

## Korea – advisory type wrap accounts

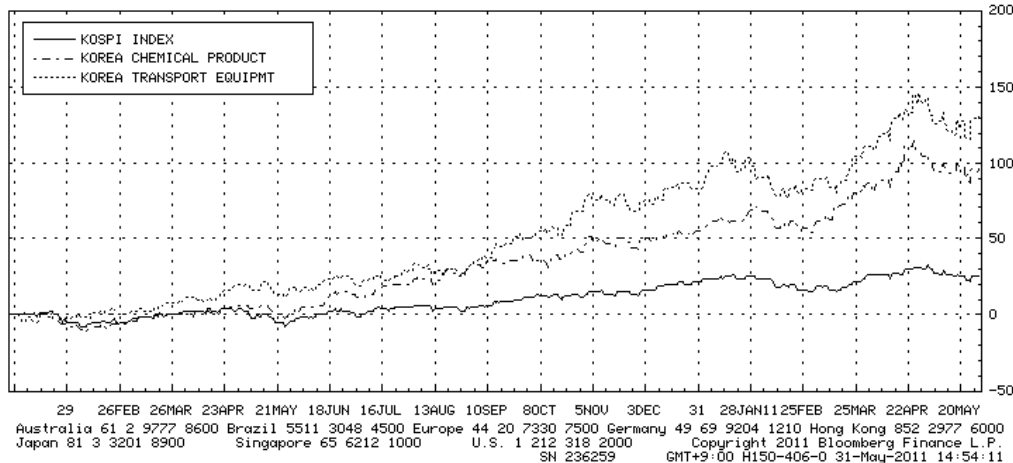
June 2011 - Author: Solim Kim, Research Analyst.

This article looks at the growth of advisory type wrap accounts and the influence they have had (and are forecast to have) on the Korean equity market. The sale of advisory wrap accounts was approved in Korea in 2001, but it was just last year that the products were highlighted in the market, when 'star fund managers' set up their own advisory firms and started to influence the performance of stocks. Wrap accounts have been overweight certain sectors, namely auto and chemical/energy and as these sectors have generated strong returns (assisted by the liquidity generated by the wrap accounts but also from significant earnings growth) this has resulted in increased attention to the wrap account market.

### KOSPI vs Chem vs Auto since the end of 2009

COMPARATIVE RETURNS						Page 1/36
Range 12/30/09 - 5/30/11		Period D Daily		516 Day Period		
Securities	Crcncy	Prc Appr	Total Ret	Difference	Annual Eq	
1 KOSPI Index	KRW	24.43 %	24.77 %		16.95 %	
2 KOSPCHEM Index	KRW	96.97 %	96.97 %	72.20 %	61.53 %	
3 KOSPTREQ Index	KRW	131.06 %	131.06 %	106.29 %	80.84 %	

(\* = No dividends or coupons)



From 30 December 2009 to 30 May 2011. Korea Transport Equipment sector includes auto and shipbuilders.  
 Source: Bloomberg

## Wrap accounts

Wrap accounts are tailored investment products for individual investors (mainly high net worth) which are run by professionals, but closely monitored by investors themselves as the accounts are managed through the individuals' own accounts. There are two products - discretionary and advisory types. For the discretionary wraps, account managers have discretion on clients' asset and invest across various asset classes depending on the clients' investment objectives. Advisory wraps are the products run by brokers with advice from investment advisory firms. Advisory wrap portfolios, which will be discussed here, are focused on equity and technically the order of transactions for the products is placed by the individual account holders.

## Growing fast

The sale of advisory type wrap accounts was approved in 2001 and discretionary wrap accounts in 2003, however, it was not until last year that wrap accounts (advisory type mainly) were mentioned frequently in the markets. Last year a number of well known fund managers from large asset management companies set up their own advisory firms. As the stocks in their portfolios became known and they significantly outperformed the market, the market became more interested in the products.

The following table shows the growth of wrap account NAVs over the past year (the period available for the data). The advisory type has grown rapidly with its portion of total wrap accounts steadily increasing.

### Wrap account NAV

W bn	Total	Advisory type wrap account	Advisory type portion	No of advisory type contract
Apr-10	27,370	1,057	4%	11,358
May-10	27,449	1,800	7%	28,865
Jun-10	28,516	2,275	8%	23,442
Jul-10	29,828	2,427	8%	26,857
Aug-10	32,328	2,869	9%	41,897
Sep-10	32,122	3,112	10%	32,802
Oct-10	34,057	3,367	10%	36,034
Nov-10	35,996	4,013	11%	43,365
Dec-10	35,648	5,241	15%	57,431
Jan-11	39,413	7,256	18%	82,599
Feb-11	41,876	7,228	17%	90,217
<b>Mar-11</b>	<b>43,997</b>	<b>8,397</b>	<b>19%</b>	<b>94,765</b>
Growth over the period	61%	694%		

Source: Korea Financial Investment Association ([www.kofia.or.kr](http://www.kofia.or.kr))

It seems that with the strong performance of the advisory wrap accounts, some retail investors (relatively high net worth individuals as the minimum subscription amount is usually higher than W30mn) seem to have pulled their money out of the mutual funds with disappointing results during the financial crisis and have invested into the wrap accounts. For the same period (April 2010 to March 2011), equity type mutual fund NAVs have declined from W99.4tr to 95tr. Based on the initial subscription, the balance has declined from W109tr to 93.6tr.

