

Is South Korea a Developed or an Emerging Market? Depends Who You Ask.

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Today, South Korea is at the forefront of the debate about what constitutes the demarcation between an emerging and a developed market. Two major index providers, FTSE and MSCI, each champion one side of the argument. Below, we outline the basic tenets of each position and then discuss the ultimate considerations for investors. Investors who utilize strategies designed to track the performance of the FTSE Emerging Markets Index (FTSE EM) are missing exposure to Korea, which constituted approximately 16% of the MSCI Emerging Markets Index (MSCI EM) as of September 30, 2013. We discuss why those tracking the FTSE EM may want to include additional South Korean equity exposure on a stand-alone basis to reduce potential differences in performance compared to the MSCI EM.

FTSE's Upgrade of South Korea in 2009 At the September 2009 meeting of FTSE's Policy Group it became official that South Korea was to be upgraded from emerging market to developed market status. The principal reasons of the decision involved:

- **Size of Economy:** South Korea is the 15th-largest economy measured by gross domestic product (GDP).
- **Trade:** South Korea is the 7th-largest exporter and the 10th-largest importer in the world.¹
- **Market Size:** South Korea is the 13th-largest stock market in the world and the 3rd-largest in the Pacific Rim (behind Japan and Australia).²

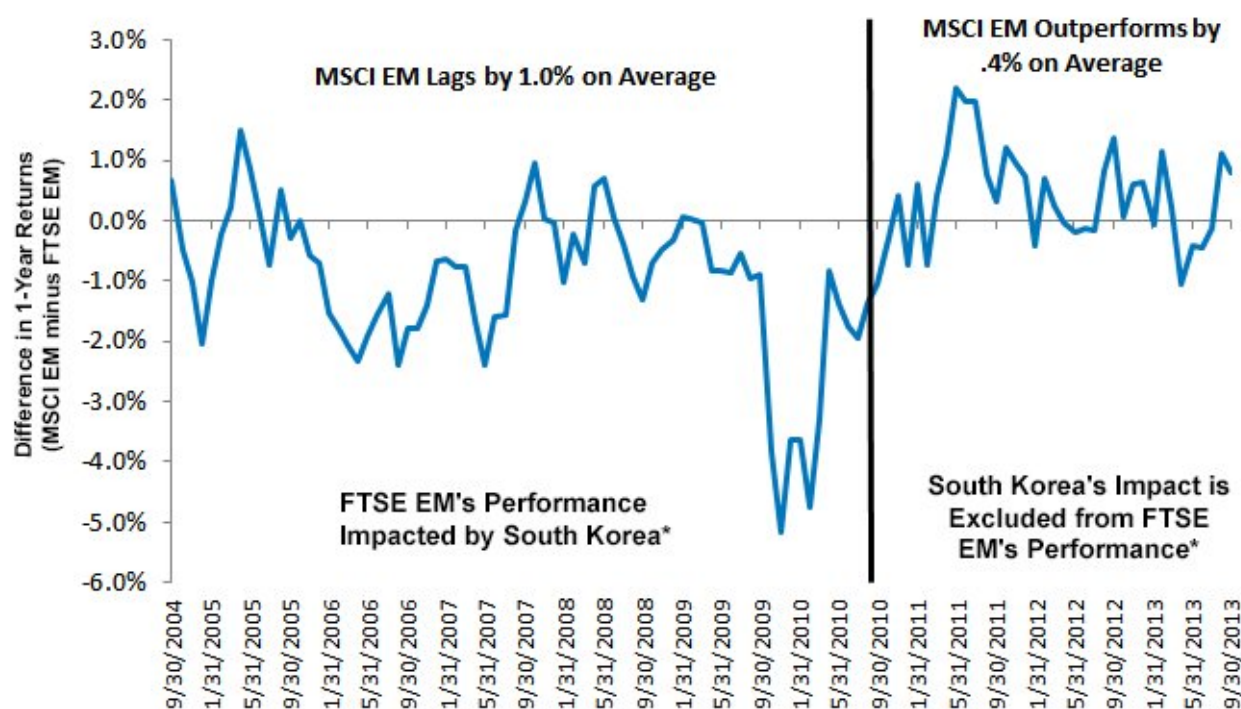
Thus, the size of South Korea's equity market, along with the scale of its economic development, outweighed any other considerations that FTSE may have had in terms of coming to its decision.

