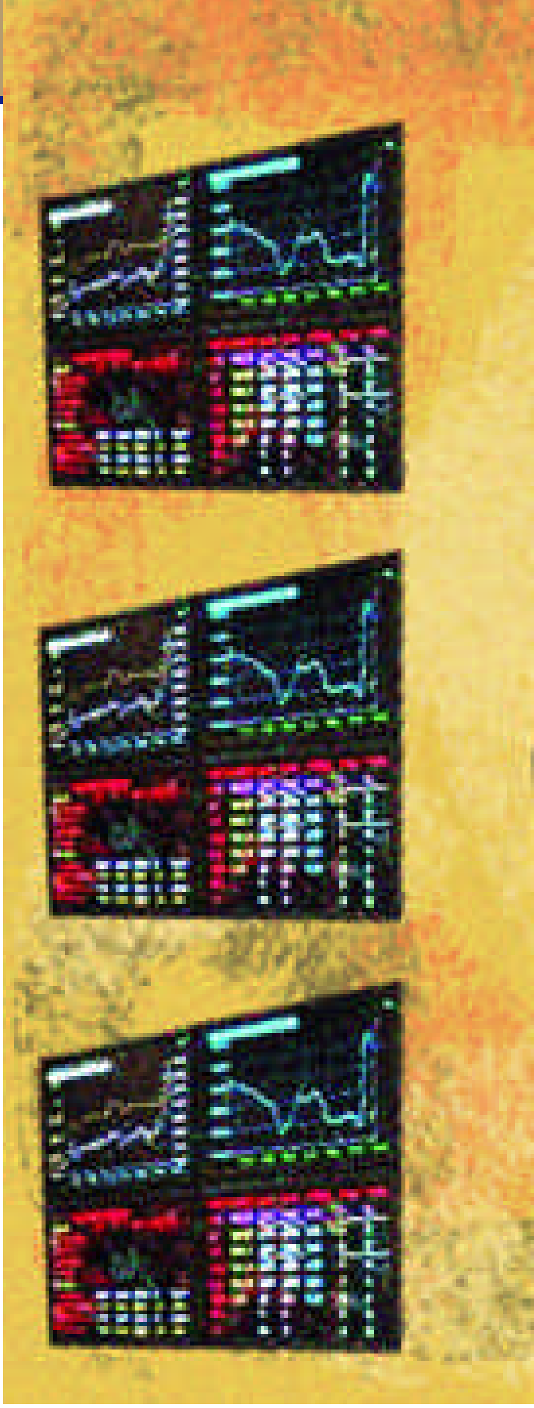
It's all Greek to the Koreans



One of the hottest debates in fund management circles at the moment is whether MSCI will re-classify Korea as a developed market as opposed to an emerging market. As *Steven Irvine* reports, the impact could be significant for Korea and Asia as a whole. But has the North Korean situation put MSCI off making the move?

How does one classify an emerging market? As a rule of thumb many people classify an emerging market as a country where you don't think twice about taking a taxi from the airport.

However, such an approach is unlikely to impress Morgan Stanley Capital International – better known as MSCI – the world's premier creator of indices. And the issue is a key one since the debate about whether South Korea is an emerging market is a hot topic.

MSCI splits the world into 'developed markets' and 'emerging markets' and this is a critical division for many global fund managers and pension funds which track MSCI indices.

According to Societe Generale and the Carson Group, $1.16 trillion of active funds is benchmarked to the particular MSCI 'developed markets' index known as EAFE (Europe, Africa and the Far East). On the contrary, only $168.4 billion is benchmarked to the emerging markets index. Adding to this huge disparity, $365 billion in passive funds tracks the EAFE versus only $15 billion tracking emerging markets.

Currently, South Korea is classified by MSCI as an 'emerging market' and makes up about 21% of that index. Should it be moved to the developed market EAFE index, it would have a major impact on fund flows not only to Korea, but also to the remaining constituents of the MSCI emerging markets index, and especially Asia. Like it or not, capital flows to a country are materially affected by MSCI.

Accordingly, if Korea were moved into the 'developed market' EAFE index it would receive a surge of funds that would boost the level of the local index, the Kospi.

