EXCLUDING BAD ACTORS FROM EMERGING MARKETS:

Beyond the "All-China" or "Ex-China" Debate

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Key Takeaways

- Emerging markets (EM) equities are at historically low prices and valuations relative to U.S. large-cap stocks.
- An under-allocation of investor capital to emerging markets, unequal growth rates, and other macroeconomic factors such as possible U.S. rate cuts are tailwinds for EM equities that indicate a possible rotation into the out-of-favor asset class.
- Chinese equities have a place in globally diversified portfolios, providing exposure to the 2nd largest economy in the world, the 3rd largest trading partner of the United States, and the largest country allocation within traditional emerging markets benchmarks.
- Contrary to popular belief, most foreign entities on U.S. blacklists are not subject to an investment ban, resulting in billions of dollars flowing to known "bad actor" companies.
- Bad actors found in today's dominant EM benchmarks include sanctioned human rights violators and defense firms that produce weapons systems for hostile states.
- A bipartisan consensus is forming in Congress to restrict investment in companies blacklisted by the U.S. government, including subsidiaries and affiliates of bad actors held by EM index funds.
- Publicly traded companies have lost value relative to their respective benchmarks when added to U.S. government blacklists, incentivizing managers to avoid bad actors.
- Responsible emerging markets investors no longer face an "All-China" or "Ex-China" dilemma, because National Security Index (NSI) provides a third option, one that actively screens out bad actor companies.
- The Alerian National Security Emerging Markets Index has outperformed the MSCI Emerging Markets Index from its launch date of 3/21/2022 through the last complete quarter ending on 6/28/2024.[1]

Executive Summary

Emerging markets equities have attractive valuations and high growth expectations, but geopolitical tensions are also elevated.[2] In the Asia-Pacific region, the United States and its allies face an increasingly assertive China, whose rapid military buildup is the most extensive in history since World War II.[3] In response to the threat, Congress has issued a bipartisan call for tighter controls on outbound capital to Chinese military companies and human rights violators, restrictions that could have a material effect on EM portfolios. Leading asset managers stubbornly refuse to remove these "bad actor" companies from their funds until legally required to divest; but forced divestment by the government could come without notice, particularly in the event of a crisis, exposing investors to potential losses. This impasse has left index investors with a false choice between two options: an "Ex-China" stance that sacrifices exposure to the world's second largest economy and an "All-China" approach that blindly accepts hostile defense firms and human rights violators.

A third approach to emerging markets is available from National Security Index (NSI), a veteran-owned business that helps Americans invest in EM responsibly. NSI uses open-source intelligence tools and methods to systematically exclude companies that test positive for one of nine national security and human rights screens. The result is an index designed to give investors emerging markets exposure without endangering U.S. troops and human rights interests. The index may also help investors sidestep companies that are susceptible to forced divestment and steep price drops following expulsion from U.S. capital markets.

Removing bad actor companies from portfolios may improve performance over time. The Alerian National Security Emerging Markets Index has outperformed the MSCI Emerging Markets Index from its launch date of 3/21/2022 through the last complete quarter ending on 6/28/2024.[4] The associated National Security Emerging Markets Index ETF (Nasdaq: NSI) launched in December 2023.

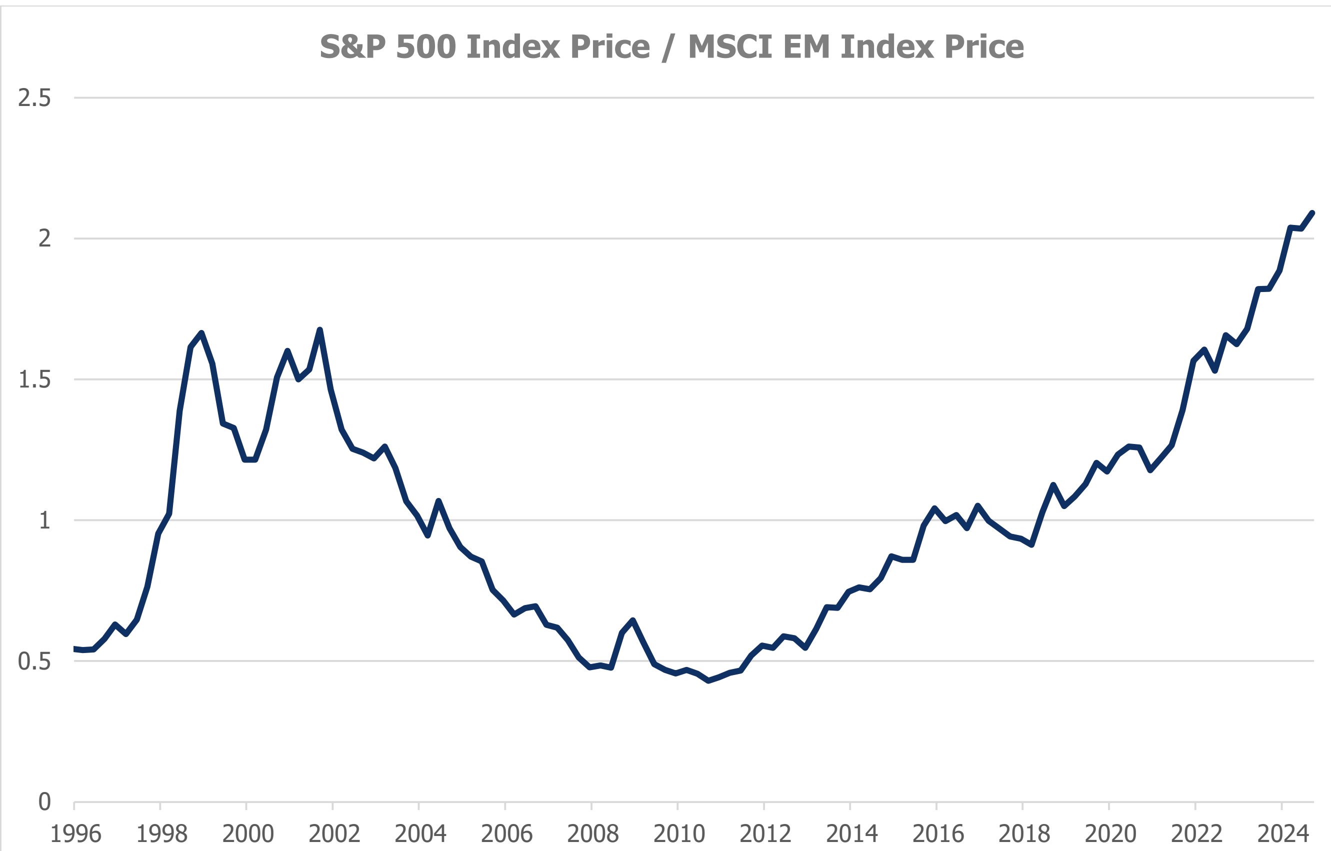
American Values & Emerging Markets Investing

