The Rise of Ex-China Funds

Investors should think twice before removing China from their emerging-market allocation.

Morningstar
July 1, 2025

Contents

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Key Takeaways

- **The emerging markets ex-China equity funds are a niche segment, but it is growing fast**: The number of ex-China funds has surged in recent years with record fund launches in 2023 and 2024.
- **Assets have skyrocketed**, going from USD 800 million in 2015 to USD 25 billion today. Most of the assets have been accumulated in 2023 and 2024, with USD 10.5 billion of net new money entering these funds last year alone. Yet, the ex-China cohort remains tiny within the broader emerging-market space and is dominated by passive strategies.
- **Most actively managed open-end funds are small and young**, raising concerns that they may not survive in the longer run.
- **The narrative behind these funds has shifted toward risk mitigation:** the regulatory crackdowns and governance issues, rising geopolitical tensions around the world, and economic uncertainty in China since the covid pandemic have unsettled investors, fueling the appeal of ex-China offerings.
- **Performance divergence is stark**: Since January 2020, the Morningstar Emerging Markets ex-China Index significantly outperformed the Morningstar China Index, with a 36% cumulative return versus near-zero performance for Chinese equities. The strong performance of India during the period has lifted the performance of emerging market ex-China.
- **Completely shunning China in an emerging-market allocation may tempt investors** because of its recent lackluster returns, but this strategy may prove shortsighted.
- **Investors should consider an emerging-market allocation without China carefully**: Removing China increases exposure to countries like India, Taiwan, and Brazil, and shifts sector allocations toward financials, energy, and materials.
- **Going ex-China reduces diversification and the opportunity set**: China offers a vast, inefficient market with unique growth dynamics and a large opportunity set. Our active/passive barometer shows that it is a fertile ground for active managers. Excluding China could hurt portfolio diversification and long-term performance potential.
- **The optimal approach may be balance**: Rather than a binary choice, combining an emerging-market ex-China fund with a dedicated China allocation—or selecting a flexible emerging-market manager who can handle China's pitfalls—would offer risk-managed exposure while preserving upside potential.

Unless specified otherwise, all the data in the report is as end of May 2025.

Introduction

Over the past quarter-century, emerging markets have transformed from a niche allocation to a widely accepted component of global investment portfolios. In the late 1990s, countries across Latin America, Eastern Europe, Africa, and Asia were beginning to attract institutional attention, primarily due to their growth potential and expanding capital markets. Among them, China stood out.

China's rise within the emerging-market universe has been nothing short of extraordinary. From joining the World Trade Organization in 2001 to becoming the world's second-largest economy around 2010, China's weight in emerging-market equity indexes rose dramatically. At its peak in October 2020, China alone represented 42% of the Morningstar Emerging Markets Target Market Exposure Index and five of the index's top 10 holdings were listed in Hong Kong. The concentration risk, along with the broader underperformance of Chinese equities and heightened geopolitical risks, has prompted both asset managers and allocators to reconsider their approach. While the first emerging-market ex-China funds appeared around 10 years ago, they have only gained momentum in the last three years.

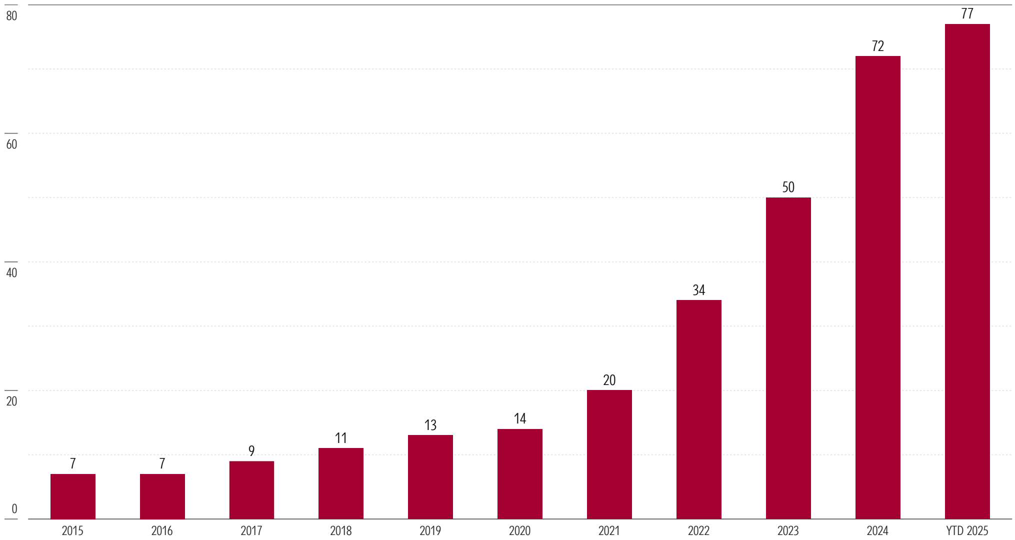
The purpose of this article is to examine the current investment landscape of emerging-market strategies excluding China. We explore the range of investment products available and offer insights into how investors can approach this growing segment.