MSCI refuses to comment on whether it intends to move Korea, but it is known that Korean government officials, investment bankers, and fund managers have agitated for the change.

MSCI has put out two papers in response. Its most recent is a 'General interest Q&A' dated January 21, with the title: "Factors considered for a potential change of status from emerging to developed market and the example of Greece."

The use of Greece is a critical benchmark, since this was the last country moved from emerging market status to developed market, a decision taken in 2001.

In examining whether there is a case for an upgrade, MSCI states that the first thing it looks at is the Gross National Income per capita. It looks at whether the country meets the World Bank definition of a high-income country. Beyond this, it looks at qualitative measures such as the ability to weather a crisis, fiscal discipline and the sustainability of growth.

It then analyses the depth and breadth of the local stock market, in terms of size and liquidity. It also looks at the number of different industries represented on the stock exchange, as a measure of its diversity.

It then looks at 'operational efficiency' meaning how well the market is regulated. It also looks at whether there are restrictions on foreign investment and whether there are capital controls.

In the case of Greece, MSCI states: "When Greece met the World Bank threshold for a high income country in 1991, MSCI determined that certain other factors were either not present or not sustainable to consider it for developed market status in the indices. At

that time, and for several years, in the face of important structural issues, fiscal and monetary policy remained relatively unstable and could not reduce large fiscal deficits and high inflation differentials with other European countries. These policies were not reversed until a clear commitment to the European Economic and Monetary Union was made. At that time Greece undertook a multi-step process, targeted at fulfilling the Maastricht Treaty criteria for qualifying for entry in the EMU such as establishing exchange rate stability and reducing inflation and the fiscal deficit. As a result of these policies, and in view of the increased chances of Greece joining EMU, interest rate differentials also declined significantly.

"At that point, with the Maastricht qualification criteria within reach, and based on additional intensive internal analysis of the Greek equity market, MSCI concluded that a formal review of the country's status was warranted."

MSCI announced this review on May 28, 2000 and announced two months later that Greece would be included in the developed markets equity index series, effective May 31, 2001.

If, having read this, you are a little confused, you probably deserve to be. Dressed in quasi-scientific language, the reality is that MSCI's decision-making process like anything else involves a subjective element.

However, those who feel Korea should be upgraded have a lot of objective evidence that they say advocates Korea's developed market status.

California-based portfolio manager Henry Seggerman of International Investment Advisers is zealous in this respect. He argues that Korea should be upgraded based on several major arguments, and has written forcibly to MSCI's index committee on the subject.

He says: "The investment community perceives the industrial stature of a country's listed enterprises as a critical element in judging whether a market is sufficiently developed for investment. Korea has the world's number one steelmaker, the world's number one shipbuilder, the world's number one memory chip maker, and the world's number one picture tube maker. Moreover, Korea's internet penetration is ahead of France or Germany and it has the world's highest broadband penetration, and its wireless penetration is ahead of the US. Korea is more than a developed economy; it is an industrial powerhouse and a technology leader."

Korea is the 11th biggest economy in the world. He adds that Korea's per capita gross national income on a purchasing power parity basis was higher than Greece and Portugal's in the consecutive years 2000, 2001 and 2002. This is relevant because Greece and Portugal are both 'developed market' EAFE members.

Taking historical data, Seggerman notes that in 2000, Korea's stock trading volume was higher than half of the present EAFE 'developed market' members and 10 times that of Austria. And that, he says, excludes the massive volumes on Korea's second board, Kosdaq.

Moreover, Korea is now a single A-rated country with over $120 billion of foreign exchange reserves – the fourth largest in the world.