National Security Index was born of the conviction that a benchmark should meet the fiduciary and moral expectations of the American people. Major index-providers from the start have used inclusion guidelines to ensure the integrity of their products. It is within this standard practice that NSI pioneered a process for excluding companies that support hostile militaries and genocidal campaigns of oppression. The results – an EM index and associated ETF – reflect an American desire to support core national interests and mitigate geopolitical risks within investment portfolios.

Why EM Now: Historically Low Relative Valuations

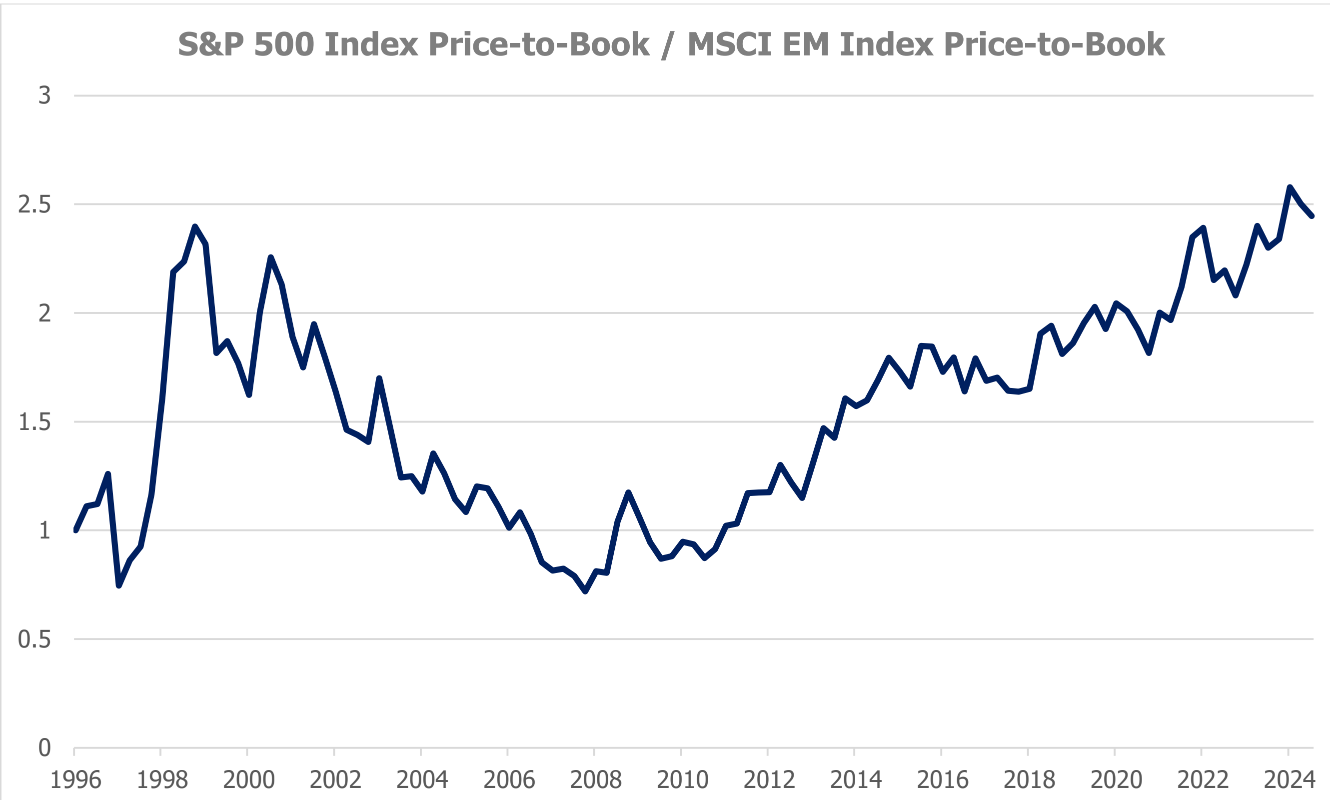
Emerging markets equities represent a historic value relative to U.S. large-cap stocks. The price of the S&P 500 relative to the MSCI Emerging Markets Index reached an all-time high in late-August 2024, the culmination of a secular bull market driven by low U.S. interest rates and a strong dollar. On a forward price-to-earnings multiple, emerging markets traded at 13.0 at the end of August 2024 (in line with its historical average), compared with 23.6 for U.S. equities (37% above its twenty-year average).[5]