## Banks as a new channel for the advisory wraps

Currently only brokers sell wrap products but from June, banks will launch similar products in the form of "advisory type trusts" which are likely to attract more liquidity. It is basically the same product, but just a different name as banks are not allowed to play a discretionary advisory role. As banks have more resources and branches than brokers, their participation in the wrap accounts business will bring more money flows to the products. It is already reported that major banks have contracts in place with large advisory firms for the portfolio construction.

Hence, the assets for those advisory firms are likely to grow even faster (though competition between the channels may be intense). According to Korea Economic Daily, there are three major advisory firms with more than W1tr assets in advisory wrap accounts. The top firm has W3.5tr assets under the advisory type as of mid May – a significant market share.

There is growing concern in the market that the rapid increase in assets may negatively impact returns.



## Market impact

Not only are the wrap funds attracting large flows but the transparent nature of the funds is exacerbating the effect. Private investors can see which stocks are being bought by the 'star fund managers' in the wrap accounts and are following suit (and avoiding the c2% wrap fees). Thus, money flows into certain stocks are greater than the wrap account balance would suggest.

It reminds me of the herding that followed the largest asset management company's allocations back in 2007 before the global financial crisis. At that time, once a stock(s) in those particular funds became known in the market, a strong rally followed.

It may not be that clear and consistent, but retail net buying has been quite significant this year – please see the table below.

### Net buying by investor type

Wbn	Foreigners	Retail	Local inst	Corporate	Foreign ownership(%)	KOSPI
2001	8,711	-3,275	-4,091	-1,346	32.22	693.7
2002	-2,711	2,678	-386	420	32.79	627.55
2003	14,586	-5,616	-9,734	765	37.64	810.71
2004	12,011	-7,799	-5,842	1,630	40.11	895.92
2005	-3,622	-8,277	8,314	3,586	37.14	1379.37
2006	-12,004	-999	9,916	3,087	35.13	1434.46
2007	-27,090	7,316	10,097	9,677	30.96	1897.13
2008	-38,070	4,170	23,873	10,028	27.22	1124.47
2009	30,105	493	-27,229	-3,369	30.47	1682.77
2010	22,340	-3,680	-13,436	-5,225	31.15	2051
<b>YTD 2011</b>	<b>-1,580</b>	<b>5,828</b>	<b>-2,440</b>	<b>-1,808</b>	<b>30.89</b>	<b>2093.79</b>
Jan-10	679	1,172	-1,645	-206	30.24	1602.43
Feb-10	-40	162	-76	-47	29.79	1594.58
Mar-10	5,381	-3,813	-1,148	-419	30.25	1692.85
Apr-10	5,437	-24	-3,651	-1,762	30.84	1741.56
May-10	-6,324	4,321	1,586	416	29.68	1,641.25
Jun-10	529	-605	275	-198	29.47	1,698.29
Jul-10	2,959	-1,241	-1,336	-381	29.87	1,759.33
Aug-10	-623	530	27	65	29.65	1,742.75
Sep-10	4,522	-2,537	-1,554	-432	29.72	1,872.81
Oct-10	4,071	-398	-2,518	-1,155	29.74	1,882.95
Nov-10	1,848	-999	-678	-171	30.44	1,904.63
Dec-10	3,902	-248	-2,719	-935	31.15	2,051.00
Jan-11	682	1,368	-957	-1,094	30.81	2,069.73
Feb-11	-3,479	1,646	1,646	187	30.67	1,939.30
Mar-11	957	-2,306	666	683	30.74	2,106.70
Apr-11	3,240	2,053	-4,375	-918	30.92	2,192.36
<b>YTD May-11</b>	<b>-2,981</b>	<b>3,068</b>	<b>580</b>	<b>-667</b>	<b>30.89</b>	<b>2,093.79</b>

As of 30 May 2011, KOSPI and KOSDAQ combined. Foreign ownership and KOSPI index at the end of each period.  
Source: KOSCOM



## Regulation

Compared to traditional equity type mutual funds, advisory type wrap accounts are less regulated. One single stock can not exceed 10% of a mutual fund while no limit is set on the advisory wraps. Also to become an equity type mutual fund, equity should account for more than 50% of the fund assets, while there is no such limit on the advisory wraps. It is practically impossible to impose performance fees on mutual funds while there is no limit on the advisory wraps (source: Financial Supervisory Service press release).

Given the concerns of the herding into the products, the supervisory authorities are closely monitoring the development of the sale of wrap accounts and whenever there is a chance to speak out, the authorities mention that they will look into the situation seriously.

It is reported that during the first half of the year the Financial Supervisory Service is to set up regulations for advisory type wrap accounts covering advisory firms' performance fees, the number of subscribers and subscription amount, etc.

## Conclusion

With banks being added as a new channel for the advisory wraps from June, we are likely to see more flows into the products and more flows into the sectors/stocks that the advisory firms prefer. So the herding could continue for some time.

At the same time, with the market becoming volatile from the uncertainty of a global macro recovery, European debt crisis development in particular and weaker than expected economic data, the current period could be a challenging time for the advisory wraps given that latest wrap accounts have experienced strong upturns only and generate high returns from that market (more momentum when there is more inflows into those sectors they invest in).