COULD THE KOSPI HIT 3,000? REEVALUATING THE 'KOREA DISCOUNT' AND INVESTOR LEARNING AND UNLEARNING IN THE KOREAN MARKET

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The KOSPI index has hit an all-time high recently, pushing past the previous record set six long years ago. This has sent investor sentiment and economic soft data into highs unseen since the financial crisis, with analysts scrambling to revise their economic and stock market growth rates up. By various measures, the Korean stock market remains cheap and range-bound, especially over the past few years despite its strong market fundamentals and credit rating. With the benchmark index's unprecedented start to the year, investor learning of "Boxpi" tendencies—which have all but been ingrained into Korean stock market investing 101—could be fading, and a vast array of positive news regarding market fundamentals and corporate governance reform in Korea could finally help resolve the "Korea discount" which has plagued the market for decades. All of this—and more—will be needed for the KOSPI to finally break the 3,000 level in the near future. Currently, it's in the best shape to do so in what seems like a very long time.

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May 2, 2011. Prior to just a couple of weeks ago, this otherwise nondescript date was the last time that the KOSPI, Korea's representative stock market index, came anywhere remotely close to hitting the 3,000 mark—a round number meaningful in its importance as a psychological shift for investors, not unlike the recent hype over Dow 20,000[1]. Closing at 2,228.96 that specific day, the index would go on to tantalize both Korean and foreign investors alike for the next six years, hovering mostly in the 1,850 to 2,100 range to earn the humorous, if not infuriating, nickname: "Boxpi".[2]

By all measures, the KOSPI has been in a rut since then. The European debt crisis helped drag the index down to 1,825.74 to end 2011, and the index continued to be range-bound since, ending 2016 at 2026.46 for a mere 11.0% gain over five years. According to Yuanta Securities (formerly Tongyang Securities, a local stock brokerage and investment banking firm), the range-bound KOSPI gained just 43.5% from its lowest to highest close over the six-and-a-half-year period from January 2010 to July 2016, ranking dead last among emerging markets in Asia such as China's Shanghai SE index (164.9%) in addition to notable developed market indexes such as Japan's Nikkei or Hong Kong's Hang Seng.[3]

Yet despite this, the KOSPI's standard deviation from its long-term average has consistently remained among the highest in Asia. This is partly explained by the often divergent and offsetting flows of capital from local individual investors and institutional or foreign ones—the cooler of heads that usually prevail. "Buy at under 2,000 and sell at over 2,000" has been a popular mantra of Korean stock market investing among individual investors—generally the more gimmicky and fickle of the entire investor population—who are both quick to actualize profits and easily swayed by sentiment and market trends such as politically-themed stocks. In fact, a simple buy at 1,800 and sell at 2,000 strategy starting in 2012 would have netted a return of roughly 52% or 15% per annum

[1] Figures are reflected from those at the time of writing (May 2017).
[2] Jung and Lee 2015
[3] Reuters 2016

over the following three years, absolutely crushing the KOSPI's return over that period.[4] The index's continued failure to break through the barriers of its "box" has led to such strong "investor learning"[5] that it has become an increasingly prevalent view in the market.

An Unprecedented Start to 2017

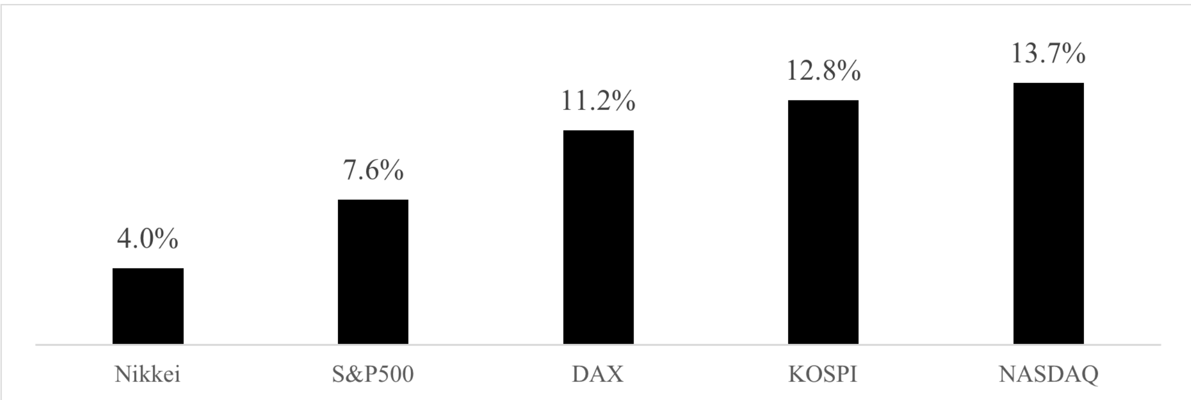
Fast forward to May 2017, and the KOSPI is seeing concrete signs of a legitimate breakthrough. Following France's unprecedented, albeit expected, election of Emmanuel Macron—quelling anti-free trade populism fears in Europe—and news of six straight months of gains in Korean exports (ranging back to November 2016) for the heavily export-driven economy, the benchmark index gained 51.52 (2.30%) to reach a new historic high of 2,292.76 just one trading day after barely beating the previous record high from six long years ago.