Figure 1. Historic Price Ratio Suggests Attractive Entry Point for Emerging Markets



Source: Bloomberg, SPX Index Last Price / MXEF Index Last Price, 03/29/1996 - 08/30/2024.

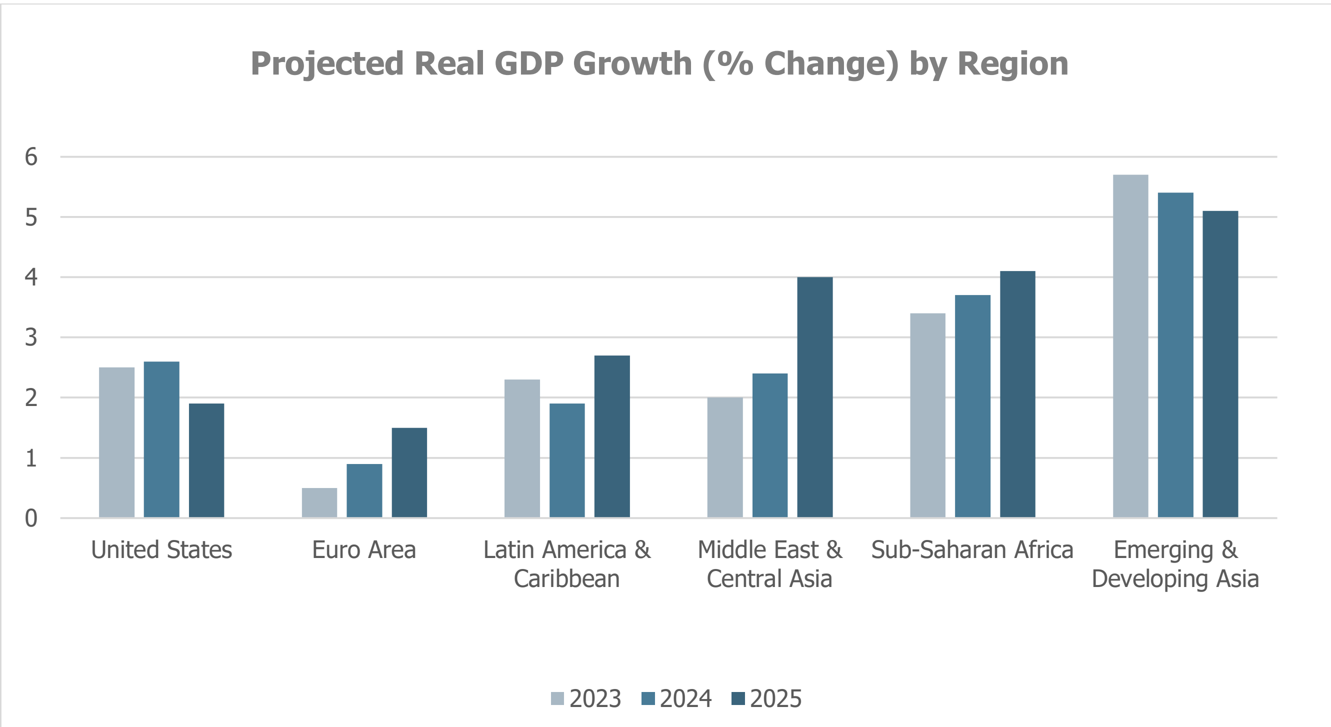
Figure 2. S&P 500 / MSCI EM Price-to-Book Ratio Near All-time Highs



Source: Bloomberg, SPX Index P/B / MXEF Index P/B, 03/29/1996 - 08/30/2024.

From a relative price-to-book (P/B) perspective, emerging markets equities have never been cheaper in comparison with U.S. stocks. The P/B ratio of the S&P 500 to the MSCI EM Index reached an all-time high in late-March 2024. These lopsided valuations indicate a possible reversal toward EM, with a weaker dollar brought on by Federal Reserve interest rate cuts potentially providing a catalyst.

Figure 3. IMF: Global GDP Trends Favor Emerging & Developing Asia



Source: International Monetary Fund, World Economic Outlook (2024).

Global growth expectations represent another tailwind for EM stocks. The International Monetary Fund projects emerging markets and developing economies to grow at 4.3% in 2025, more than twice the 1.8% increase expected from advanced economies. Regionally, the highest real gross domestic product (GDP) growth projections are in Emerging and Developing Asia, where a 5.1% expansion (4.5% in China) is expected to dwarf the United States forecast of 1.9%.[6] Given the investment limitations of the frontier markets in Africa and the Middle East, asset allocators seeking above-average growth can ill afford to ignore Asia.