A Growing Breed, but It's a Passive Game

The emerging-market ex-China proposition is a recent idea. Before 2015, these funds were virtually nonexistent, or at least not widely offered through public funds. A large majority of the 77 investment funds currently registered in the Morningstar database globally have been launched in the last five years with a net acceleration since 2022, as the Chinese equity market tumbled and investors were spooked by geopolitical risks. It was a record year in 2024 with 22 new products hitting the market. Around half of the funds are domiciled in Europe, the rest in North America, and a few in Asia-Pacific. The growing number of funds in Europe led to the creation of a dedicated Morningstar category within our Europe, Asia, and Africa category system in April 2025.[1]

1 The EAA Fund Global Emerging Markets Ex-China Equity was launched in April 2025.

Exhibit 1 Number of Ex-China Funds Globally (2015-25)

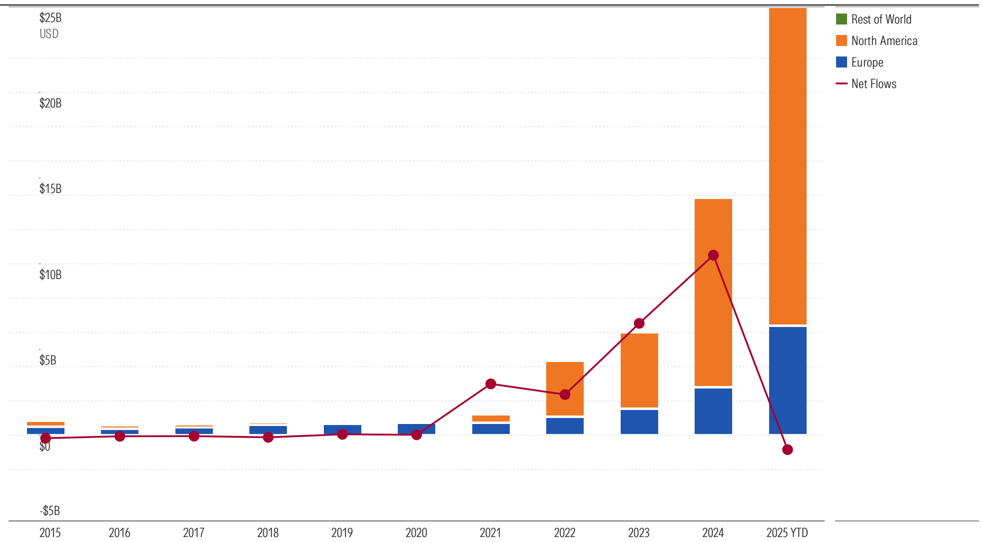


Source: Morningstar Direct. Data as of May 31, 2025.

Asset growth has been striking, although it began from a very modest starting point. The bulk of net inflows occurred from 2021 onward, culminating in a record year in 2024 with USD 10.5 billion of net new money before cooling down this year through May. The capital inflow last year was particularly striking given the broader context of defiance toward the asset class: global emerging-market equity funds saw outflows of USD 9.9 billion in 2024.

