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Factor Investing in the Emerging Markets

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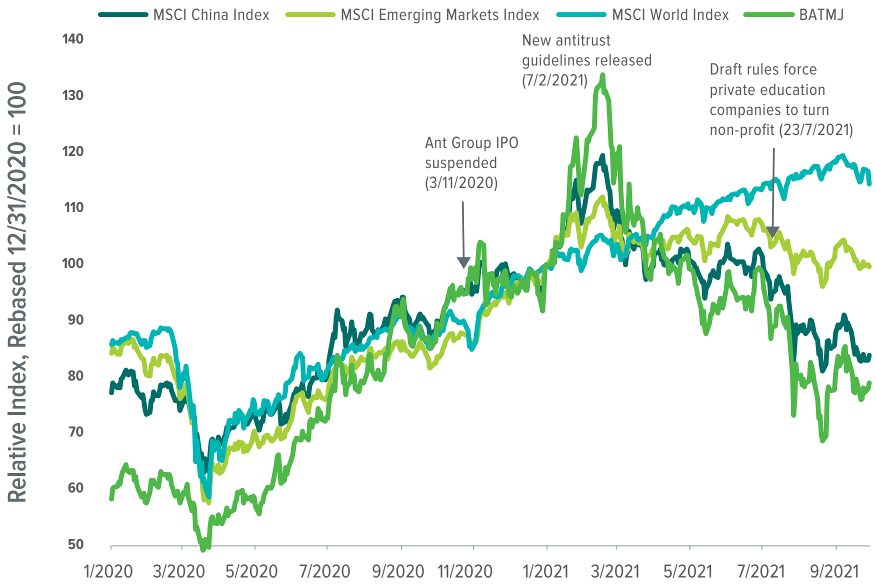
Snapshot

- Recent regulatory changes in China have created headwinds for equities within the country.
- We believe that the emerging-markets asset class can provide opportunities for skilled investors due to pockets of inefficiency that tend to be present.
- Value, momentum and quality factors have all performed well in the emerging markets this year and exceeded their long-term return averages.

Recent regulatory changes in China focused on global tax optimization, data collection and natural monopolies have created headwinds for equities within the country. As seen in Exhibit 1, the sudden manner in which these changes were launched was disruptive to the entire emerging-market region, especially China. The MSCI China Index, which is heavily weighted in large technology names and makes up a significant percentage of the MSCI Emerging Markets Index, was down over 20% for the year-to-date as of September 30, 2021. The BATMJ stocks (an acronym used to refer to the five largest tech companies in China)—Baidu, Alibaba, Tencent, Meituan and JD.com)—were hit hardest. The decline was mostly in response to the potential impact that recent and future regulations could have on economic growth.

Factors are security characteristics that explain their co-movement: Rewarded factors lead to long-term portfolio benefits. Grouped into families, factors help capture systematic alpha sources or reduce risks of drawdown.

Exhibit 1: Emerging Markets Fall Behind the World



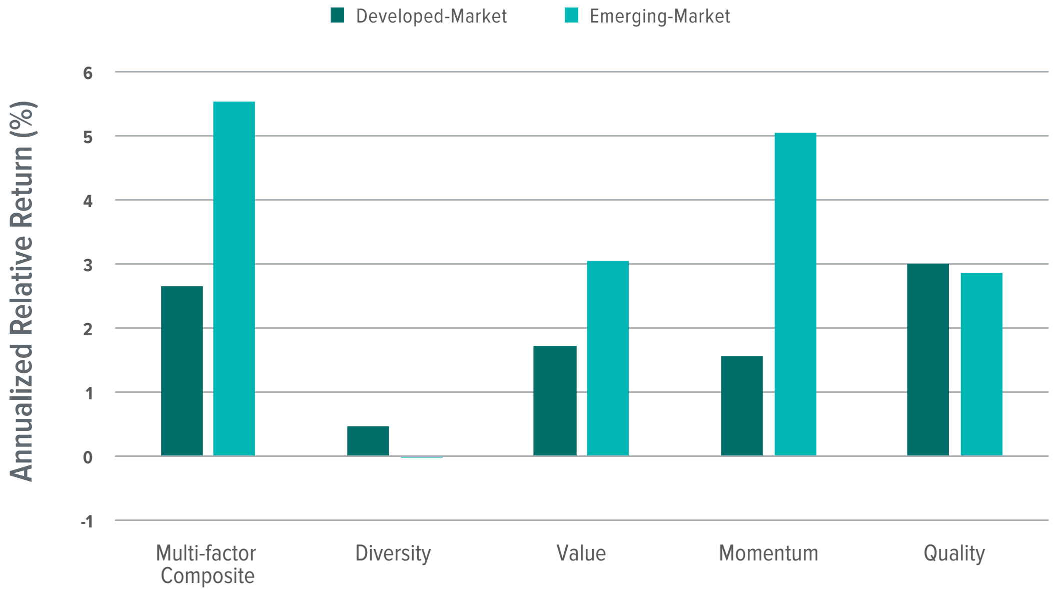
Source: MSCI, FactSet, Reuters, Bloomberg. Data spans 1/1/2020-30/9/2021. BATMJ reflects performance of the following stocks: Baidu, Alibaba, Tencent, Meituan, JD.com. All indexes are total return. Index returns are for illustrative purposes only and do not represent actual investment performance. Index returns do not reflect any management fees, transaction costs or expenses. Indexes are unmanaged and one cannot invest directly in an index. Past performance is not a reliable indicator of future results.