The fifteen-year bull market in large-cap U.S. equities that followed the Global Financial Crisis has been a great run for the S&P 500, yet history shows that high valuations are negatively correlated with future returns. When the next rotation into international stocks comes, as it has in the past, growth investors may find EM more economically attractive than developed markets with comparatively low GDP projections. As the world's second largest economy, China belongs in diversified emerging markets, but investors have reason to exercise caution.

What are Chinese Bad Actors?

The term "bad actor" depicts companies involved in the People's Republic of China's (PRC) security state and military buildup. The label also applies to companies complicit in the Chinese government's campaign of oppression against minority groups in Xinjiang Province, human rights violations that include forced labor, involuntary sterilization, and even organ harvesting on an industrial scale.[7]

Human Rights Violators

The U.S. has sanctioned Zheijiang Dahua Technology for its activities in support of China's military buildup and human rights violations, but the company's stock remains a constituent in leading EM benchmarks.

Bad actor companies involved in the Uyghur genocide are knowingly held by Wall Street asset managers. One example is Zhejiang Dahua Technology, an advanced-technology surveillance company found in leading emerging markets benchmarks. The Bureau of Industry and Security (BIS), the Commerce Department agency responsible for controlling technology exports, blacklisted Dahua in 2019 for its involvement in Beijing's campaign of repression, mass arbitrary detention, and surveillance against Muslim minority groups in Xinjiang.[8]

BIS further restricted Dahua's access to U.S. technology three years later, when the company was identified as part of China's military modernization efforts.[9] Shortly thereafter, the Federal Communications Commission banned Dahua from the United States altogether over national security risks, issuing a countrywide "rip and replace" order for its products.[10]

The largest EM indexes also include companies sanctioned under the Uyghur Forced Labor Prevention Act (UFLPA), bipartisan legislation designed to ensure that Americans do not fund human rights violators.[11] Companies on the UFLPA Entity List are barred from exporting goods and services to the United States, but they may still receive capital from U.S. asset managers. EM index funds that track major benchmarks collectively hold ten Chinese companies under human rights sanctions.

Figure 4. Sanctioned Human Rights Violators Inside Leading Emerging Markets Indexes

Publicly Traded Company	Sanctions Program[12]
BGI Genomics and BGI Group (BGI)	BIS Entity List
Camel Group Co. Ltd.	UFLPA Entity List
Changhong Meiling Co. Ltd.	UFLPA Entity List
COFCO Sugar Holdings Co. Ltd.	UFLPA Entity List
Xinjiang Daqo New Energy Corporation (Daqo New Energy Corporation subsidiary)	UFLPA Entity List
Hoshine Silicon Industry Co. Ltd.	UFLPA Entity List
Ninestar Corp.	UFLPA Entity List
Xinjiang GCL New Energy Material Technology, Co. Ltd (GCL Technology Holdings Ltd. subsidiary)	UFLPA Entity List
Xinjiang Zhongtai Chemical Co. Ltd.	UFLPA Entity List
Zhejiang Dahua Technology Co. Ltd.	BIS Entity List

Chinese Military Companies

U.S. persons are legally prohibited from owning stock in Aviation Industry Corporation of China, the PLA's main supplier of warplanes, but its subsidiaries remain constituents of leading EM benchmarks.

Wall Street has been funding the modernization and buildup of the People's Liberation Army (PLA) through index funds and other investment products. The U.S. House of Representatives "China Committee" in April 2024 released a bipartisan report estimating that U.S.-domiciled funds hold $6.5 billion of stock in 63 Chinese companies blacklisted by the federal government for advancing the PRC's military capabilities or supporting its human rights abuses.[13] The list includes subsidiaries of major arms dealers, like the Aviation Industry Corporation of China (a.k.a. AVIC), a state-owned defense conglomerate that provides most of the PLA's aircraft. Also included were companies and affiliates at the core of the PLA's nuclear weapons program, such as China National Nuclear Power, whose breeder reactors produce fissile material used in the warheads of ballistic missiles targeting the United States.

The China Committee ultimately found the existing regulations prohibiting investment in Chinese companies tied to national security risks or human rights violations to be insufficient. "Congress," the committee concluded, "must act to restrict U.S. investment in entities tied, directly or indirectly, to the PLA, critical technology sectors, or forced labor and genocide."[14] First among the committee's recommendations was legislation to restrict investment in companies blacklisted by the U.S. government, including subsidiaries, affiliates, parents and holding companies.

The China Committee report has prompted action on Capitol Hill. Speaker of the House Mike Johnson has announced plans to introduce legislation restricting outbound investment to the PRC, including sanctions designed to "punish Chinese military firms that provide material support to Russia and Iran."[15] Such a bill is unlikely to become law in the short-term, but it foreshadows the sort of capital controls that Congress may consider under a new administration.

Emerging markets index funds hold $6.5 billion of stock in 63 Chinese companies blacklisted by the federal government for advancing the PRC's military capabilities or supporting its human rights abuses.

Chinese Military Companies Operating in the U.S.

