

## Korea - Equity market fund flow

August 2008 - Author: Solim Kim, Research Analyst

**It may not be the best time to write about the positive outlook on the Korean equity market (or equity market overall) from an economic point of view, however, I would like to remind you that in the long run, structurally, Korea is moving into a more favourable and stable environment for equity investment in terms of fund flows.**

Firstly, let's take a brief look at the Korean market. As of end July, the Korean equity market size is W890tr (99% of 2007 GDP) - KOSPI of W810tr and KOSDAQ of 80tr with 1,796 listed companies (765 on KOSPI and 1031 on KOSDAQ). At the peak in October 2007, total market capitalisation reached W1,146tr (W1,029tr KOSPI and KOSDAQ W117tr).

Into this market, sustainable liquidity will be provided in the long term by National Pension Fund (NPF) and corporate pension scheme.

### National Pension Fund

The asset size of NPF is W219tn as of end 2007 and the government estimates W251tr by 2008 and W284tr by end 2009. It is within the top 5 pension funds worldwide by size.

The largest investments are currently still made into domestic bonds, but NPF has been increasing the equity portion gradually. The Ministry of Health, Welfare and Family Affairs (MoHWF) has recently finalised National Pension Fund's 2009 year end target asset allocation and the weight allocated to the domestic equity portion is 20.3% (W57.5tr), versus the 2008 target of 17% (W42.6tr). The 2007 actual weight was 15.1% (W33 tr). This increased portion in equity will be at the expense of domestic bonds which will be reduced to 60.4% in 2009 from the 2008 target of 66.4%.

NPF also has a long term guideline (to end 2013) which states that they will maintain a level of at least 20% in domestic equity. In addition, the new head of the National Pension Service mentioned at a recent press conference that the fund would increase the equity portion (both domestic and overseas) to 40% by 2012. Given that domestic equity usually accounts for about two thirds of equity, the domestic equity portion could easily rise above 25%.

### Corporate Pension Fund

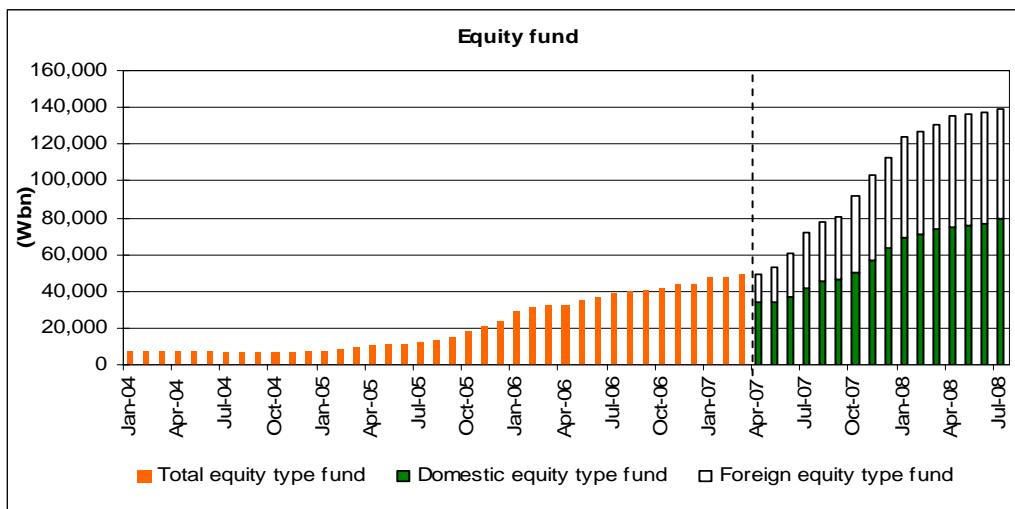
The corporate pension scheme started in December 2005 and is going through a transition period. While most corporates are still using an existing retirement insurance scheme, where companies put severance payments aside and that payment is tax deductible, my understanding is that this tax deductibility will not be applied from 2010 and the market therefore expects corporates to ultimately adopt a corporate pension scheme.