Between January 2021 and the end of May 2025, assets invested in ex-China emerging-market funds ballooned from USD 800 million to USD 25 billion, with roughly three-quarters of that capital housed in US-domiciled products. Still, these funds represent only a niche within the broader emerging-market category—mutual funds and exchange-traded funds focused on global emerging-market equities held around USD 1 trillion in total assets globally as of the end of May 2025.

Exhibit 2 Assets Under Management in Ex-China Funds by Region and Net Flows (2015-25)



Source: Morningstar Direct. Data as of May 31, 2025.

Passive Dominance

The ex-China theme is predominantly driven by passive investing. As of the end of May 2025, 84% of total assets were held in index-tracking strategies, with iShares capturing the lion's share. The US-listed iShares MSCI Emerging Markets ex China ETF and its European counterpart—the iShares MSCI Emerging Markets ex China ETF USD—collectively managed USD 16.6 billion of assets.

In contrast, actively managed funds in this segment remain relatively small. While a few have managed to scale, the majority have not. Of the 56 actively managed funds currently on record, 85% have less than five years of existence and 70% hold less than USD 100 million in assets, raising questions about their long-term sustainability unless their assets increase meaningfully.

Exhibit 3 The 10 Largest Ex-China Equity Funds Globally

* Oldest share class is referenced.

Name	Passive (Y/N)	ISIN	AUM (mil USD)	Fees*
iShares MSCI Emerging Mkts ex China ETF	Yes	US46434G7640	13,994	0.25
iShares MSCI EM ex China ETF	Yes	IE00BMG6Z448	2,719	0.18
Amundi MSCI Emerging Mkt Ex China ETF	Yes	LU2009202107	1,905	0.15
DFA Emerging Mkts ex China Cr Eq Port	No	US25239Y2871	1,238	0.43
Columbia EM Core ex-China ETF	Yes	US19762B2025	1,177	0.16
Amundi MSCI Em Ex Chn ESG Selection ETF	Yes	LU2345046655	518	0.35
Goldman Sachs Em Mkts Ex-CHN Cr Eq Ptf	No	LU2595376497	433	0.63
Invesco Emerging Markets ex China (UK)	No	GB0033048280	360	1.50
BGF Emerging Markets Ex-China Fund	No	LU2719175460	264	0.84
HSBC MSCI Emerging Mkts ex China Eq Idx	Yes	GB00BRV4L519	218	0.10
Nordea 1 - EM ex China Sust Stars Equity	No	LU2528868859	207	0.09

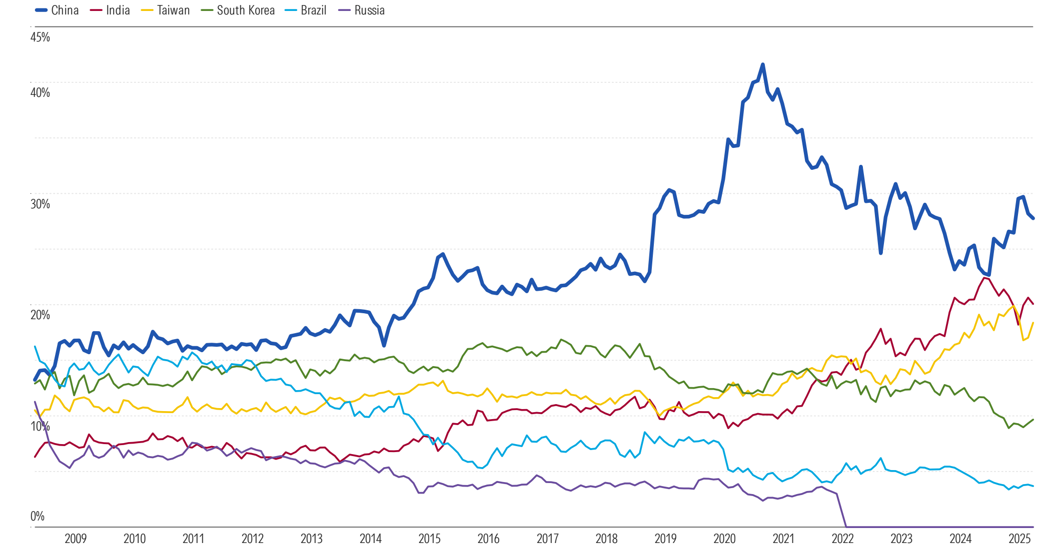
Source: Morningstar Direct. Data as of May 31, 2025.