Another area of focus for Congress has been a Department of Defense (DOD) requirement to publish a list of Chinese military companies operating in the United States.[16] The report, mandated by section 1260H of the Fiscal Year 2021 National Defense Authorization Act, defines "Chinese military companies" as entities that are:

A. Directly or indirectly owned, controlled, or beneficially owned by, or in an official or unofficial capacity acting as an agent of or on behalf of, the People's Liberation Army or any of its affiliates;

or

B. Identified as a Military-Civil Fusion (MCF) contributor to the Chinese defense industrial base.

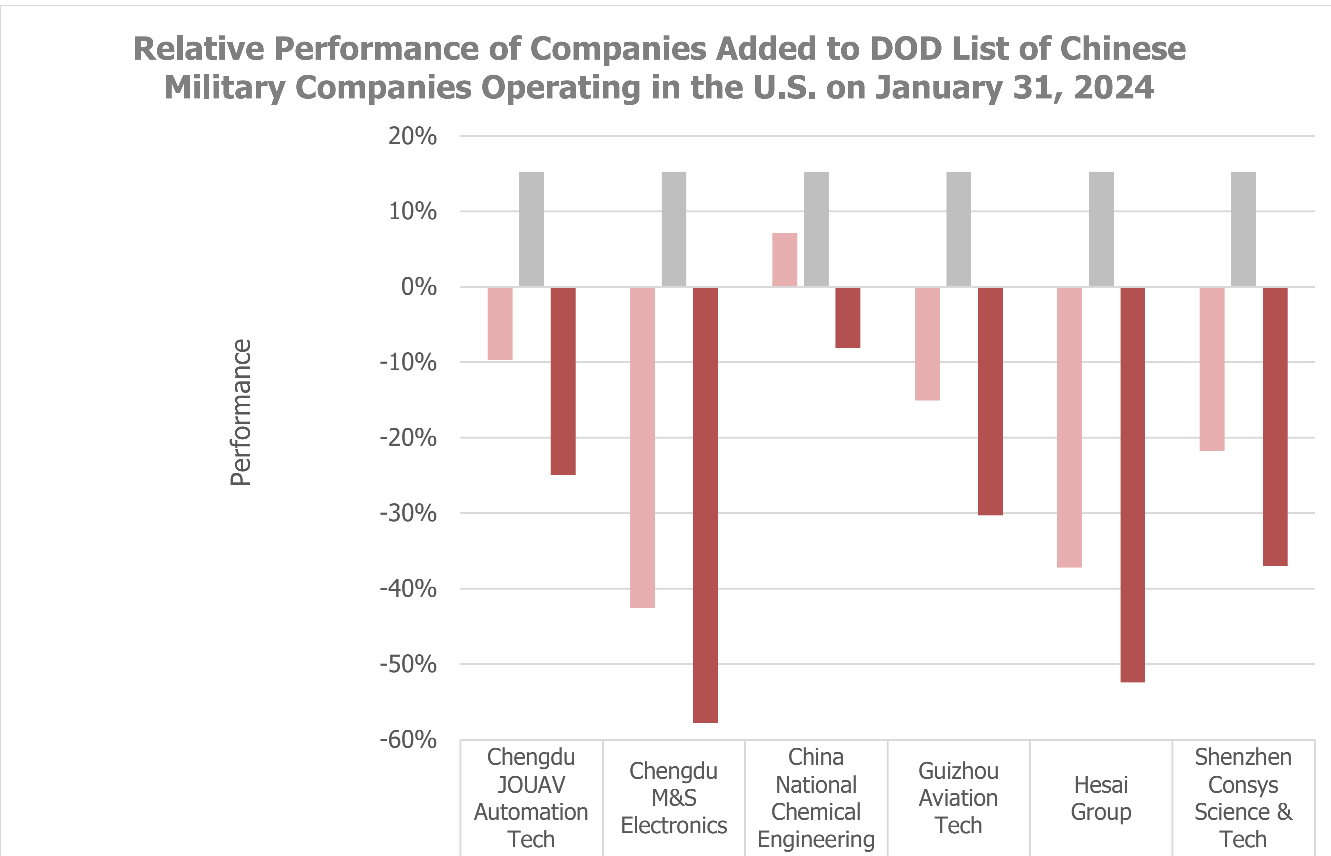
Military-Civil Fusion is a national strategy of the Chinese Communist Party (CCP) to develop the People's Liberation Army into the most advanced armed forces in the world by appropriating commercially-available technologies. A key part of MCF is the elimination of barriers between China's civilian research and private sectors, and its military and defense industrial sectors, according to the Department of State.[17] The PLA's convergence with civilian enterprises enhances the value of NSI's open-source intelligence tools and methods to the process of screening out Chinese defense contractors.

Despite materially aiding the PLA, most Chinese military companies operating in the United States are open to investment by U.S. persons, including index funds. Congress has passed legislation prohibiting DOD from doing business with companies on the 1260H List, but the restriction does not go into effect until July 2026, and the Pentagon has little-or-no contracts with theses Chinese entities anyhow.

Being Added to U.S. Blacklist Can Hurt Stock Prices

Publicly traded companies added to the 1260H List in January 2024 underperformed the MSCI China Index by 35% through August 2024 (see Figure 5).[18] Accurately measuring the effect of blacklisting is challenging given small samples, but the underperformance of the companies most recently added to the 1260H List indicates a market view that Chinese military companies are susceptible to future investment restrictions. In fact, Members of Congress have introduced legislation that would in part ban U.S. investment in 1260H List companies.