With this, various research institutes estimate that the size of corporate pension funds would reach W45tr~67tr by 2010 and c.150tr by 2015 (FSS report). Initially, there are rules which set limits on equity investment for corporate pension schemes (DB - 30% max in equity, 50% max in equity /hybrid type funds, DC - no equity investment is allowed) but given that developed countries, which have run these schemes for a long time, give discretion on asset allocations (i.e. not much limit on equity), the Korean scheme is expected to go in that direction eventually. When corporate pension funds are widely adopted (in 2010), it will likely boost the equity market as it did in other countries.

In addition to these long term positive fund flows, some other recent trends support stable liquidity into the market - local equity type funds (fund with 60%+ investment in equity) and other local buying.

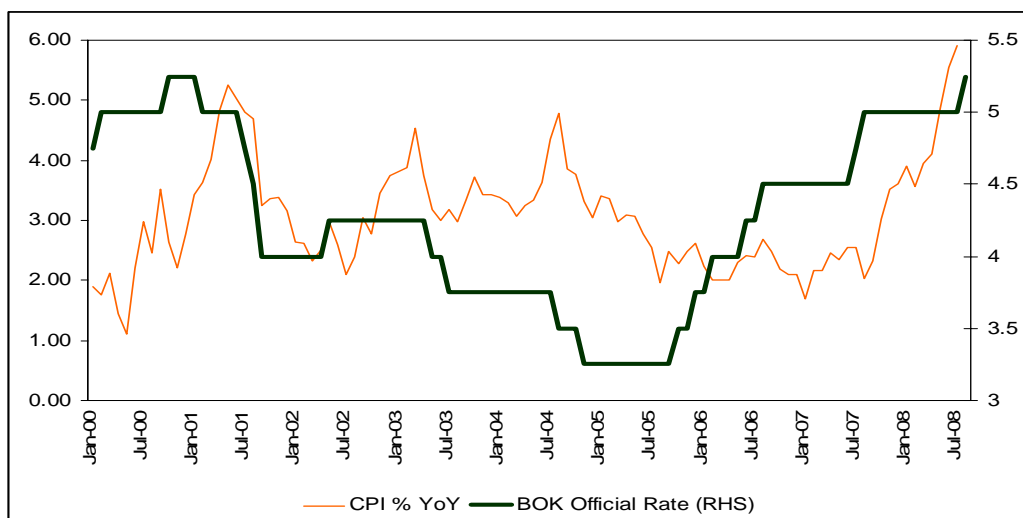
**Equity type funds**

As of end July, the value of equity type funds stand at c.140tr based on fund flows including both domestic funds of 80tr and overseas funds of 60tr. This amount has been growing with little volatility.



Current classification of foreign fund since April 2007  
Source: Asset Management Association of Korea (AMAK)

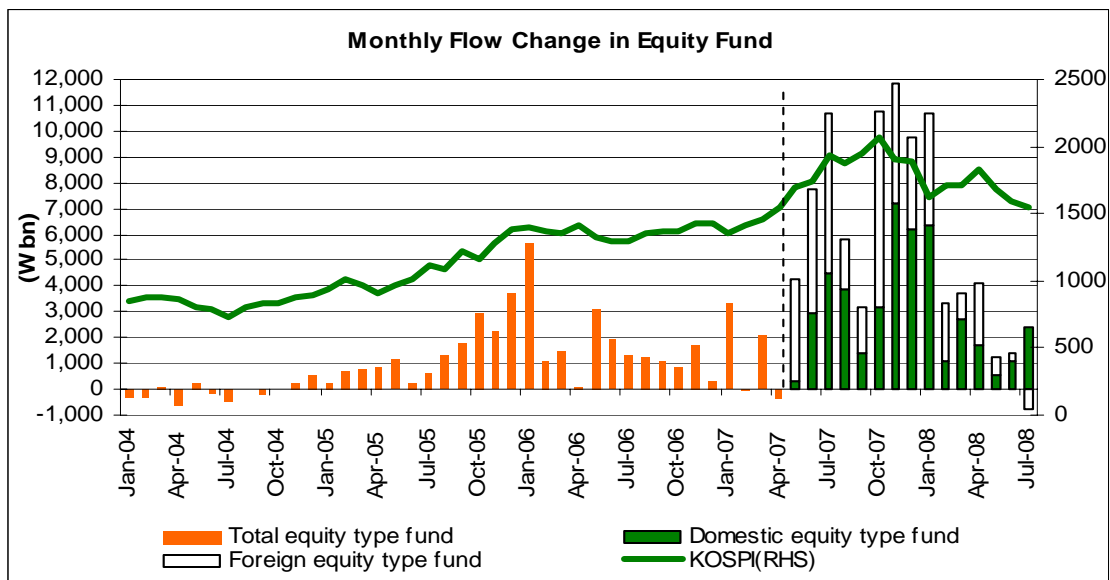
One of the reasons I believe is the instalment plan equity fund introduced in early 2000s. Though gradual in the initial stage, this indirect vehicle helps retail investors easily participate in the equity market. The equity fund started to grow strongly in 2005 when the interest rate was quite low. This led some money out of bank deposits into the equity market.