Ex-China Funds: A Shifting Narrative

An Asset-Allocation Story—at First

The narrative behind the ex-China theme has shifted over time. Initially, the claim was about providing a purer exposure to the rest of the emerging-market universe as China is progressing toward "developed market" status. Its sheer scale and rapid economic ascent have made it a heavyweight in emerging-market benchmarks. For example, in the Morningstar Emerging Market Target Market Exposure Index, China has consistently represented over 20% of the total weighting in the past decade, often dwarfing other large emerging-market constituents such as India, Brazil, or South Korea.

Exhibit 4 Weight of Key Emerging Markets in the Morningstar EM TME Index (2008-2025)



Source: Morningstar Direct. Data as of May 31, 2025.

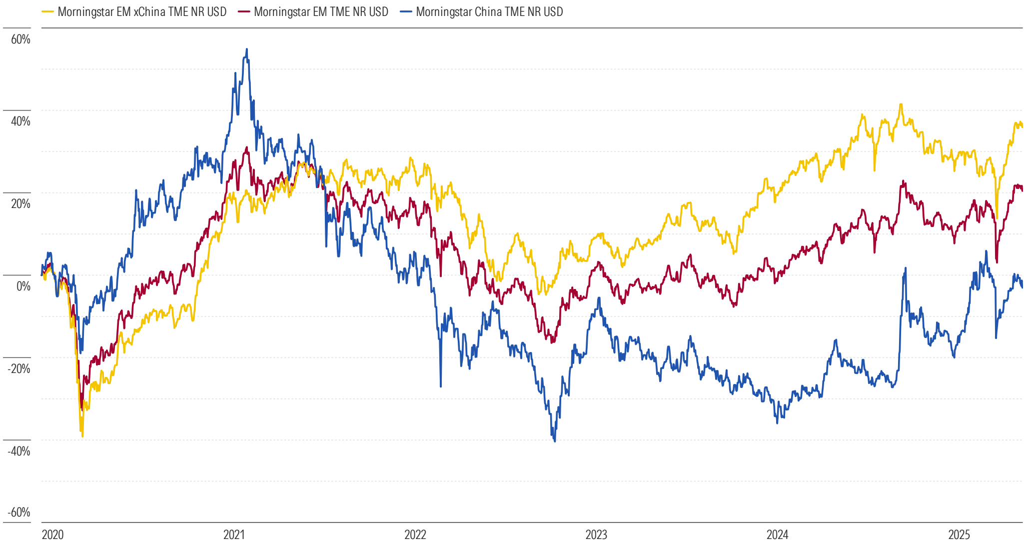
The logic continued that the rising weight of China in emerging-market benchmarks was diminishing the geographical diversification benefits traditionally associated with emerging-market funds. The developing world includes disparate countries and regions with different drivers and less synchronized economic cycles. Over time, some believed that China—given its sheer size, distinct economic structure, and growing global influence—would warrant a dedicated allocation in investors' portfolios, distinct from the broader developing world and would be recognized as such by the index providers. So, investors would eventually pair an ex-China strategy with a China-focused fund.

Now, It's All About Avoiding China's Challenges

While a structural separation of China from the rest of emerging markets may still be a long-term outcome that would require revisiting the asset-allocation approach, the narrative has shifted more decisively toward risk mitigation over the past five years. China's equity markets have encountered numerous challenges since the covid pandemic, including prolonged lockdowns and a delayed economic reopening that dampened consumer confidence, regulatory crackdowns on sectors like technology and education, and ongoing instability in the real estate sector. Rising geopolitical tensions—particularly with the United States—have also weighed heavily on investor sentiment toward China. The Russian invasion of Ukraine underscored for investors the systemic risks posed by geopolitical flashpoints, drawing uncomfortable parallels with the possibility of an escalation over Taiwan. These heightened concerns have reinforced the perceived vulnerability of investing in China.