Figure 5. Performance of Department of Defense Blacklisted Companies



	Chengdu JOUAV Automation Tech	Chengdu M&S Electronics	China National Chemical Engineering	Guizhou Aviation Tech	Hesai Group	Shenzhen Consys Science & Tech
Performance (31 JAN 24 - 30 AUG 24)	-9.8%	-42.6%	7.1%	-15.1%	-37.2%	-21.8%
MSCI China Index	15.2%	15.2%	15.2%	15.2%	15.2%	15.2%
Relative Performance	-25.0%	-57.8%	-8.1%	-30.3%	-52.4%	-37.0%

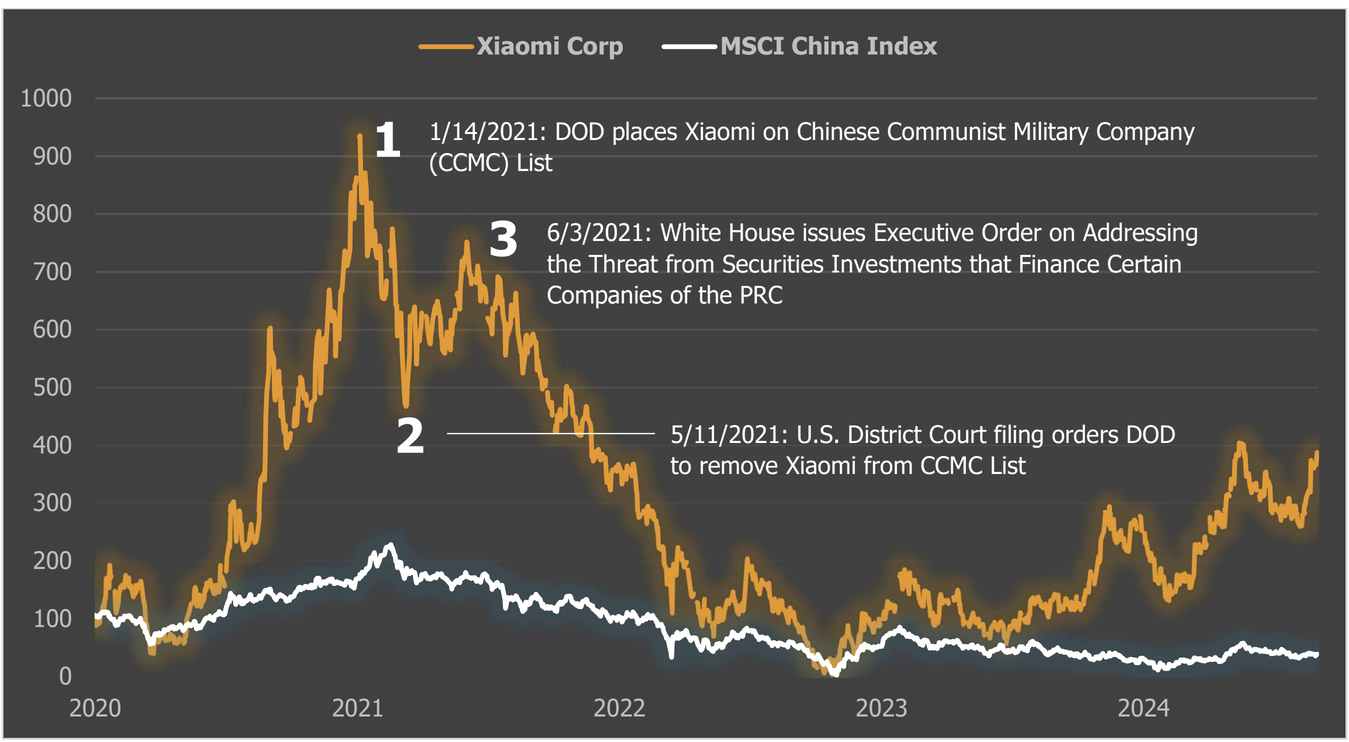
Source: Bloomberg

The Xiaomi Case

The price movement of electronics manufacturer Xiaomi Corporation, one of the largest companies named to DOD's 1260H List, suggests that blacklisting can significantly affect a stock's value. Xiaomi's stock crashed by more than 46% after the Pentagon identified it as a "Communist Chinese Military Company" in January 2021. Xiaomi then sued the U.S. government over the blacklisting, denying any connection to the PLA. Several months later, after the two parties reportedly reached an agreement, a U.S. District Court ordered DOD to delist Xiaomi; its stock rallied by 21% over the next three weeks.[19]

Despite escaping the DOD blacklist, Xiaomi's stock price collapsed again in June 2021, as the Biden Administration announced new restrictions on Chinese companies that undermine U.S. national security. The executive order mandated divestment (i.e., forced selling) of specific companies as well as those yet to be identified by department heads in the president's cabinet.[20] Xiaomi was not listed in the document, but its prior placement on the 1260H List may have raised doubts about its standing in U.S. capital markets, leading to deeper subsequent drawdowns.

Figure 6. Xiaomi Stock before and after DOD Blacklisting[21]



Source: Bloomberg, 1810 HK Equity, 01/01/2020 - 08/30/2024.

Sanctions Risk: Will Washington Delist Chinese Bad Actors?