Source: Bank of Korea, National Statistics Office

In the near term, rising interest rates and the banks' marketing to receive more deposits due to their high loan to deposit ratio (apart from uncertainties in the global economy overall), will cause some resistance in moving funds into equity, but the recent trend of continuous positive fund flow, despite volatile KOSPI performance, shows certain resilience in fund flows into the equity market.

The graph below shows monthly fund flow into equity funds. In 2004, there were many occasions of outflows, but there have been only two months of negative fund flows since January 2005 - Feb and April 07. Interestingly, during the past month, which saw very volatile market movements, domestic equity funds still saw a positive fund flow of W2.4tr, while overseas funds experienced a negative flow of W 781bn. This may have come from more volatility in the markets where Korean investors have large exposure, such as China and India, but continuous increment in domestic equity funds signals that Korean investors appetite for equity investments have not turned.



Source: Asset Management Association of Korea (AMAK)

Net buying trends by investors can also explain the local support to a certain degree. Foreigners have been heavy net sellers in the last four years and YTD 2008, already W25tr worth has been sold – the foreign ownership level has come down to 28.5% as of end July from 42% in April 2004. This has been relatively well absorbed by locals (both institutions and retail investors). Corporate buying activity has also been a plus and share buyback trends can largely explain this increase.

### Net buying by investor in KOSPI and KOSDAQ

(W bn)	Foreigner	Retail	Domestic Inst.					Corporate
				Pension	Insurance	ITCs	Others	
2001	8,711	-3,275	-4,091	737	-1,145	-2,149	-1,534	-1,346
2002	-2,711	2,678	-386	895	-546	923	-1,658	420
2003	14,655	-5,486	-9,825	899	-765	-7,930	-2,030	656
2004	11,770	-7,537	-5,843	2,043	-404	-5,165	-2,317	1,610
2005	-3,622	-8,277	8,314	-183	1,144	10,436	-3,083	3,586
2006	-12,004	-999	9,916	838	2,277	6,418	384	3,087
2007	-27,083	7,261	10,135	3,872	1,310	4,599	353	9,687
YTD2008	-25,878	3,468	13,691	3,261	2,733	539	7,158	8,719
Jan-08	-8,947	2,026	4,597	1,359	648	1,564	1,026	2,324
Feb-08	-2,072	216	465	240	271	-727	681	1,391
Mar-08	-4,514	274	1,648	123	333	606	585	2,592
Apr-08	-1,038	-779	1,221	313	156	-27	780	596
May-08	909	-397	-827	356	164	-1,762	413	315
Jun-08	-5,144	1,987	2,170	88	223	596	1,261	988
Jul-08	-5,072	141	4,418	781	938	288	2,411	513

Source: KOSCOM

Though uncertainties in both the global and domestic economy will set a negative tone on the market for some time, in terms of fund flows, the Korean market is likely to be resilient with the help of domestic buying. In the longer term, more sustainable liquidity from the National Pension Fund and the corporate pension sector should provide support to the market.