

MSCI index changes

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Authors: *Murray Davey, Managing Director and CIO, Global Emerging Markets*
Adrian Cowell, Director and Fund Manager

MSCI yesterday (June 15th) announced changes to their country classifications.

Israel will be “promoted” from their emerging market index to developed status, effective from May 2010.

Korea will remain as an emerging market. A further review for both Korea and Taiwan will occur next year.

Gulf countries (UAE, Qatar and Kuwait) will not be reclassified as emerging, but stay as frontier markets. This will also be reviewed again next year.

Israel

Israel will go from being the 10th largest emerging market (ahead of Indonesia, behind Malaysia) to being the 18th largest developed market (on a par with Belgium and Denmark).

Whilst this decision will no doubt generate some capital flows into and out of the market from passive index trackers, we suspect it will not have much of a medium term impact on the market.

The good news is that it provides another small piece of evidence that emerging economies are developing and maturing – if they did not eventually do so, then the whole thesis of investing in higher risk emerging countries would be called into question.

The bad news is that we suspect that most developed portfolios will only have room for one or two Israeli stocks (it will have a benchmark weight of only about 0.4%). All but the biggest half a dozen Israeli stocks will become small cap, or even micro cap in a global context. Fortunately, Israel has a reasonably deep and efficient domestic capital market, so the consequences are not too severe. The hollowing out of smaller domestic markets as liquidity concentrates in London and New York is not a healthy process, but it is perhaps inevitable in an increasingly integrated global economy.

South Korea

The Republic of Korea (RoK) is, according to MSCI, still “emerging” - on hold for review in June 2010.

The publicly quoted half of the Korean peninsula formerly known, perhaps appropriately, as the “Hermit Kingdom”, will remain an MSCI classified emerging market with a review of its status and progress on reforming key issues which will be assessed again in June 2010.

The RoK meets developed market qualifications in terms of economic development and liquidity in the markets. However, three official reasons have been cited behind retention of “emerging market” status:

- 👑 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 issues for the Korean authorities. Currency convertibility impacts management of the exchange rate, capital flows and foreign reserves. The foreigner ID system has involvement in this issue. Real time stock market information is a more commercial issue between the Korea Stock Exchange and its indices/information, and the use thereof to develop other investment products.

Whilst it has not been officially cited, the geopolitical problems associated with the missile programme of the Democratic People's Republic of Korea (DPRK) and RoK will probably not have helped the cause of developed market status.

And finally, Israel is now 2.8% of the MSCI Emerging Market benchmark. In June 1998, it was 3% of our then-benchmark, the IFCI Composite. Not much change in 11 years. However, Hong Kong/China is now 19% of our benchmark. It was 0.5% in 1998. Korea has risen from 1.5% to 12% and India from 1.9% to 8%. The losers? Mexico (12% to 4%) and South Africa (14% to 7%).

Sources: MSCI, Rexiter Capital Management Limited