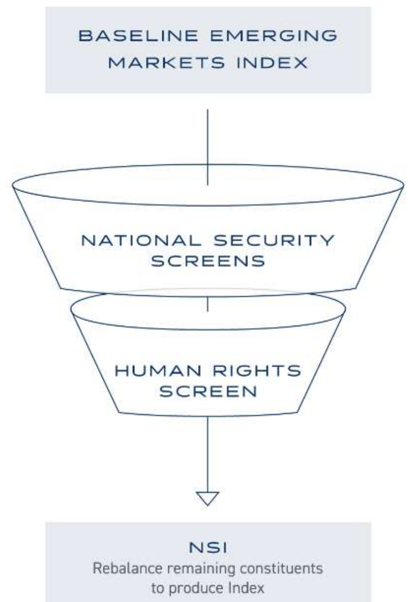
Capital controls on Chinese bad actors represent a rare area of agreement between Democrats and Republicans in Washington, D.C. The Biden Administration in 2023 issued an executive order designed to curb private investments in artificial intelligence, quantum computing, and semiconductor technologies with military applications for the PLA. A crackdown on U.S. capital flows to publicly traded Chinese military companies could follow in the next administration.

The main problem facing policymakers is the federal government's failure to harmonize sanctioning programs. Just 39 publicly traded companies are on the Treasury Department's list that restricts U.S. persons from buying or selling the securities of Chinese military-industrial complex companies. Meanwhile, the securities of other blacklisted companies and their affiliates are available without restriction. This policy discrepancy has resulted in hundreds of companies inside the PLA value chain being funded from retirement accounts, pension funds, and other unwitting American investors.

> **"Congress specifically should pass legislation to restrict investment in companies blacklisted by the U.S. government, including subsidiaries, affiliates, parents, and holding companies."**
>
> *Bipartisan Report from the House Select Committee on the Strategic Competition between the United States and the Chinese Communist Party*[22]

A Better Way: Screening Out Bad Actors

National Security Index believes there is a better way to invest overseas. Americans can responsibly seek exposure to diversified emerging markets – including China – by systematically excluding bad actor companies. This commonsense solution frees investors from the “All-China” or “Ex-China” impasse.



NSI excludes national security threats and human rights violators from a baseline emerging markets index. The nine screens, powered by a proprietary open-source intelligence process, were designed by NSI’s team of investment professionals and former military intelligence officers. The remaining constituents are then reweighted by market capitalization, sector-neutral, to produce the Alerian National Security Emerging Markets Index. The index is updated semi-annually using the most current data available.

Figure 7. National Security Index Screens

Index Performance

The debate over whether to include Chinese equities in emerging markets is no longer limited to "All-China" and "Ex-China," choices that many responsible investors find simply unsatisfying. "All-China" is morally problematic for national security and human rights advocates, while "Ex-China" forfeits the second largest economy from portfolios, limiting diversification benefits and long-term growth expectations. With NSI, American investors can now benefit from diversified emerging markets without turning their backs on vital national security interests and basic human rights.

Figure 8. Total Return of Alerian National Security Emerging Markets Index and MSCI Emerging Markets Index from Launch Date (3/21/2022) through Last Quarter (6/28/2024)

Index Name	1YR (%)	2YR (%)	Since Launch* (%)	(Annualized Equivalent Rate)
Alerian National Security Emerging Markets Index	13.01%	19.14	4.88	2.11
MSCI Emerging Markets Index	12.90%	15.34	4.07	1.76

Source: Bloomberg, SNNSEMT Index and MXEF Index.

Past performance is not a guarantee of future results.

The indices shown are for informational purposes only and are not reflective of any investment. As it is not possible to invest in the indices, the data shown does not reflect or compare features of an actual investment, such as its objectives, costs and expenses, liquidity, safety, guarantees of insurance, fluctuation of principal or return, or tax features. Past performance is no guarantee of future results.

* 21 March 2022 is the launch date of the Alerian National Security Emerging Markets Index.

For more information on National Security Index, please visit https://www.nationalsecurityindex.com/.

Endnotes

[1] Source: Bloomberg tickers SNNSEMT Index and MXEF Index.
[2] Attractive valuations statement is based on Bloomberg Estimates price/earnings ratios of 13.0 for MSCI Emerging Markets Index, 15.1 for MSCI EAFE Index, and 23.6 for S&P 500 Index as of August 30, 2024. High growth expectations statement is based on International Monetary Fund real GDP growth projections of 1.8% and 4.3% in its advanced economies grouping (i.e., developed markets) and emerging and developing economies group (i.e., emerging markets), respectively, for 2025. Sources: Bloomberg; International Monetary Fund, World Economic Outlook Update, July 2024.
[3] Military assessment is based on congressional testimony from the Commander of the United States Indo-Pacific Command. Source: U.S. House Armed Services Committee, “Statement of Admiral John C. Aquilino, U.S. Navy Commander, U.S. Indo-Pacific Command: U.S. Indo-Pacific Command Posture,” March 20, 2024, p. 24.
[4] Source: Bloomberg tickers SNNSEMT Index and MXEF Index.
[5] As of August 30, 2024, the 20-year Bloomberg Estimate price-to-earnings ratio of MSCI Emerging Markets Index and S&P 500 Index was 12.9 and 17.2, respectively. Source: Bloomberg.
[6] International Monetary Fund, World Economic Outlook Update, July 2024.
[7] A 2022 United Nations report on China’s treatment of the Uyghurs concluded that “serious human rights violations” had been committed that collectively may constitute “crime against humanity.” Sources: United Nations Human Rights Office, “OHCHR Assessment of human rights concerns in the Xinjiang Uyghur Autonomous Region, People’s Republic of China,” August 31, 2022. Alex Willemyns, “Experts: China is sequencing Uyghur DNA for organ Harvesting,” *Radio Free Asia*, March 20, 2024.
[8] Federal Register, “Addition of Certain Entities to the Entity List,” Document No. 2019-22210, October 9, 2019.
[9] Federal Register, “Implementation of Additional Export Controls: Certain Advanced Computing and Semiconductor Manufacturing Items; Supercomputer and Semiconductor End Use; Entity List Modification,” Document No. 2022-21658, October 7, 2022.
[10] Federal Register, “Protecting Against National Security Threats to the Communications Supply Chain Through the Equipment Authorization Program,” Document No. 2022-28263, February 6, 2023.
[11] Federal Register, “Notice Regarding the Uyghur Forced Labor Prevention Act Entity List,” Document 2024-17509, August 9, 2024; FactSet. “The largest EM indexes” are the benchmarks of the three largest U.S.-domiciled index funds holding each sanctioned entity.
[12] Department of Homeland Security, “UFLPA Entity List,” August 2024, available at https://www.dhs.gov/uflpa-entity-list; Federal Register, “Notice Regarding the Uyghur Forced Labor Prevention Act Entity List,” Document No. 2024-17509, August 9, 2024; U.S. Department of Commerce, Bureau of Industry and Security, Supplement No. 4 to Part 744, Title 15, August 9, 2024; FactSet.
[13] The House Select Committee on the Strategic Competition between the United States and The Chinese Communist Party, “Investigative Report: How American Financial Institutions Provide Billions of Dollars to PRC Companies Committing Human Rights Abuses and Fueling the PRC’s Military,” April 2024, p. 1.
[14] Ibid, p. 2.
[15] Speaker of the House Mike Johnson, “Speaker Johnson Lays Out Three-Part Foreign Policy Framework for the 21st Century,” July 8, 2024.

