MSCI Korea

Developed or emerging… it is official again… and again… it is emergence as usual for the Hermit Kingdom!

…according to the oracle that is MSCI Barra!

June 2010, Adrian Cowell, Director and Fund Manager

One year ago, following its Annual Market Classification Review, we commented upon the decision of MSCI Barra to leave the stock market of South Korea to continue enjoying its Emerging Market status, but also to retain its position as a market under review for promotion to developed status in 2010. Israel stole a march and was promoted, but Taiwan showed solidarity with the RoK.

Scroll forward one year and MSCI Barra has done it again! Done what?

The Hermit Kingdom's stock market will repeat its emergence for another 12 months to mid 2011, at which point MSCI Barra's respondents will have another opportunity to pontificate on the RoK's market status. Can the RoK go for a three-peat? In a job's worth world (our own included) we hesitate to predict change if "rules is rules".

…review of the associated verbiage this time around is a rather sorry case of extreme "déjà vue" so we apologise for the cut and paste job below which is provided as it is almost impossible to find anything new to say on the matter. What was stated one year ago remains relevant today, with a small adjustment to a percentage or two, and anyway the calculator is not to hand;

Quote - June 2009 article…

It is official again… it is emergence as usual for the Hermit Kingdom!

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To emerge or not to emerge, that is the perennial question to mangle the MSCI Bard

The institutional investment world may have been eagerly awaiting the results of the protracted MSCI Barra conclave (also known as the Market Classification Consultation – a twelve month process, with preliminary conclusions presented after six months in December 2008) on whether the stock market of the Republic of Korea (RoK) should be reclassified as a "developed market", thereby joining the MSCI World Index, or whether it should remain in division two, another year of losing out in the play-offs and more "emergence as usual"! Then again, the investment world may not have been waiting – there is after all, a lot of other stuff going on!

The consequences of promotion, were it to happen, would be a peninsula shift of tectonic proportions from a 12.4% weighting in the MSCI global emerging markets index to a drastically downsized but doubtless perfectly formed 1.64% weighting in the world index *(Source: Factset, June 19)*. Had it won through in the play-offs, the RoK, that "shrimp between two whales" (the listed bottom half of the dangling peninsula between China and Japan), would have become an even smaller fish in the developed pond, the victim of passive *(surely massive – ed*) adjustments in quotas! Portfolios would probably concentrate to match their managers, and rafts of mid caps and small caps would be cast adrift in the West and East Seas - lost to the investment world. Rampant Exchange Traded Funds (ETFs)!

In any event, come 15th June 2009, the puff of white smoke from said conclave was either not to be, or possibly the smoke was lost in the exhaust clouds blasting off from the launch pads of Musudan-ri and Dongchan-ri in the Democratic People's Republic of Korea (DPRK) as the Dear Leader, Kim Jong-Il, apparently randomly, loosed off rockets of various sizes in various directions to accompany his 25th May detonation of a 20 kiloton thunderbox at Punggye-ri. This detonation was initially detected as a seismic tremor 10km underground measuring 4.7 on the Richter scale. It is now probably confirmed as his second underground test of a nuclear device, the equivalent of the bomb dropped on Nagasaki. Perhaps it was a big night the night before, Dear Leader and Brilliant Comrade… yes we now have a new Brilliant Comrade in the mix!

But we digress.

The RoK, the publicly quoted half of the Korean peninsula formerly known, perhaps appropriately, as the "Hermit Kingdom", will remain in hermitage with a review of its status and progress on reforming key issues to be assessed again in June 2010, despite meeting developed market qualifications in terms of economic development and liquidity in the markets.

Three accessibility issues have been cited as reasons for emergence as usual;

- Convertibility of the currency – the on-shore Korean won market is too constrained, and there is no off-shore market in the currency.
- Foreigner ID system – this system is too rigid, complicating inter alia block trades and in specie transfers.
- Anti-competitive practices relating to provision of real time stock market data.

These three areas present significant challenges for the Korean authorities. Currency convertibility impacts management of the exchange rate, capital flows and foreign reserves, cramping a possibly genetic predilection for hands-on management residing within the Ministry of Strategy and Finance and the Bank of Korea. The foreigner ID system is in part linked to this issue. Real time stock market information is a more commercial issue between the Korea Stock Exchange with its indices/information, and the use thereof by others to develop investment products.