Another two trading days later on May 11, the KOSPI closed at yet another high of 2296.37 Since then, the KOSPI has continued to reach new high after new high. Year-to-date, the KOSPI has gained 12.8% (see [Figure 1])—a return that is in line with those of the highest achievers among developed markets such as the NASDAQ (13.7%), which is currently fueled by incredible gains from its roaring large-cap tech stocks including Amazon, Google, and Apple. This is in stark contrast to the KOSPI's dismal net return of just 11.0% over the last five calendar years ending 2016, which has ranked the index towards the very bottom among developed markets' returns during that period—especially when compared to key indexes such as the Nikkei (126.1%), the NASDAQ (106.6%), the DAX (94.6%), and the S&P500 (78.0%), all of which have trounced the KOSPI despite similarly less-than-stellar economies and GDP growth rates themselves.

Optimism amidst surging global equities and Korean market fundamentals

The KOSPI is not alone in its strong start to the year. In fact, since Donald Trump's election in November 2016 (and even in the months trailing up to that point), major stock indexes around the world have been rallying. Buoyed by expectations of higher growth in the U.S. from Trump's grandeur plans of fiscal policy and tax reform as well as what is looking to be a slow but sure recovery of the global economy, investor sentiment and on some level, soft data, have both risen to levels unseen since the financial crisis. Major related keywords such as "animal spirits" and "irrational exuberance" have made their way back into the media's list of favorite words.

[Figure 1: 2017 Year-to-Date Index Returns]



Source: Yahoo Finance

Whether justified or not, worldwide gains following the U.S. elections have held steady coming into 2017. Prior to its most recent advancements, the KOSPI has lagged its international counterparts with no notable gains in the short period following the election, so Korea's

[4] Ahn 2014
[5] Referring to Robert Shiller's investor learning

benchmark index may just be benefitting from a catch-up effect to global equities.
In any case, analysts have since been scrambling to adjust their forecasts for the KOSPI, with almost every major securities firm revising its prediction upwards compared to reports published towards the end of 2016. Citing global stock rallies outlined above, the improving global economic outlook, upward revisions of Korea's 2017 GDP growth rate by various institutions such as the IMF and Bank of Korea, and continuous positive gains in exports and corporate earnings, analysts now expect the KOSPI to reach a range of 2,250 to 2,400 by year's end (see [Table 1]).

[Table 1: Year-End KOSPI Forecasts by Firm]

Securities Firm	As of 2016	Current*
Mirae Asset Daewoo	2150	2250
Meritz	2250	2250
KB	2135	2260
Daishin	2300	2300
Samsung	2210	2330
NH	2250	2350
Hana	2350	2350
Shinhan	2350	2350
E-best	2300	2400

*As of May 2017; Source: FNGuide

Many view these revisions as still too conservative. Shin Sung-ho, head of IBK Investment & Securities, recently stated that the KOSPI has just started its ascent and could break 3,000 by year's end, citing "strong earnings growth, stable currency fluctuation forecasts, and the continued low interest rate environment in Korea."[6] International securities firms and investment banks seem to be echoing this optimism. Nomura Securities, in a 2017 report on macroeconomic policies and the stock market outlook in Korea, cited the potential of a 3,000 KOSPI "if the dividend payout ratio of the KOSPI rises to that of Japan's 50 percent from the current 20 percent."[7]