The bulk of the selloff happened over the past six months as China's government turned most of the nation's for-profit tutoring firms into non-profits. Investors seemed to be particularly surprised by how quickly the changes unfolded and the eventual scale of their impact. We think a structural shift in the market seems imminent and that it should serve as a clear wakeup call to investors regarding the regulatory risks of investing in the country.

Factor investing in emerging markets

We believe that the emerging-markets asset class can provide opportunities for skilled investors due to pockets of inefficiency that tend to be present. Emerging markets generally lack some of the transparency of more developed markets and are therefore more likely to present opportunities for active management. As seen in Exhibit 2, factor investing in emerging markets has outperformed similar strategies in developed markets over the last 20 years.

Exhibit 2: Opportunity in Emerging Markets

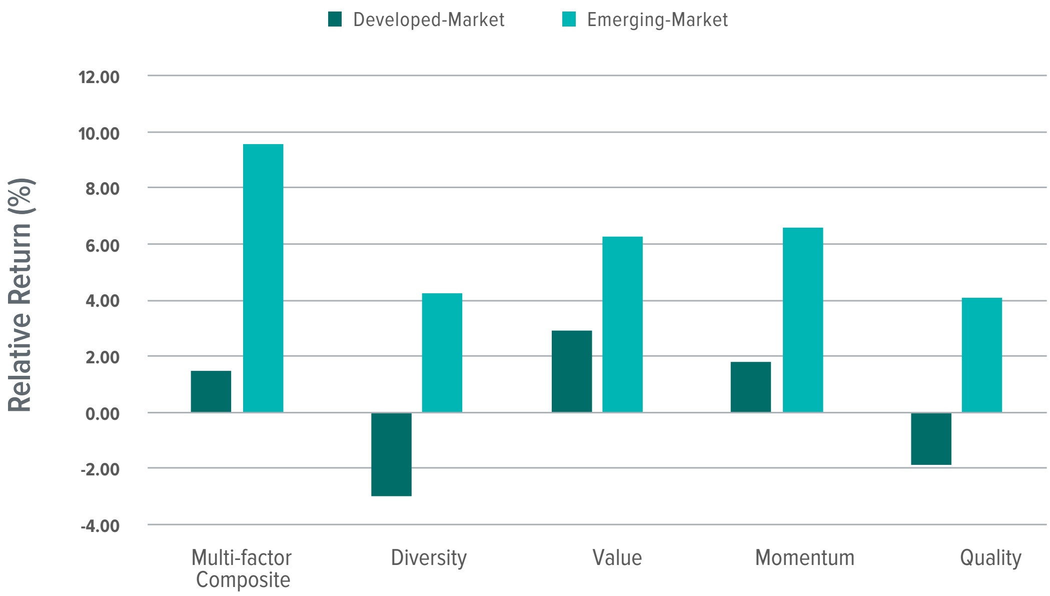


Source: SEI, MSCI, FactSet. Data spans 1/6/1999-30/9/2021. Value, momentum and quality are liquidity-weighted top tercile comparing to liquidity-weighted benchmarks. Liquidity weighting underweights mega-cap stocks compared to market-capitalisation weighting. Developed-market benchmark is MSCI World Index. Emerging-market benchmark is MSCI Emerging Markets Index. Diversity is the difference between the liquidity-weighted benchmark and cap-weighted benchmark. Multi-factor composite is the equal-weighted average between value, momentum and quality.