[16] The U.S. Department of Defense identifies Chinese military companies operating in the United States in accordance with Section 1260H of the William M. ("Mac") Thornberry National Defense Authorization Act for Fiscal Year 2021 (Public Law 116-283).
[17] U.S. Department of State, "The Chinese Communist Party's Military-Civil Fusion Policy," available at 'https://2017-2021.state.gov/military-civil-fusion/'.
[18] U.S. Department of Defense, "DOD Releases List of People's Republic of China (PRC) Military Companies in Accordance With Section 1260H of the National Defense Authorization Act for Fiscal Year 2021," January 31, 2024; Advanced Micro-Fabrication Equipment Inc. was added to the DOD list on January 14, 2021.
[19] "U.S. will remove Xiaomi from blacklist, reversing jab by Trump," *Reuters*, May 12, 2021.
[20] The White House, "Executive Order on Addressing the Threat from Securities Investments that Finance Certain Companies of the People's Republic of China," June 3, 2021.
[21] Sources: Bloomberg; "U.S. Blacklists Xiaomi in Widening Assault on China Tech," *Bloomberg News*, January 15, 2021; The White House, "Fact Sheet: Executive Order Addressing the Threat from Securities Investments that Finance Certain Companies of the People's Republic of China," June 3, 2021; Ibid, *Reuters*.
[22] House Select Committee on the Strategic Competition between the United States and the Chinese Communist Party, "Press Release on Committee Report: American Financial Institutions Funneled Billions into PRC Companies Fueling the CCP's Military, Surveillance State, and Uyghur Genocide," April 18, 2024.

Important Risk Information:

There is no guarantee that any investment strategy will achieve its objectives, generate profits or avoid losses. Investors cannot invest directly in an index, and unmanaged index returns do not reflect any fees, expenses or sales charges.

Investors should consider the investment objective, risks, and charges and expenses of the Fund before investing. The prospectus and the summary prospectus contain this and other information about the Fund and should be read carefully before investing. The prospectus may be obtained at 833-906-5569 or http://www.nationalsecurityindex.com.

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In addition to the risks generally associated with investing in securities of foreign companies, countries with emerging markets also may have relatively unstable governments, social and legal systems that do not protect shareholders, economies based on only a few industries, and securities markets that trade a small number of issues. A Fund's direct or indirect investments in foreign securities, including depositary receipts, involve risks not associated with investing in U.S. securities that can adversely affect the Fund's performance. Foreign markets, particularly emerging markets, may be less liquid, more volatile and subject to less government supervision than domestic markets. Sector Exposure Risk is the Current Market Value of all Positions that are Eligible Securities in any given industry sector. While the shares of ETFs are tradeable on secondary markets, they may not readily trade in all market conditions and may trade at significant discounts in periods of market stress. ETFs trade like stocks, are subject to investment risk, fluctuate in market value and may trade at prices above or below the ETF's net asset value. Brokerage commissions and ETF expenses will reduce returns. There is no guarantee that the Fund will achieve its objective. ETFs are subject to specific risks, depending on the nature of the underlying strategy of the Fund. These risks could include liquidity risk, sector risk, as well as risks associated with fixed income securities, real estate investments, and commodities, to name a few.

Definitions:

Alerian National Security Emerging Markets Index is designed to exclude companies benefiting end-users that threaten the national security interests of the United States. The Index is calculated and sponsored by VettaFi, LLC, which is an organization that is independent of the Fund; Tuttle Capital Management, LLC; Northern Lights Distributors, LLC; and National Security Index, LLC.

MSCI EM (Emerging Markets) Index is a free float-adjusted market capitalization index that is designed to measure equity market performance of emerging markets.

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