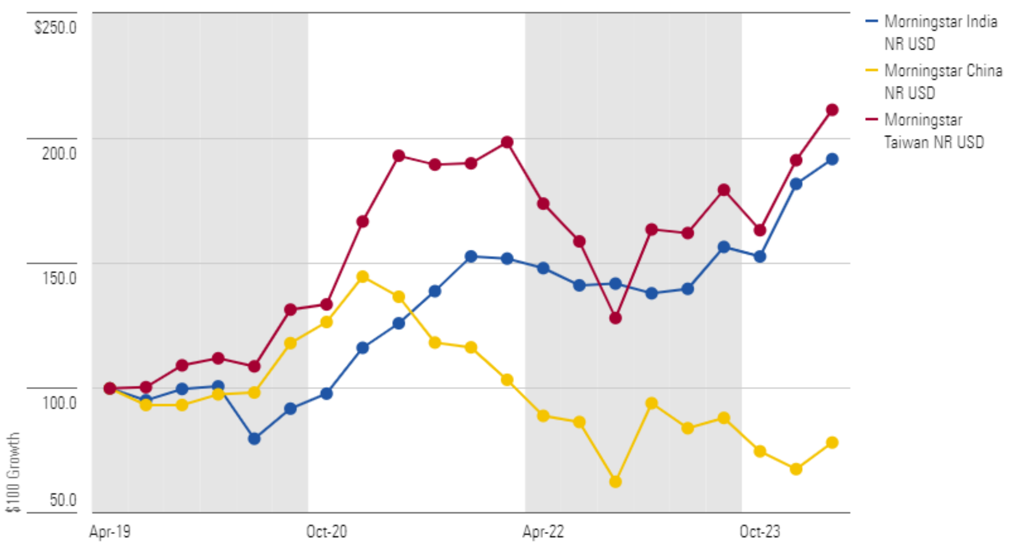
Introduction

In the last few years, Indian equities have experienced a significant rally (Exhibit 1), driven by strong GDP growth, robust corporate earnings, ample market liquidity, and increasing participation from domestic retail investors. This upward trajectory has led global funds, especially those focused on emerging markets, to increase their allocation to Indian equities. Additionally, the underperformance of Chinese equities, entangled in domestic macroeconomic challenges, has amplified this shift. As the second-largest component of global emerging-markets indexes, this reallocation to India is a logical development.

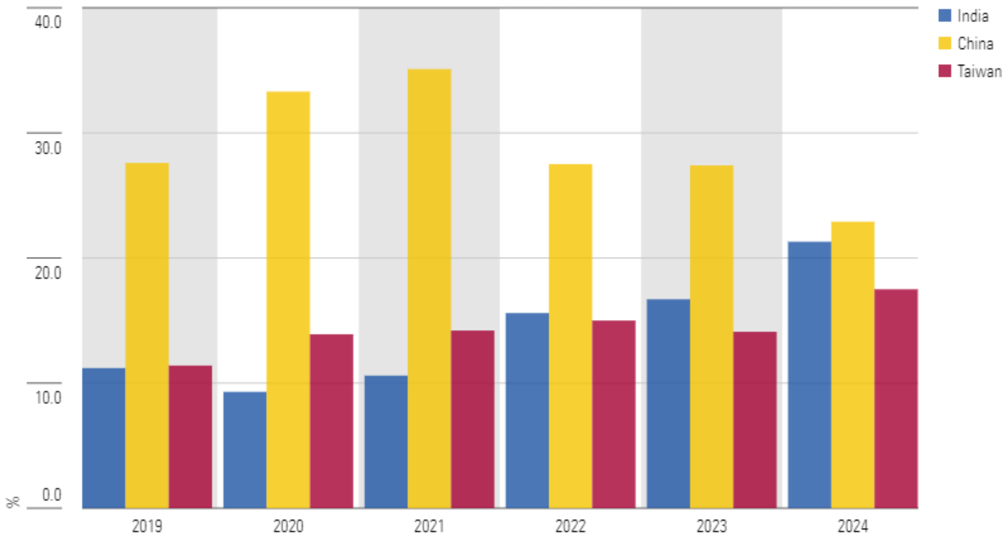
Exhibit 1 Among Major Emerging Markets, India Has Been a Strong Performer During April 2019-April 2024



Source: Morningstar Direct. Data as of April 30, 2024.