For all these reasons, China's equity market has underperformed massively: From January 2020 to the end of May 2025, the Morningstar Emerging Market Ex-China TME Index returned 36% in USD cumulatively, while the Morningstar China Target Market Exposure Index lost 3%. During that period, many high-quality emerging-market funds stumbled in China,[2] which in turn have reinforced the appeal of ex-China funds.

Exhibit 5 Cumulative Performance since January 2020 (in USD)



Source: Morningstar Direct. Data as of May 31, 2025.

Portfolio Strategy

China and Ex-China

One may choose to invest in an ex-China emerging-market fund with the intention of maintaining a separate dedicated allocation to China. Barring sizable bets against the emerging-market index's country allocation, the resulting portfolio would offer an exposure largely like a typical core diversified emerging-market fund, preserving the long-term return potential and diversification benefits of the asset class. This approach acknowledges China's growing maturity and distinct economic trajectory.

Delegating a dedicated China allocation to a specialist in that market can make sense. Beyond passive strategies, China's equity landscape remains a compelling environment for active managers compared with more developed markets. According to Morningstar's European Active/Passive barometer, one-third of active China equity funds have both survived and beaten their passive competitors in the last 15 years, making it one of the highest long-term success rates of our study.[3] Factors such as limited transparency, regulatory unpredictability, uneven information dissemination, and high retail investor participation contribute to that market inefficiency, providing a favorable environment for skilled managers, if accessible at reasonable costs. Morningstar's Manager Research team covers several robust active funds in this space[4] that are well-positioned to navigate these complexities, providing investors with tailored exposure and the potential to capture alpha that passive strategies might miss.

2 See Caquineau & Liang. *"Why Quality Growth Failed in Emerging Markets."* May 2025.

3 See Gorbatikov, Zarate & Calay. "Morningstar's European Active/Passive Barometer - Year-End 2024." March 2025.

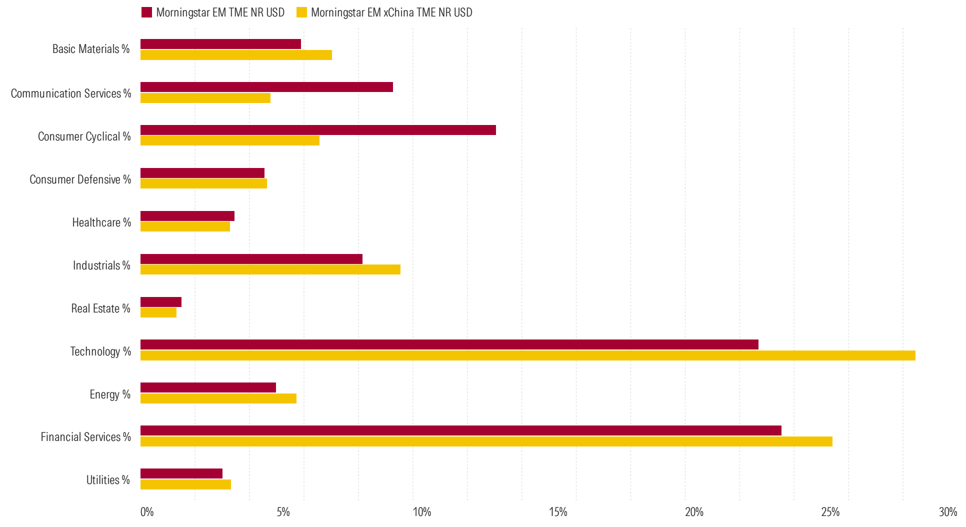
4 See Appendix for a list of highly rated China equity strategies.

Completely Avoiding China

Avoiding China with the goal of eliminating the associated risks may be understandable in the current environment. Also, deeper concerns remain on shareholders rights and government intervention. In China, state-owned enterprises, or SOE's, have seen their weight decline in the last decade, but around 20% of the Morningstar China Index is still made up of SOEs. These companies may prioritize state policy objectives over return on equity or capital efficiency.[5] That said, some of these risks are also seen in other emerging markets and are not exclusive to China.

