Markets

The Big Take

# Why Bringing a $1.8 Trillion Stock Market to the Big Leagues Could Backfire

Korea’s ambition to become a developed market is spurring money managers to have second thoughts on whether such a move is a good idea — or even worth it.

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For years, South Korea has been home to more global conglomerates than Hong Kong, boasted a higher purchasing power than Japan or Spain, registered a longer life expectancy than New Zealand and three years ago even briefly overtook Italy in GDP per capita. Yet every year, indexing giant MSCI Inc. has categorized the country as an emerging market, a designation that has hurt Korea’s investment potential and damped stock valuations.

Korea is tired of it. This year, ahead of an annual review by MSCI in June, regulators have launched a revamp of the country’s capital markets, including plans to widen access to the currency market while also floating options to lift a

short-selling ban. The reforms are intended to convince MSCI that Asia's fourth-largest economy deserves a spot among the 23 developed countries, which are meant to embody what money managers expect of mature capital markets.
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The potential upgrade is a big enough deal for the nation's $1.8 trillion equities market that it has caught the attention of President Yoon Suk Yeol, who said his priority was to address "outdated regulations" and better protect minority shareholders. His government is even looking to extend trading hours for the won, a years-long contention and main sticking point for MSCI, which declined to comment.

Yoon Suk Yeol
*Photographer: SeongJoon Cho/Bloomberg*

Achieving the milestone could burnish the nation's reputation as a new power player within Asia, attracting more than $50 billion of inflows, according to Goldman Sachs Group Inc. and Bank of Singapore estimates. Fund managers hope the upgrade will narrow the so-called "Korea discount" — a perennial markdown of stock market valuations below regional and global peers. An upgrade may also reduce volatility and fuel the next leg of the benchmark Kospi, which is trading just shy of a bull market.

A rising tide of investors and analysts believe that MSCI is on the cusp of finally granting Korea the coveted developed market status. But even if Korea does finally get what it wants, some money managers are having second thoughts about whether making the jump is such a good thing after all. Or even worth it.

“If Korea gets upgraded to developed markets status, it will become a smaller fish in a bigger pond, with fewer Korean stocks likely contributing to MSCI indexes,” said Chang Hwan Sung, a portfolio manager overseeing multi-asset investments at Invesco Ltd. in Hong Kong.

WATCH: South Korea Aims for ‘Developed Recognition’ (Video)

Korea’s eventual upgrade may well turn into a cautionary tale about the pitfalls of moving from the emerging column into developed – a change some compare to going from college sports to the big leagues. With a 12% share of the MSCI EM index, the upgrade could mean a weighting switch to around 1-2% of the developed market index. For Lee Young Jae, senior investment manager at Pictet Asset Management Ltd. in London, that would mean selling about 10 Korean stocks he currently owns in a roughly $800 million emerging market fund and buying only one back for a similar developed fund, most likely Samsung Electronics Co. “You may just have one company in Korea and forget about it,” Lee said.

There’s no hard and fast rule when it comes to what distinguishes a developed market from an emerging one, which has become one of the deepest fault lines in international finance. Instead of measuring a country’s standard of living or gross domestic product, index compilers are focused more on specific criteria like the ease with which investors can complete off-exchange transactions.

FTSE Russell and S&P Dow Jones Indices already moved Korea to developed status in 2009 and 2001, respectively, citing the size and sophistication of its market. But MSCI's upgrade is seen as the most important for fund flows because it has the biggest market share in the business.

MSCI identifies a developed market based on three main metrics: economic development, the size and liquidity of equity trading and accessibility, according to its website. This can lead to a degree of subjectivity when deciding which countries deserve the prestigious developed label, analysts say.

"I think Korea rightly deserves that because since 1997 we've classified it as an advanced economy," said International Monetary Fund Asia Pacific Director Krishna Srinivasan. He said that the country has crossed the threshold into the developed category "across many dimensions" since then, so its case for inclusion is much stronger now.

There's big money at stake. About $1.81 trillion track the MSCI emerging markets index globally, while $3.49 trillion follow the MSCI developed markets gauge, according to Goldman Sachs estimates. Such huge followings have turned index compilers MSCI, FTSE Russell and S&P Dow Jones into the world's biggest arbiters of global money flows, creating indexes that passive investors use and active ones try to outperform. Bloomberg LP, the parent of Bloomberg News, competes with these providers by compiling its own indexes.