Seggerman continues: "More than

"Korea is an industrial powerhouse and a technology leader"

Table1: MSCI Korea weighting within emerging and possible developed markets

	Current emerging weight	Possible future developed weight
MSCI Pacific Ex-Japan	-	32.5%
MSCI AC Asia Ex-Japan	26.8%	26.8%
MSCI Asia PAC Ex-Japan	16.5%	16.5%
MSCI EAFE	-	2.2%
MSCI World Ex-Japan	-	1.0%
MSCI World	-	0.9%
MSCI AC World	0.9%	0.9%
MSCI EMF Asia	38.4%	-
MSCI EMF	21.3%	-

Source: MSCI, UBS Warburg

four years ago, Korea wiped out virtually all capital controls and foreign ownership limits. Finland, Norway, Singapore, Sweden and Switzerland were all admitted to the EAFE index despite the existence at the time of varying levels of capital controls and/or foreign ownership limits. These controls are virtually non-existent in Korea."

Indeed, the country is so lacking in controls that foreign investors own as much as 60% of top Korean firms such as Posco.

Seggerman adds: "In addition to removing foreign ownership limits, Korea has moved to a Western model on many levels. Listed companies now release quarterly results. All companies release consolidated results, when applicable."

Seggerman believes the most important reason for Greece's upgrade was its entry in EMU. But he says: "Why should joining a politically-organized economic union – which has little or no effect on the attractiveness of a country's equity issues – result in qualification for a benchmark index which is advertised as having some scientific basis?"

As he concludes: "I believe the facts supporting Korea's admission to EAFE are plainly overwhelming and incontrovertible."

In order to see whether others agreed with Seggerman's views we conducted a poll. We sent this to our online readership and received 298 responses from fund managers, CFOs and financial professionals.

The first thing we asked was whether respondents considered Korea to be a more developed economy than the last country that MSCI upgraded, Greece. An overwhelming 90.2% said yes.

We then asked whether they thought it appropriate for MSCI to upgrade Korea from emerging-market status to developed market. Here again a majority said yes – in this case, 82.8%.

A further 87.8% believed this would be beneficial for Korean stocks, and around 80% thought it would add 100 points or more to the index (see charts).

Did passionate, nationalistic Koreans skew the results? No. Only 15.8% of respondents were Korean. And if we isolated just the responses from fund managers, 78.1% believed Korea should be moved to the developed market index.

Given that the overwhelming majority of those polled favoured the move, what is preventing it? Clearly, tensions in North Korea are a concern. However, only 46.9% of respondents said they thought that tensions in North Korea were the main factor hindering MSCI from making the change.

We asked respondents to give us more general comments in this area. Those who came down on the negative side of the question repeatedly emphasized poor corporate governance among *chaebols* as MSCI's main concern, as well as an incestuous relationship between the large conglomerates and the government.

Other comments included:

"The legal and regulatory framework is not one of a developed market."

"The country will need at least another five years to acid test its institutions".

"It is a constraint that all funds who invest in Korea need to have an ID number."

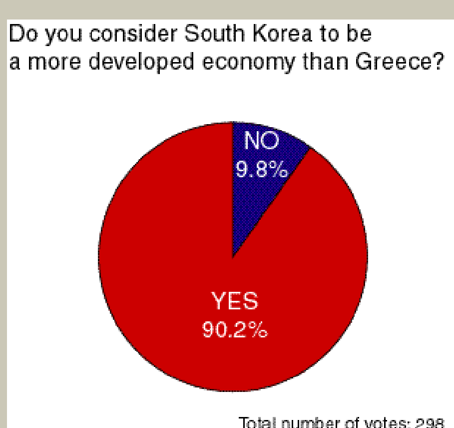
"When North Korea implodes, South Korea's GDP will go back to emerging market status."

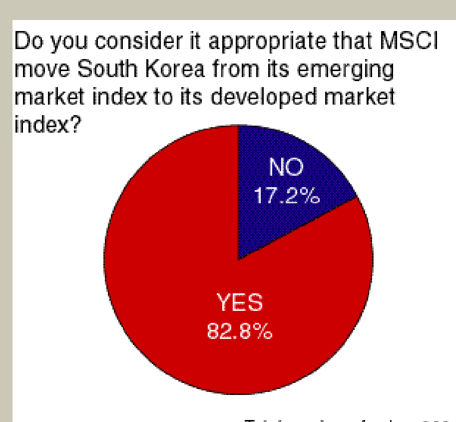
"Unification with North Korea could cause average incomes/education level/productivity to be dragged to sub-developed country levels."