The combination of strong market performance and uptick in global investors' sentiment has notably raised India's weight in the Morningstar Emerging Market Index and MSCI Emerging Market Index in recent years, while concurrently witnessing a significant slide in Chinese equities' weight. (Exhibit 2).

Exhibit 2 Trend of India, Taiwan, and China Weight in Morningstar Emerging Market Index

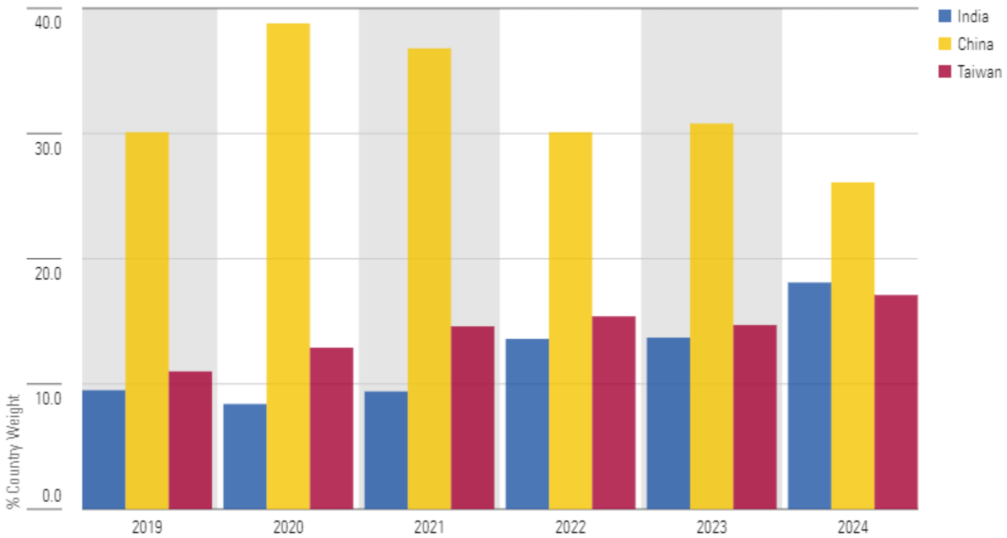


Source: Morningstar Direct Data as of April 30, 2024.

That being said, understanding the structural differences between the Morningstar Emerging Market Index and the MSCI Emerging Market Index is crucial for investors due to the distinct market representations and implications for diversification.

The Morningstar Emerging Market Index includes large-, mid-, and small-cap stocks from 25 emerging markets, covering the top 97% of the investable universe by market capitalization, with around 79% exposure to large-cap stocks. In contrast, the MSCI Emerging Market Index encompasses large- and mid-cap stocks from 24 emerging markets, covering approximately 85% of the free float-adjusted market capitalization in each country, with 89% exposure to large-cap stocks. The broader inclusion of small-cap stocks in the Morningstar Emerging Markets Index offers a more comprehensive view of emerging-markets' performance. As such, China's weight is significantly larger in the MSCI Emerging Markets Index (Exhibit 3), as it includes more mega- and large-cap companies.

Exhibit 3 Trend of India, Taiwan, and China Weight in MSCI Emerging Market Index



Source: Morningstar Direct Data as of April 30, 2024.

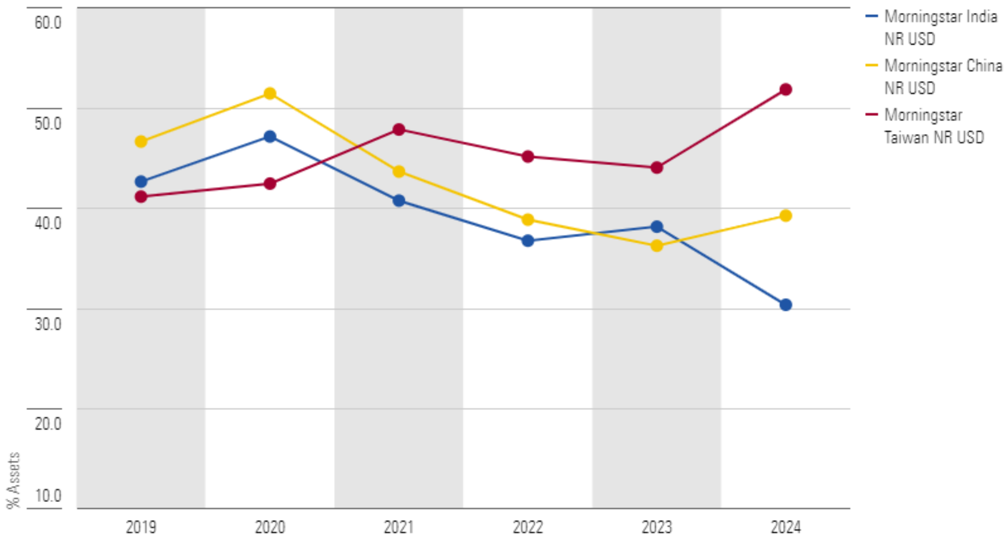
Another market that witnessed strong growth alongside India over the trailing five years through April 2024 is Taiwan. Consequently, its share in the Morningstar Emerging Market Index increased to 17.5% as of April 2024. However, it's important to note that Taiwan's market is highly concentrated, with its rally primarily driven by one stock: Taiwan Semiconductor Manufacturing Company (TSMC), which constitutes approximately 37% of the Morningstar Taiwan Index. This concentration presents a significant risk for investors.