Completely shunning China in an emerging-market allocation may also tempt investors because of its recent lackluster performance. But this strategy carries its own biases and risks that should be carefully assessed. First, it significantly alters a portfolio's sector and market composition. In the case of an actively managed fund, the magnitude of these bets will vary fund by fund. But looking at the index gives an indication of the general direction. Comparing the Morningstar Emerging Market Index alongside the Morningstar Ex-China Emerging Market Index, China's exclusion leads to decreased exposure to sectors like communication services and consumer discretionary—areas where large Chinese firms like Tencent, Alibaba, and Meituan dominate. However, most ex-China emerging-markets funds and indexes retain exposure to Taiwan, home to key technology players such as TSMC, which increase investors' exposure to the technology sector, perhaps counterintuitively. Elsewhere, the sector profile tilts more toward financials, energy, and materials—industries more prevalent in the broader emerging-markets universe outside of China.

Exhibit 6 Sector Exposure



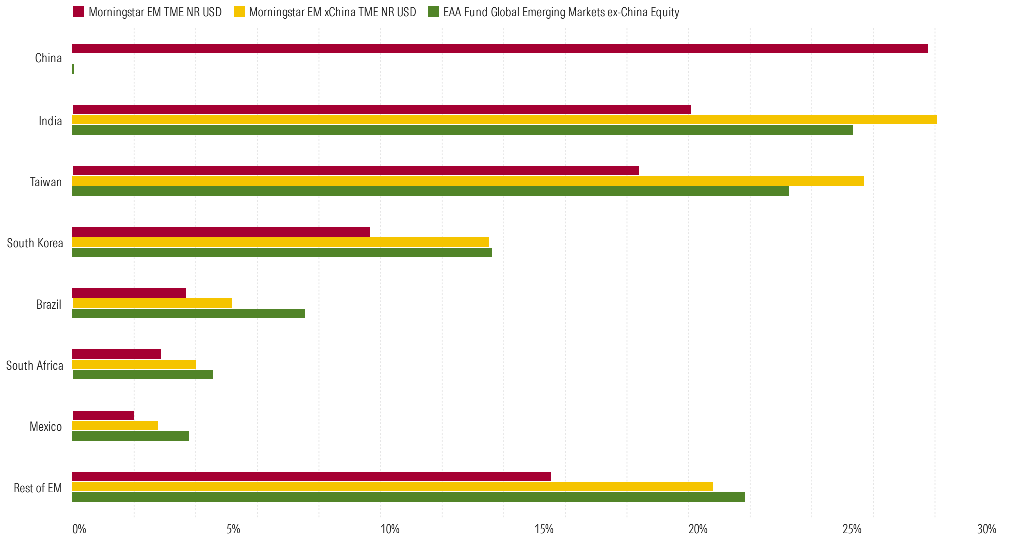
Source: Morningstar Direct. Data as of May 31, 2025.

Excluding China implies other major "active bets" against the traditional emerging-market index. It gives way to other large emerging markets, especially India, which becomes a dominant weight. Taiwan also becomes more prominent, which will give investors pause if going ex-China was a strategy to

5 See also Arnott, Amy C. "The Pros and Cons of Investing in China." June 17, 2025. Morningstar.

hedge against a potential conflict over Taiwan. South Korea and Latin American markets like Brazil and Mexico, as well as some Southeast Asian economies, also gain in weight. This shifts the geographical exposure materially.