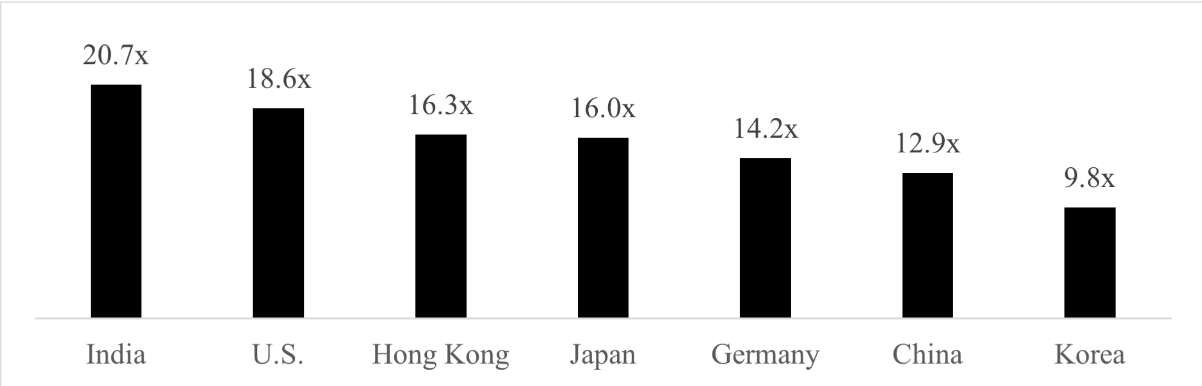
Both scenarios seem rather unlikely. Considering the KOSPI was just a hair's breadth above 2,000 at the end of 2016, reaching 3,000 would signify a net return of almost 66.7% for 2017—an unprecedented level for any nation, much less one with a developed, low-growth economy like Korea's. Despite this, the unique situation in Korea fosters optimism for the future.

The Korea Discount: Geopolitical Risk and Corporate Governance

No discussion of the Korean stock market and its potential return can ignore the effects of the "Korea discount," a specific type of equity premium puzzle referring to the persistent discount in the Korean stock market's valuation relative to those of its peers[8]. In other words, the cost of capital for Korean firms in the domestic market has empirically been found to be higher than that of its foreign counterparts after controlling for relevant factors.[9] Popularly and intuitively understood by looking at stock market valuations relative to some measure of corporate earnings—such as in the form of a trailing or forward P/E ratio—Korea has consistently lagged its major peers for much of recent history, remaining in the range between 9x and 11x (see [Figure 2] on the next page for an overview of the P/E ratios of major stock markets). This is largely attributed to two main factors.

[6] Kang 2017
[7] Kang 2017
[8] Suh and Sim 2007
[9] Choi, Lee and Pae 2012

[Figure 2: P/E Ratio of Major Stock Markets*]



*As of March 17, 2017; Source: Korea Exchange

The first, less convincing argument is that the constant threat of North Korea provides a form of inherent geopolitical risk that continues to undermine the value of Korean stocks. This makes Korea, despite its relatively strong market fundamentals and credit rating (even most recently surpassing that of China's and Japan's), a riskier bet when compared to its peers. The threat can be analyzed as a form of "Black Swan" effect or catastrophe risk—referring to the extremely unlikely yet highly devastating possibility of a huge losses. While this form of tail risk has largely been ignored or discounted as recently as the 2007-2008 financial crisis, the ubiquitous nature of the North Korean threat could perhaps be interpreted as a more convincing and salient risk. On some level, this would seem to almost contradict the recent stock market boom; after all, North Korea's most recent provocations and ballistic missile launchings have heightened tensions in the region to arguably their highest levels since Kim Jong-un came into power. Critics of this notion point to the KOSPI's increasingly weaker reaction to North Korean provocations even before the most recent events, claiming they may show a lack of clear correlation between the two. This sort of thinking may ignore the possibility that perhaps Korean stocks have been surging despite North Korean aggression, but regardless, it is difficult to imagine the stock market not receiving some sort of major boost should the threat be eradicated completely.

The second, more robust explanation lies in poor corporate governance by large-scale conglomerates, especially those virtually controlled by *chaebol* families. Plagued by circular shareholding and the potential for corporate asset exploitation, these firms—which make up a bulk of the entire Korean stock market—offer paltry dividends and overall uncertainty regarding how the firm is managed.