The MSCI Barra press release dated 15th June 2009 drew encouragement from "the goodwill expressed by the Korean authorities through their efforts to understand the issues and explore options to address them". Doublespeak?

Comment from within the RoK was of a different tone.

On 16th June, the *Maekyung,* the leading economic daily stated; "as Korea accounts for 13% of the MSCI Emerging Markets Index, MSCI would find it difficult to market the index if a large part of it left! Sectorally Korea contributes 27.9% of IT, 29.7% of consumer discretionary, and 32% of industrials." So there. Bric that in your pipe and smoke it.

The Korea Times, an English language daily, on the same day wailed in umbrage; "chills the country's hopes once and for all for more investors…." Aha! So develop, and they will come! As simple as that.

In the same article the Korea Times quoted a spokesman for the Korea Stock Exchange who was not surprised. "after months of reviews, MSCI recommended… to revise some practices and regulations… but we could not follow the advice. It is not certain whether MSCI will upgrade Korea during next year's review as the country has no immediate plan to phase in the MSCI recommendations". Therein lies the rub.

And there we are. Intransigence either side of a line of yellow tape crossing the table in the market access equivalent of the hut in the truce village of Panmunjom in the Demilitarised Zone (DMZ), where DPRK and RoK negotiators have met on and off for more than fifty years, purportedly to try to bring the Korean War to an end.

However, the world of indices is a competitive one. Footsie 1, MSCI 0! The Footsie will promote Korea to developed market status in September 2009. On the one hand we have a trans-Atlantic battle of the benchmarks, and on the other the efforts of an aspiring economic climber and its regulatory environment!

Unquote

What can we add this time around?

In early June 2010, the Ministry of Strategy and Finance (MoSF) introduced some capital controls to limit the use of foreign exchange derivatives. These measures are designed to reduce currency volatility.

The government had originally planned to liberalise the foreign exchange market by 2009, virtually removing all regulatory controls and allowing international settlements in the Korean won. Not now!

Kim Ik-Joo, Director General of the International Finance Bureau, MoSF has been quoted in the Korea Times of 21st June 2010 as saying; "we are not saying that our plan has been ditched. We have suspended it temporarily". Mr Kim went on to state that it was too early to discuss trading the Korean won internationally. The government hangs on ever tighter.

A more strident debate appeared in the pages of the JoongAng Daily of 15th June with the starting point the soccer World Cup in South Africa. The MSCI Barra decision was being gently leaked in advance. The RoK and Greece played each other in the first round of group matches and the result was a resounding 2-0 win for South Korea!… but Greece joined the euro currency union in 2001, and was promoted to developed market status by MSCI! And the developed market index contains all the PIGS countries with their "excessive debts and huge deficits".

The article magnanimously admits that the Korean government "can not make the changes as requested this year", but goes on to ask "which better deserves the title of a developed market? A country that is begging for a bail out package from the European Union and the International Monetary Fund or a country with over US$270billion in foreign currency reserves?"

The article wonders whether the MSCI "is being particularly strict with Korea or whether it is discriminating for some other reason". But it does at least end by recognising "Of course the Korean government needs to consider what the MSCI is asking for in a more positive light. Korea does not comply with global standards when it demands exceptions from rules by citing its unique situation". The special circumstances of the unique situation. Heard that one before.

So there it is! All the serial extrapolators, neo-strategists, proto-strategists and pseudo-strategists who predicted that MSCI would follow the Footsie can put their pencils away, at least for another year. Administrators of developed markets ETFs can heave a collective sigh of relief.

And next time around? What are the chances of the Korean government feeling comfortable with acceding to the MSCI demands? What are the chances of the MSCI dropping its demands? The divided peninsula has an unmatched track record in steps forward, sideways and backwards. Managing the status quo can sometimes be easier than managing change.

But then perhaps developed and emerging market status can be adjusted every four years on the basis of whether the respective soccer teams make it out of the group stages to qualify for the knockout stage of the Soccer World Cup? That would entail rationalising both “divisions” to 16 constituents each… and the final results could be subject to whimsical referees…

…RoK, having dispensed with Greece but losing comprehensively to Argentina, needs to beat Nigeria to make it through, and the DPRK returns to earth with a humiliating Portuguese bump after its vain heroics against Brazil. Do not be surprised if the world’s top soccer hooligan, Kim Jong-Il, throws something out of his pram in disgust.