Value: a **mean-reverting** strategy that based on acquiring assets at a discount to their fair valuation. Momentum: a **trend-following** investment strategy that is based on acquiring assets with recent improvement in their price, earnings, or other relevant fundamentals.Quality: a **long-term buy and hold** strategy that is based on acquiring assets with superior and stable profitability with high barriers of entry.

As shown in Exhibit 3, value, momentum and quality have performed well in the year to date through 30 September 2021, and exceeded their long-term return averages. Both diversity (underweight mega caps) and a multi-factor approach have also benefited.

Exhibit 3: Opportunity in Emerging Markets



Source: SEI, MSCI, FactSet. Data spans 1/1/2021-30/9/2021. Value, momentum and quality are liquidity-weighted top-tercile compared to liquidity-weighted benchmarks. Liquidity weighting underweights mega-cap stocks compared to market-capitalisation weighting. Developed-market benchmark is MSCI World Index. Emerging-market benchmark is MSCI Emerging Markets Index. Diversity is the difference between liquidity-weighted benchmark and cap-weighted benchmark. The multi-factor composite is the equal-weighted average between value, momentum and quality.

Our Portfolio

Exhibit 4 looks at the top holdings in SEI's internally managed emerging-markets equity strategy, which is a sleeve of the SGMF Factor Allocation Global Equity Fund. The strategy has performed well for the year to date, outperforming its MSCI Emerging Markets Index benchmark by 7.6%, in line with the alpha style performance.

Exhibit 4: Active Holdings

	Positioning			Score: 100% is best, 0% is worst			Performance
	Region	Active Weight	Benchmark Weight	Value	Momentum	Stability	YTD Return**
Top 5 Active Holdings as at 31 Dec 2020							
United Microelectronics	TaiWan	2.05%	0.24%	48%	98%	68%	41.1%
Li Ning	China	1.71%	0.17%	15%	81%	74%	69.1%
LG	Korea	1.31%	0.12%	76%	89%	42%	-13.3%
Lenovo	China	1.18%	0.08%	65%	85%	73%	18.1%
Lite-On Technology	TaiWan	1.10%	0.05%	79%	34%	82%	39.0%
Average		1.47%	0.13%	57%	78%	68%	33.9%
Chinese Tech: BATMJ							
Alibaba	China	-1.75%	7.25%	21%	83%	74%	-36.4%
Tencent	China	-1.37%	6.10%	17%	83%	79%	-18.3%
Meituan	China	-1.28%	1.95%	7%	94%	24%	-16.6%
JD.COM	China	0.70%	1.06%	26%	95%	47%	-17.5%
Baidu	China	-0.56%	0.56%	52%	91%	62%	-28.9%
Average		-0.85%	3.38%	24%	89%	57%	-23.5%

Source: FactSet, SEI. Data spans 1/1/2021-30/9/2021. Top 5 active holdings are of SEI's internally managed emerging-markets equity portfolio, which is a sleeve of the SGMF Factor Allocation Global Equity Fund. MSCI Emerging Markets Index returned -0.99% during this same period.

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As current market leadership broadens beyond large-capitalisation technology stocks, the market should once again punish complacency and reward active stock selection. While passive flows create a high concentration of stocks that are more richly priced than their estimated fair value, our actively managed strategies are designed to capitalise on long-term drivers of market performance through their exposure to value, momentum and stability. The long-term viability of these alpha sources has been proven out by years of academic research.

The active holdings in our internally managed emerging-market equity strategies are generally underweight expensive technology names with high momentum scores. The portfolio is also more balanced and diverse than its benchmark.

Fundamentally, a portfolio that owns cheap, high-quality stocks should naturally enjoy a higher “safety margin” and be able to navigate through a period of changing market dynamics better than a portfolio owning expensive, low-quality names. This is even more important when investors face a market with less efficiency but also greater corporate governance risks.

Standardised Performance as at 30 September 2021

	30/9/2017- 30/9/2017-	30/9/2017- 30/9/2017-	30/9/2017- 30/9/2017-	30/9/2017- 30/9/2017-	30/9/2017- 30/9/2017-	30/9/2017- 30/9/2017-	Since Inception
SGMF Factor Allocation Global Equity Fund (USD Inst)	31.60%						21.51%
MSCI ACWI Index (Net) (USD)	27.44%						21.51%

Date of inception is 31/10/2019.

Source: MSCI, SEI. Past performance is not a reliable indicator of future results.

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