MSCI Keeps South Korea as an Emerging Market in 2013 MSCI does not disagree with the core tenets of FTSE's argument, namely that the economic development, market size and liquidity of South Korea are at developed market standards. However, these characteristics were not enough to outweigh two central issues which MSCI cites as having made no progress from its June 2012 to its June 2013 reclassification studies.

- **Limited Convertibility of the Korean Won:** Investors are forced to trade the Korean won during Korean business hours and forced to use local counterparties. If Korea were to be upgraded, it would be the only developed market currency that was not freely traded—thus compromising the trading and liquidity of the developed market index-tracking strategies.
- **Issues with In-Kind Transfers:** Korea would be the only developed market to make in-kind transfers of securities prohibitive, were MSCI to make the upgrade.

MSCI closes its 2013 reclassification study with respect to South Korea by saying that until progress is made on both of these fronts, South Korea will not attain developed market status. What is interesting about this MSCI discussion: If Korea had been upgraded to a developed market, we estimate that its weight would have been reduced to approximately 4%–5% of the developed world indexes as of September 30, 2013, but it is currently a large weight (i.e., three times as large) in the emerging markets index. MSCI is using some important characteristics to demarcate emerging from developed markets—and it wants its developed world countries to share the free conversion

of currencies and allowance of in-kind transfers. While these issues do impact the MSCI EM, they concern characteristics that apply to emerging markets and are more accepted in that universe. **Performance Differentials** Given its large weight in the MSCI EM, the exclusion of South Korea can lead to large performance differentials between the FTSE EM and the MSCI EM. **Difference in 1-Year Returns (MSCI EM minus FTSE EM) from 9/30/2003 to 9/30/2013**



*South Korea was removed from the FTSE EM in September of 2009. Utilizing one-year returns, we can say that periods after 9/30/2010 would utilize results for the FTSE EM that fully excluded South Korea.

Sources: Bloomberg, Zephyr StyleADVISOR. Past performance is not indicative of future results. You cannot invest directly in an index.

• **South Korea Included in FTSE EM:** As we see in the above chart, during this period (9/30/2003 to 9/30/2010) the MSCI EM lags the FTSE EM by an average of 1.0%. • **South Korea Excluded from FTSE EM:** As we see in the above chart, during this period (9/30/2010 to 9/30/2013) the MSCI EM outperforms the FTSE EM by an average of .4%. Of course, since there is no way to know ahead of time whether South Korea's equity market will under- or outperform, we can't say that excluding South Korea will always hurt FTSE EM's performance compared to MSCI EM. What we can say is that South Korea is a major exposure in MSCI EM—the second-largest country weight as of September 30, 2013, so its exclusion could potentially result in significant differences in performance. **Conclusion: Single-Country Indexes for South Korea Could Be of Interest** For those utilizing strategies that track the performance of the FTSE EM after costs, fees and expenses, single-country indexes for South Korea could be of interest. Even looking toward the FTSE Developed ex North America Index may not be enough, as South Korea garnered only an approximate weight of 4% as of September 30, 2013. Performance differentials to the MSCI EM could be important, and any potential mitigation of their impact could be beneficial. 1Source: Woods, 2013. 2Source: Woods, 2013. 3Source: HSCI, 2013.

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Investments in emerging, offshore or frontier markets are generally less liquid and less efficient than investments in developed markets and are subject to additional risks, such as risks of adverse governmental regulation and intervention or political developments. Investments focused in Korea are increasing the impact of events and developments associated with the region, which can adversely affect performance. Investments in currency involve additional special risks, such as credit risk and interest rate fluctuations. Foreign investing involves special risks, such as risk of loss from currency fluctuation or political or economic uncertainty.