Considering these developments, this study aims to explore the equity allocations within cross-border emerging-markets focused funds, examining how they are positioning in the Indian equity market.

Broad-Based Growth Has Boosted India's Appeal for Global Emerging-Markets Funds

One of the key reasons global emerging-markets funds have increased their allocation to India is the structural transformation in the Indian equity market in recent years. Over the last five years, the market has not only delivered strong performance but also expanded in breadth, significantly driven by a surge in new stock listings. A substantial portion of these IPOs has come from mid- and small-cap companies. As a reflection of this expansion, the Morningstar India Index now comprises 497 names compared with 280 in May 2019. Unlike Taiwan's concentrated market rally, the rise of Indian equities has been more broad-based, leading to a notable decline in market concentration. The percentage of assets in the top 10 holdings of the Morningstar India Index has decreased to 30.4% as of April 2024 from 42.7% in May 2019 (Exhibit 4). Moreover, the sector composition of the market has shifted significantly. Up until December 2022, the financial services and information technology (including communication services) sectors had almost similar weight levels (~32%) in the Morningstar India Index. However, by March 2024, the financial sector has surged to over 40% of the Morningstar India Index, while the IT and communication services sectors' weight had reduced to approximately 14%. With these shifts in mind, it is crucial for investors to understand sector-specific risks as it helps them manage risks and diversify effectively.

Exhibit 4 % Assets in Top 10 Holdings

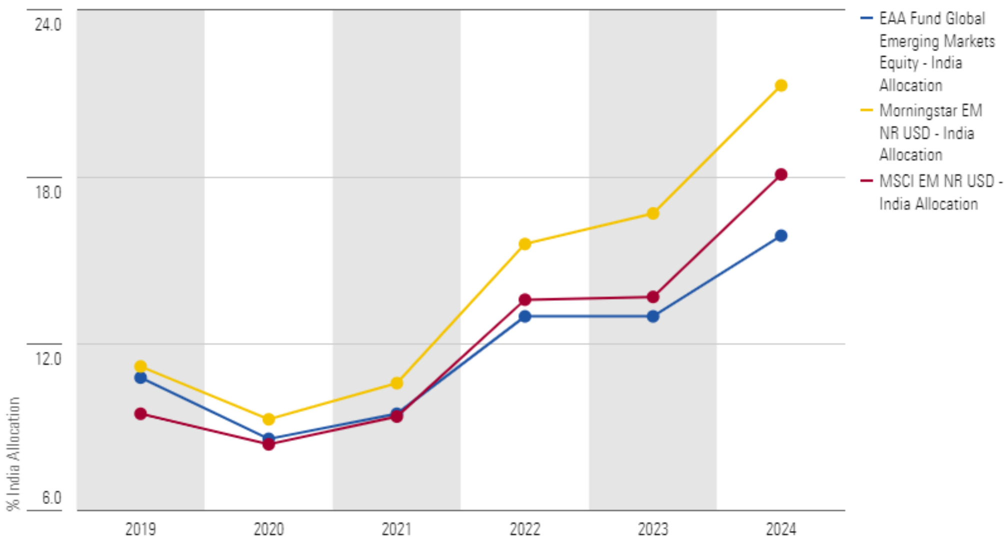


Source: Morningstar Direct Data as of April 30, 2024.

How Have the Emerging-Markets-Focused Funds Positioned?