"Korea is volatile compared to most developed markets."

On the positive (and humourous) side, one respondent commented: "I think South Korea is a much more economically developed country than

FinanceAsia conducted a poll in February. We asked:





Greece. Greece is somewhere I would enjoy my holidays."

On closer inspection

On a visit to Seoul, *FinanceAsia* asked a host of local professionals for their view on the subject. While nearly all were Korean, they aired a balanced range of views. Several were positive.

Steve Lim, JPMorgan's head of investment banking took the view: "It's going to happen. It's just a matter of timing. Eventually it will have a positive impact on Korea and the stock market."

Another local investment banker commented: "Korea is no longer an emerging market. It is a single A-rated country. The quality of the companies here is much higher than the rest of Asia."

Goldman Sachs' head of Korean research, Terence Lim, stated the firm's in-house view was that an announcement about Korea's inclusion could be expected in the second half of the year but "recent geopolitical tensions and the economic downturn could delay the process."

One of the strongest optimists on Korea was John Walker, who runs Shinhan Macquarie Financial Advisory, which manages a fund focused on investing in Korean infrastructure. He had few doubts as to Korea's level of economic development: "In our mind Korea is a developed market. The Macquarie Global Infrastructure Fund doesn't invest in non-OECD countries and emerging markets. But last year we bought a toll road in Korea. Our investors were quite happy with this."

Table 2: MSCI EMF Asia market weightings following possible Korean reclassification

	Current weight	Possible future weight	Possible inflows
MSCI Taiwan US$	24.6%	39.9%	3,708
MSCI China US$	12.0%	19.5%	1,809
MSCI Malyasia (EM) US$	10.1%	16.4%	1,523
MSCI India US$	8.6%	13.9%	1,294
MSCI Thailand US$	3.1%	5.1%	471
MSCI Indonesia F US$	1.8%	3.0%	274
MSCI Philippines US$	0.9%	1.4%	134
MSCI Pakistan US$	0.5%	0.9%	79
MSCI Korea US$	38.4%		

Source: MSCI, UBS Warburg

Macquarie is putting its money where its mouth is, he adds. It has seeded the local Korean fund to the tune of W30 billion. "That is the largest amount Macquarie has ever seeded in any of our funds. As far as we are concerned, Korea is the outstanding market in Asia. We think it is a developed market and that it is open to new financial technologies and products."

Rhee Won-Jae, head of international trading at Dongwon Securities, notes that the Korean stock market already contains $100 billion of foreign money. He reckons that Korea deserves to be part of the developed market index, but there are a lot of "jitters" right now, particularly thanks to North Korea.

"It has been talked about," agrees Hyundai Securities' Jason Song. "MSCI was considering it because our market capitalization to turnover was decent compared to developed countries. But that factor has been subdued in the last six months because turnover is down 60% versus six months ago."

Another local banker has some serious doubts, however. "If you look at the economy, Korea is a leader in memory chips, handset manufacturing, steel, automobiles, broadband, shipbuilding etcetera," he begins. "But if you go a little deeper, and really look at the way the capital market and business world work in Korea, it is not comparable to a developed market country."

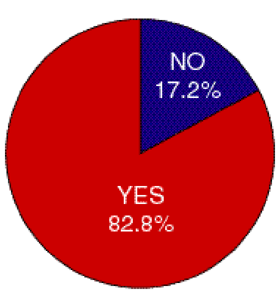
He continues: "The stock market is definitely undervalued. Why? Because local people don't have confidence in their own stocks. A guy from a big US fund told me that if you'd bought Korean stocks 10 years ago, your return would be zero. In 1988 when Seoul hosted the Olympics, the Kospi was at 1000. That's why banks have excessive liquidity. There's W300 trillion of excess liquidity floating around the banking system rather than going into stocks."

And why is money not going into stocks? "There was historically high profitability last year, but the companies were still not giving dividends. They were giving dividends according to the par value not the market value of stock. So dividends are only around 1%."

So, he concludes, "From my personal view, an upgrade by MSCI is likely to take more time."