Historically, *chaebol* owners have almost always been pardoned in some way by conservative governments for various related charges such as the embezzlement of company funds or blatant tunneling to affiliate firms, usually in the name of keeping these systematically important companies afloat. While various corporate governance reform measures have been implemented with additional rules on circular shareholding, limits on tax exemptions, and restrictions on tunneling, the issue is still an ongoing dialogue in Korean politics today.

Overcoming the 'Korea discount'

Thus, a more convincing argument for KOSPI 3,000 or an implied P/E ratio in the 13x to 14x range, which cannot be attained in the near future merely by improved market fundamentals such as corporate earnings or export gains, would most likely include structural reform that could resolve the Korea discount. This would seem to be the only plausible way that such high forecasted returns could be justified. Fortunately, there has been ample evidence over the past year to support this optimistic outlook.

First, it is important to understand the significance of Samsung Electronics, one of the largest publicly traded companies in the world with a market capitalization of over KRW 320 trillion. With the firm comprising roughly 20% of the entire Korean stock market by itself, fluctuations in its stock heavily sway the market. Shares in Samsung Electronics ended 2016 just above KRW 1.8 million, and it has since rallied close to 30% to the KRW 2.3 million level today; in other words, its growth has contributed roughly 6% to the entire stock market this year just by itself.

While business-related factors such as the much-anticipated release of the Galaxy S8 and the surging growth of the semiconductor industry have undoubtedly contributed greatly to the company's historically high profits over the past two quarters, one of the key accelerators for growth and investor sentiment has been Elliott Management's involvement in the company in early October 2016. The prominent U.S. activist hedge fund sent an open letter to demand more transparent corporate governance through higher dividends and a plan to split the firm into a holding company and an operating company. This opened up the possibility of increasing corporate governance reform pressures for Korean firms both from home and from abroad. The market, viewing transparency as a clear positive, sent Samsung Electronics surging 4.4% the very next trading day, with the stock continuing its rally since—just at the mere consideration of such a plan.

Another significant event related to corporate governance has been the imprisonment of Samsung's vice chairman and de-facto head Lee Jae-yong for his alleged involvement in the Choi Soon-sil scandal. An unexpected and even unprecedented move by the Korean government on the back of strong candlelight protests and particularly souring public opinion on corruption and *chaebol* involvement, the decision marks a remarkable shift in the favorable treatment of *chaebol* families, or at the very least, the potential for such changes moving forward.

In addition, the election of the relatively progressive Democratic Party's Moon Jae-in as president is a boon to such sentiment. Vowing *chaebol* and corporate governance reform as one of the key proponents of his election pledge and with heightened restrictions on tunneling and implementation of the stewardship code already underway, Moon is signaling that he is truly a drastic shift away from nine years of conservative rule—better reflecting public opinion on the *chaebol* and how the economy should be run.

In that sense, Samsung Electronics is an excellent microcosm of the Korean stock market, with heightened market fundamentals, improving macroeconomic factors, and the potential for change in companies' corporate governance all contributing to gains that have not been seen in years. This is evidenced further by the fact that large-cap stocks, those usually controlled by or affiliated with large *chaebol* groups, have outpaced mid- and small-cap stocks so far this year quite substantially.[10] Overcoming the *chaebol's* opaque corporate governance is a key factor to resolve the Korea discount that has plagued the stock market's gains.

Looking Ahead

No stock market can ever be explained fully by a mere few factors, and reaching a new level of 3,000 in the near future will take a lightning rod of different factors to be even close to plausible. Despite investor sentiment seemingly at all-time highs, many risks still loom ahead. Already, investor unlearning of the superiority of stocks in the long run and the relative cheapness of Korean stocks, pushed by various economic newspapers and stock market enthusiasts to further add fuel to the fire, seem to be in full swing. In addition, the investor re-learning of 'Boxpi' tendencies is rearing its ugly head as well, as evidenced by the most recent selloff by individual investors and the KOSPI's inability to break 2,300. To maintain current market levels and avoid another mass selloff, investor sentiment will have to continue to

[10] Another key factor may be that large-cap firms have generally more export-driven exposure to the global economy.

be fueled by positive news regarding market fundamentals and reform.

Ultimately, barring some major, unprecedented strides in the economy overall, concrete plans on corporate governance reform will be the key to a true breakthrough in the level of the KOSPI, and whether such drastic changes can be actualized in the near future still remains to be seen. This will be a huge factor for the KOSPI in the long-term; in the meantime, investor sentiment will have to keep the market afloat to further this virtuous cycle in the economy.

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