The interplay of robust market performance, a favorable market structure shift, and China's underperformance has driven a significant rise in the average allocation to India by funds in the Morningstar Europe, Asia, and Africa, or EAA, global emerging-markets equity category over the past five years (Exhibit 5). Despite this surge, the average allocation remains underweight compared with the market index, with the gap widening over this period (Exhibit 5). Fund managers show a clear preference for large-cap Indian stocks, as the underweight gap relative to the MSCI Emerging Market Index is narrower than that to the Morningstar Emerging Market Index.

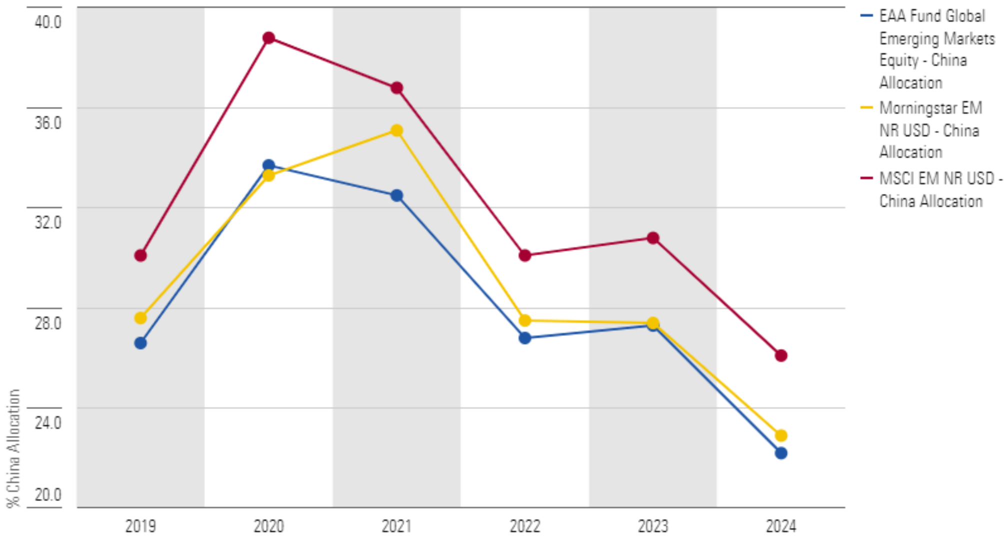
Exhibit 5 Trend of Average Allocation to India by Global Emerging-Markets Funds



Source: Morningstar Direct Data as of April 30, 2024.

On the contrary, despite the China equities' relative underperformance, the average China allocation by funds within the EAA global emerging-markets equity category over the past five years has been narrowed to reach at the market index level (Exhibit 6).

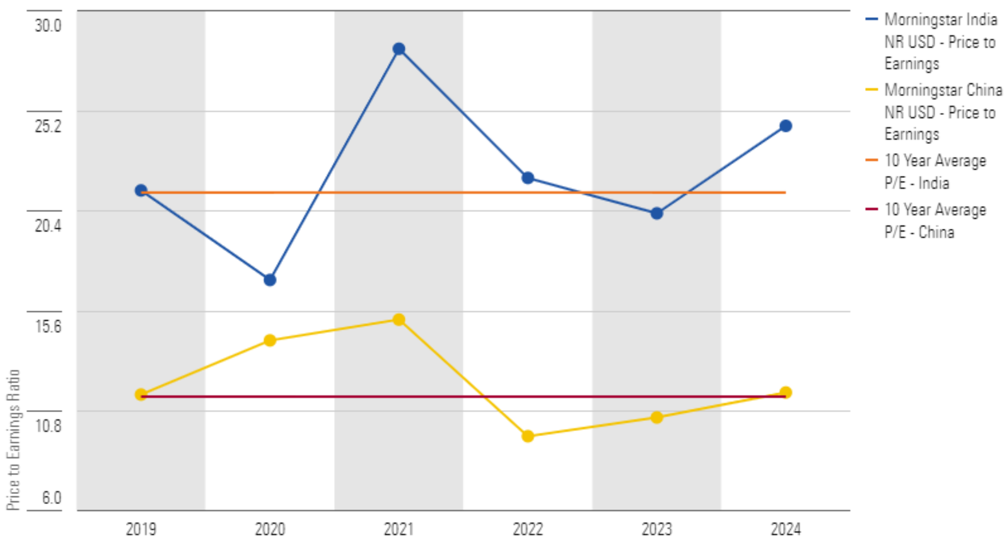
Exhibit 6 Trend of Average Allocation to China by Global Emerging-Markets Funds



Source: Morningstar Direct Data as of April 30, 2024.