Exhibit 7 Market Exposure



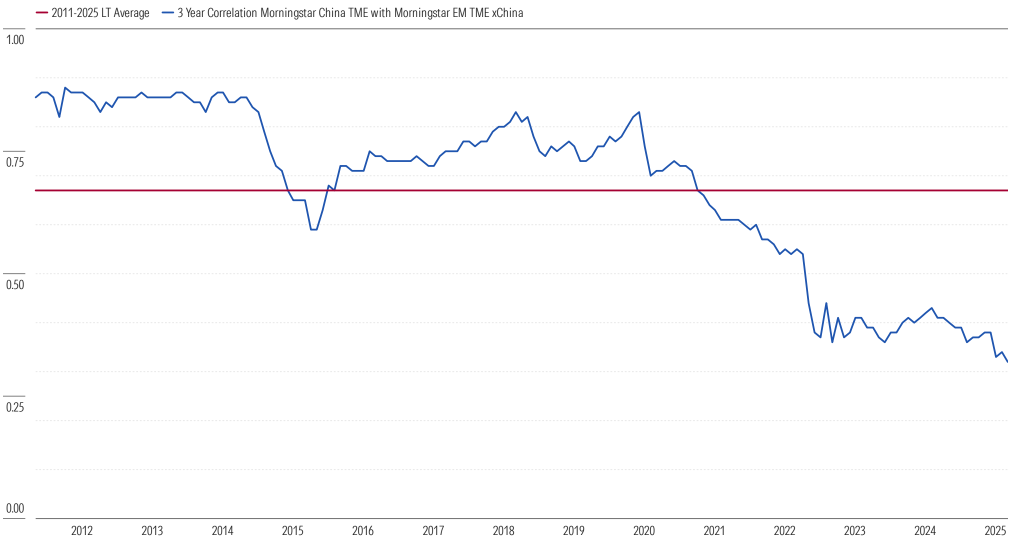
Source: Morningstar Direct. Data as of May 31, 2025.

A Reduced Opportunity Set

The China equity market is one of the largest and most diverse within the emerging-market universe. As of mid-2025, there are around 5,400 publicly listed companies across mainland China's stock exchanges (Shanghai and Shenzhen), with an additional set of Chinese firms listed in Hong Kong and the United States. The depth of the market is reflected not only in the number of stocks, but also in the breadth of industries represented and the availability of both large-cap and small-cap investment opportunities.

Going ex-China also reduces overall diversification benefits. China's economy has been increasingly driven by domestic consumption patterns, unique policy interventions, and structural reforms that do not necessarily align with the global commodity or export-driven trends that sometimes dominate other emerging markets. In the past 20 years, the Chinese equity market has been completely transformed. From a market centered around "old economy sectors" like financials (mostly banks), energy, and telecom stocks, it became increasingly dominated by the consumer and technology sectors by the end of the last decade with giants such as Tencent, Meituan, Alibaba, JD, and Baidu becoming index heavyweights. In parallel, China's correlation with the rest of the developing world has been on a downward trend. Granted, the country's idiosyncratic issues since the pandemic have pushed the correlation down; but it is not unreasonable to think that China has an increasingly distinct economic cycle that should keep a relatively low correlation with other emerging-market countries such as India and South Korea.

Exhibit 8 Rolling 3-Year Correlation



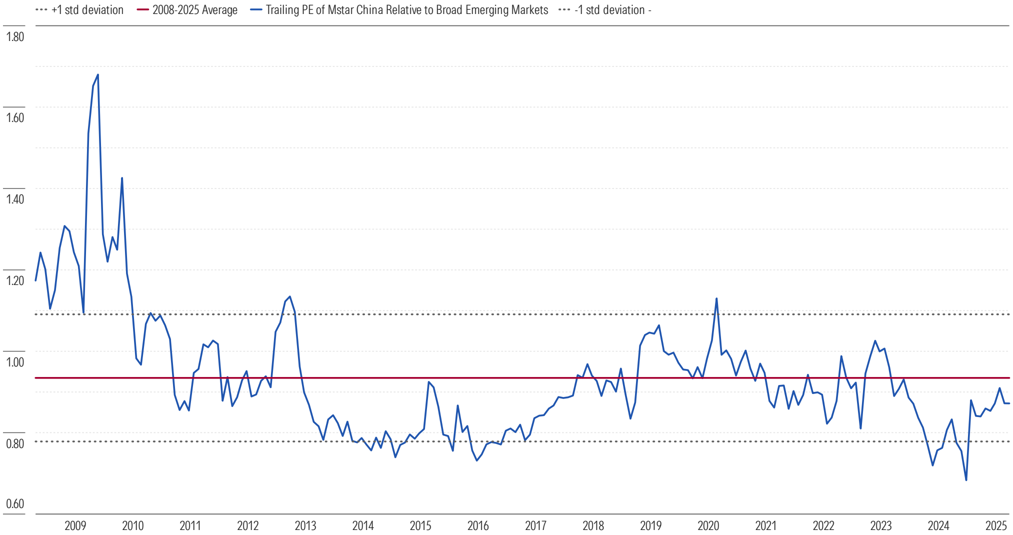
Source: Morningstar Direct. Data as of May 31, 2025.