## South Korea is the Fourth-Largest Member in the MSCI EM Index

Source: Bloomberg
Data as of May 25, 2023

Critics say the indexes are now increasingly used to determine the make-up of a portfolio with an ability to send stocks soaring on expectation of large inflows — or vice versa on an exclusion.

Israel became the first country in the Middle East to join MSCI's list of developed markets in 2010. Expecting a boon to its capital markets, the move instead triggered $2.5 billion in outflows the year after, according to Bank of Israel data. Turnover for the stock benchmark and total market capitalization tumbled more than 40% in the two years after the announcement. "The upgrade itself was not a blessing as it took years to get volumes back to where they were," said Daniel Rapoport, head of global sales, equities & derivatives at Leumi Capital Markets in Tel Aviv.

Then there's Greece, which was upgraded to a developed market in 2001 despite its stock market bubble bursting just a couple of years before. In the two years after the upgrade, stocks slumped as much as 45% while average trading volumes initially slid 17% in 2002 before a quick recovery. Greece became the first developed market country to be downgraded back to emerging following the debt crisis in 2013 but is seeking to regain the status again in coming years. When Portugal's stock market was upgraded in 1997, its index continued climbing before a swift 43% tumble that began mid-1998. Analysts say that Taiwan and India may be jostling for a spot next.

While Goldman and the Bank of Singapore project inflows, the majority of market participants interviewed by Bloomberg News — including Invesco, Pictet and T. Rowe Price Group Inc. -- expressed concern about possible outflows. Daishin Securities Co. estimates nearly $33 billion in funds exiting while Societe Generale Group puts the figure at $9.4 billion.

For Korea, its journey to this moment has been more than a quarter of a century in the making. The nation's rapid ascent from the rubbles of the Korean war in the early 1950s into a manufacturing powerhouse earned the envy of many developed and emerging markets alike. The momentum reversed when the Asian Financial Crisis hit in July 1997. Korea's foreign debt burdens ballooned and many heavily-indebted companies collapsed. That year, the Kospi tumbled by a record 42%, while the won slumped 47%, setting up a path for a $57 billion IMF bailout. The trauma from an exodus of foreign capital during that crisis has remained a sore spot for the government ever since.

Korea is now home to some of the world's biggest and most recognizable conglomerates including Samsung, Hyundai Motor Co. and Posco Holdings Inc. Netflix plans to invest $2.5 billion in Korean dramas over the next four years. Its K-Pop stars like Blackpink or BTS are now among the world's best-selling artists.

Even with these tailwinds, Korea has remained an underdog. Its companies tend to get lower valuations because of the reputation of chaebols — the nation's family-run conglomerates — regarding poor corporate governance and an unfriendly stance toward minority shareholders that's created the "Korean discount." The Kospi trades at about one-third of the book value of global equities, and about half of Taiwan's, Bloomberg-compiled data shows.

Some portfolio managers hope that an upgrade could finally prompt a revamp of corporate governance and narrow the discount or eliminate it completely. “Once South Korea joins the developed market list, it will be compared to main developed market companies. Then investor expectations will become different and companies will have no choice but to improve their shareholder friendly measures,” said Park Yoo-Kyung, Asia Pacific head of responsible investment & governance at Dutch pension fund APG Asset Management Asia.

Restrictions on the country’s currency markets lie at the heart of MSCI’s deliberation. Unlike the Japanese yen or even the Thai baht, trading in the won is limited to local business hours given regulators’ fears about outflows during periods of heightened financial risk.

“Ultimately, what MSCI wants is opening the offshore currency market to allow exchanging the won 24 hours,” said Lee Kangkook, a professor of economics at Ritsumeikan University in Kyoto, Japan.

The country is looking to expand trading of the won to London hours and allow some offshore firms to participate directly in the local interbank currency market starting late 2024, though offshore trading will remain banned. There are other smaller points that need to be tackled before MSCI can upgrade the country, the compiler said in a report last year. These include the lack of transparency on dividends and foreign investor registration requirements, which are already being addressed.

Under President Yoon, Korea has vowed to tackle these and other issues in the coming years, partially motivated by a bid for a global bond index inclusion by FTSE Russell, which could happen as soon as in the fall.

Investors say Korea’s ambitions are forcing the government to examine the investor-friendliness of its markets. For Jonathan Pines, portfolio manager for Asia ex-Japan at Federated Hermes in London, that’s the key development that emerges from the potential upgrade: Korean regulators “are doing these positive things, driven in part by the motivation of getting admitted.”