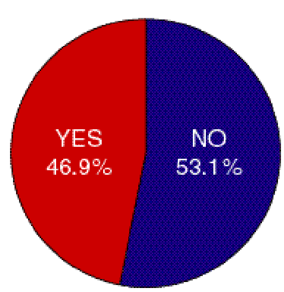
FinanceAsia conducted a poll in February. We asked:

Do you believe categorizing Korea as a developed market would be beneficial for South Korean stocks?



Total number of votes: 298

Do you believe the situation in North Korea is the main factor preventing a change in South Korea's status?



Total number of votes: 294

This scepticism is no bad thing, because at least it is constructive. And Korea is fortunate that it has a top tier of bureaucrats who listen to just such comments from market participants and act on them.

One of the outstanding bureaucrats of his generation is Dr Byeon Yang-ho, of the Ministry of Finance and Economy. He too is vexed about Korean companies not paying dividends. Currently, only KT&G (the tobacco company) and Korea Gas pay decent dividends.

He points out that one of Korea's top companies says its dividend rate is 80% of face value. But the face value is W5000. So that is W4000 per share. Meanwhile the current market price is W300,000 so that is a dividend yield of slightly over 1%.

That is not good enough, he says: "We need to encourage Korean firms to raise dividend payouts. So the government is going to create a 'dividend index' of 50 Korean companies whose record on dividends and corporate governance is very good. Any firm in this index will be a first-rate company and those outside can be considered second tier. It will be launched in the second half of this year."

The implication is clear. In a country where corporate pride remains important, the nation's proudest companies will do anything to avoid being considered "second tier".

He adds the key thing is to make sure the index is created in an above-board fashion: "The selection committee is really important. Only highly respected people will be chosen. The research team at Seoul University's school of management are doing this job and will form a selection committee."

At root, Byeon believes the Korean stock market is highly undervalued – and with top companies trading at PE multiples of 5-6 times it is hard to disagree. But the answer to this problem rests less with MSCI, than, he believes, to regain the trust of Korean people in their own stock market. The new index is part of this.

The other thrusts are fiscal and legislative. "We are talking to the tax bureau to overhaul the tax incentive scheme. It would be good to eliminate the current tax incentive for fixed-income products and introduce incentives for long-term equity investments and equity funds."

Byeon defines 'long term' as holding a fund or a stock for more than three years.

He says new legislation is also pending that will introduce class action suits for minority shareholders, to help them protect their rights. And a new asset management law is going through which will require trustees to be not just custodians but to oversee the behaviour of fund managers. "We need to increase surveillance over the fund management industry to enhance its credibility," he says. Again, it's all about public trust.

In addition, the whole legislative regime is going to be streamlined. He notes: "We have 42 different financial laws governing banks, insurance companies and so forth. We are going to streamline this into two laws."

These domestic changes are all steps in the right direction. Over time they may drive more retail investors into the stock market. His idea of a domestic 'dividend index' is an innovative approach.

Ironically, that may be a longer-term solution to the current malaise in the Kospi's performance. In the short term, MSCI could be more critical.

An MSCI upgrade would not only be a boost to South Korean pride, it would also lead to an overnight surge in the Kospi.

How much of a surge? This remains a source of speculation and high-powered math.

In a research report on the subject, UBS Warburg speculated in January that $2.85 billion would flow into Korea as a result of the upgrade. It reckoned $1.9 billion of that would come from active funds. It based its calculations on a view that Korea would make up 2.2% of the EAFE and 32.5% of the MSCI Pacific ex-Japan (where it is currently not included.)

However, the irony of what UBSW terms "The Korea conundrum" is that it calculates the biggest beneficiary of the whole shake-up will be not Korea, but Taiwan. That's because Korea's removal from the MSCI EMF Asia would lead to an increase in Taiwan's weighting in this index. It therefore calculates that Taiwan would benefit from Korea's re-classification to the tune of $3.7 billion of inflows, with its weighting increasing from 13.7% to 17.4%. The second biggest beneficiary would be China, which would see $1.8 billion of inflows.

As the UBSW estimates show (see charts), Asia as a whole would benefit from the move.

Over to you, MSCI... **FA**

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