The Timing Factor

From a valuation perspective, now may not be the ideal time to shift entirely to an ex-China allocation. As sentiment around China remains cautious—driven by concerns over regulatory pressures, slowing growth, and geopolitical tensions—these fears are arguably priced in and therefore often coincide with attractive entry points for long-term investors.

China's equity market has experienced a multiyear stretch of underperformance, and its valuation metrics such as the P/E ratio have hit historically low levels in 2024. While China regained some grounds in the year to date through May, it still trades at a notable discount compared with other major emerging markets like India and Taiwan. As of the end of May 2025, its P/E ratio was below that of the broader emerging-market index and below its long-term average, suggesting that much of the negative sentiment might already be priced in. For contrarian investors seeking long-term value, this valuation gap may offer a compelling reason to maintain or even increase exposure to China, rather than exclude it altogether at what could be a cyclical low.

Exhibit 9 Morningstar China Index Relative P/E vs Morningstar Emerging Markets Index (2008-25)



Source: Morningstar Direct. Data as of May 31, 2025.

Conclusion

Emerging-market ex-China funds have grown rapidly in recent years, reflecting both structural and tactical shifts in investor sentiment. These funds are all relatively new and it's hard to say if they are here to stay. The surge in their popularity is linked to China's current woes, which may not last forever.

It's likely that China will be treated as a stand-alone allocation in the future, possibly split for the rest of the developing world like how Japan's status changed over time. This will legitimately solidify the emerging-markets ex-China category of funds. But using these funds to completely shun China is a drastic move that brings several risks investors should be mindful of. Such a decision significantly reshapes sector and country exposures, amplifying weights in markets like India, Taiwan, and Brazil, while reducing exposure to China's unique growth drivers and vast equity universe. This alters diversification benefits and reduces access to one of the world's most inefficient—and potentially alpha-rich—markets. Furthermore, timing matters. China's current valuation levels are attractive compared with other emerging markets, offering contrarian investors potential long-term upside.

For long-term investors, combining emerging-market ex-China strategies with a reduced China allocation can strike a balance between mitigating risks and preserving access to China's vast and idiosyncratic market. Most investors would however be better off delegating that decision and opt for a global emerging-market fund managed by a skilled active manager capable of dynamically adjusting exposure to China in response to evolving risks and opportunities. Granted, market-timing is a tricky exercise. But such a flexible approach may be better than completely avoiding China. It allows for the underweighting of China when warranted, without fully abandoning its long-term growth potential and alpha opportunity. In doing so, investors avoid the binary choice of inclusion versus exclusion, while retaining diversified and adaptable exposure to the broader emerging-market landscape.

Appendix

Exhibit 10 China Equity Funds: Our Preferred Options

Fund Standard Name	ISIN	Morningstar Rating	Morningstar Medalist Rating	Morningstar Medalist Rating People Pillar	Morningstar Medalist Rating Process Pillar	Morningstar Medalist Rating Parent Pillar	Fund Size (USD Mil)
abrdn - All China Sustainable Eq	LU0231483743	★★★	Bronze	Above Average	Above Average	Average	329
FSSA China Growth Fund	IE0004811224	★★★★	Silver	High	High	Average	2,541
JPM China Fund	LU0051755006	★★	Bronze	Above Average	Above Average	Above Average	3,385
Schroder ISF China Opportunities	LU0244355391	★★★	Gold	High	High	Above Average	968
UBS (Lux) EF China Opportunity (USD)	LU0067412154	★★★	Neutral	Above Average	Above Average	Average	2,909
Veritas China Fund	IE00B4QQGH82	★★★★	Silver	High	Above Average	Above Average	23

Funds in the EAA Fund China Equity Morningstar category covered by Morningstar Manager Research with People and Process pillar ratings set at a minimum of Above Average & Above Average. The Morningstar Rating and Morningstar Medalist Rating are displayed for the fund's oldest share class. The ratings may differ depending on the share class and its associated fees. .

Source: Morningstar Direct. Data as of May 31, 2025.

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