Some of the asset managers under our Morningstar Analyst Rating coverage attribute this allocation disparity to the varying equity valuations between the two countries (Exhibit 7), as they remain cautious about the generally elevated valuation levels of Indian equities.

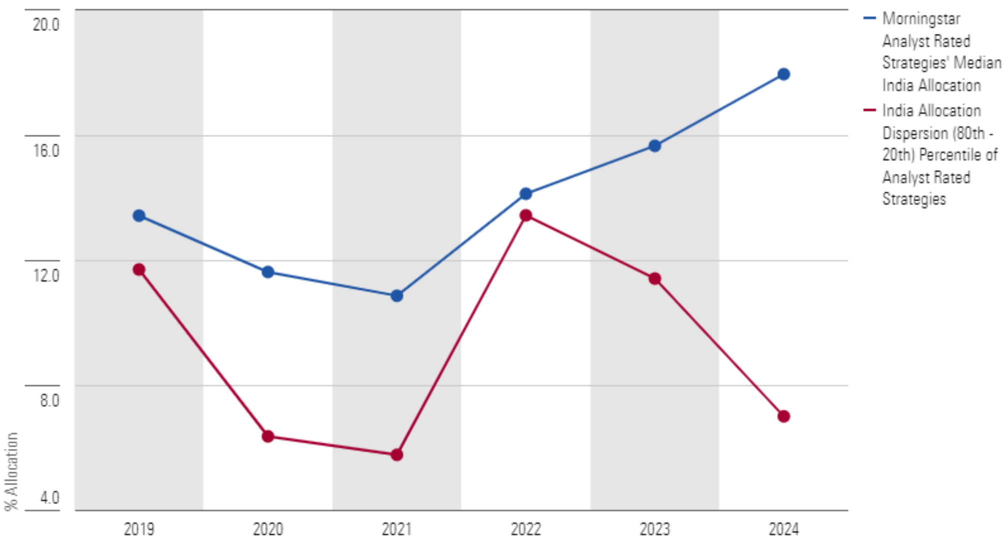
Exhibit 7 Valuation of Indian Equities Look Steep Compared with China



Source: Morningstar Direct Data as of April 30, 2024.

As India's weight in various global emerging-markets indexes witnessed a surge in the trailing five years, many of our analyst-rated funds in the EAA global emerging-markets category have generally increased their exposure to India in response. However, this trend has not been consistent across all funds. The level of exposure to India has varied significantly among these funds in recent years. Recently, the variation has decreased significantly when compared with a year ago. This trend indicates that some fund managers are carefully balancing India's growing weight in the emerging-markets indexes with their cautious view of Indian equities' rich valuations. The reduced dispersion in India allocations reflects a convergence: some managers who previously had a relatively higher exposure to India are reducing their positions, while those who were underweight are increasing their allocations. This balance shows a nuanced approach among different managers when it comes to managing investments in India.

Exhibit 8 Allocation Dispersion Among Morningstar Analyst-Rated Managers Have Declined Sharply in the Past Year



Source: Morningstar Direct Data as of April 30, 2024.

Illustrating this cautious optimism, the JP Morgan Emerging Markets fund (rated Silver on its C share class), has been reducing its India exposure since October 2022, citing concerns about the Indian market's steep valuations. Despite this, they still see long-term structural investment appeal in the market. In contrast, the abrdn Global Emerging Markets fund, (currently Under Review), has been steadily increasing its India allocation, driven by growing confidence in India's long-term fundamentals.

Shifting Sands: What Should Investors Look Out For?

The convergence of Chinese and Indian stock weights in global emerging market indexes is remarkable, considering that historically, the difference between the two countries' weights in the Morningstar Emerging Market Index exceeded 30% at one point in October 2020. It's worth noting, though, that India's robust stock market rally has not been able to offset the steep decline in China's equities market. This alignment of weights between the two countries underscores a significant shift in the emerging-markets landscape that investors should be aware of.

The continued momentum in Indian equities will likely depend on sustained economic growth, corporate earnings performance, and political stability. While the broader base of market growth in India presents a lower concentration risk compared with markets like Taiwan, investors should remain vigilant about valuation levels and sector-specific risks. As global funds increasingly favor Indian equities, this trend could provide both opportunities and challenges, necessitating a balanced and informed investment approach.

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