IF KOREA'S STOCK MARKET FOLLOWS JAPAN, MANY EMERGING MARKETS FUNDS WON'T HAVE IT

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South Korea is a peculiar country for asset allocators because our industry is torn over the question of whether the world's 13th-largest economy is an "emerging" or "developed" market. It can be a difference-maker because some emerging markets funds may have a double-digit weight in the country while others have no allocation at all (figure 1). For example, the Vanguard Emerging Markets Stock Index Fund (VWO) has no exposure to Korea because its index provider, FTSE, puts the country in the developed category. The five non-WisdomTree Funds listed in figure 1 are all major ones with large asset bases.

Figure 1: South Korea Weight, Emerging Markets

Ticker	Name	South Korea Weight (%)
XC	WisdomTree Emerging Markets ex-China Fund	15.6%
XSOE	WisdomTree Emerging Markets ex-State-Owned Enterprises Fund	12.8%
DGRE	WisdomTree Emerging Markets Quality Dividend Growth Fund	11.7%
DGS	WisdomTree Emerging Markets Small Cap Dividend Fund	11.7%
EMMF	WisdomTree Emerging Markets Multifactor Fund	10.1%
DEM	WisdomTree Emerging Markets High Dividend Fund	4.1%
	Five Major ETFs With Zero South Korea Exposure:	
VWO	Vanguard Emerging Markets Stock Index Fund	Zero
SPEM	SPDR Portfolio Emerging Markets ETF	Zero
SCHE	Schwab Emerging Markets Equity ETF	Zero
FNDE	DFA Dimensional Emerging Markets Core Equity 2 ETF	Zero
ESGE	iShares ESG Aware MSCI Emerging Markets ETF	Zero

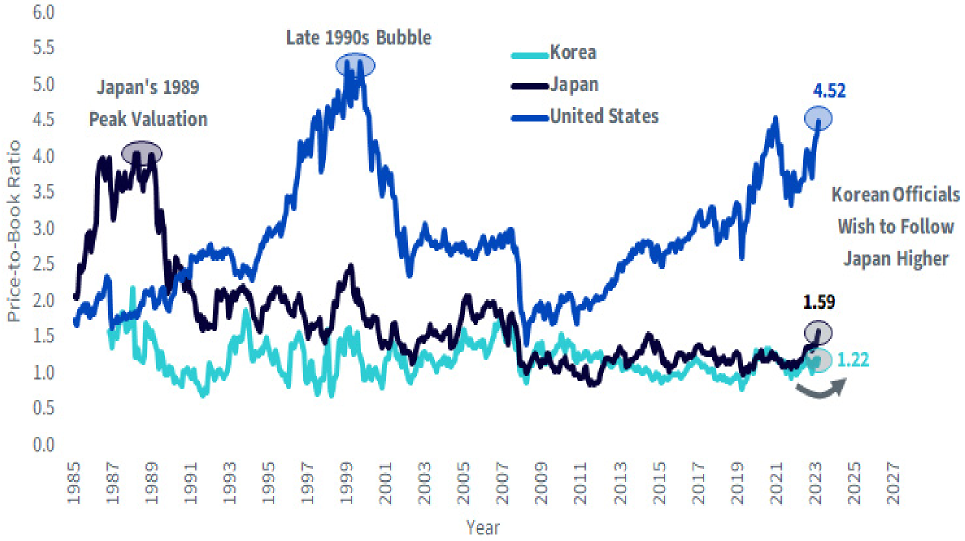
Sources: WisdomTree and competitor fact sheets, as of 3/20/24. Weights are subject to change.

WisdomTree's emerging markets investors could find themselves in an alpha generation situation if Korea's leadership pulls off a key goal this year: narrowing its stock market's so-called "Korea Discount" by following Japan's lead on corporate governance reform.

The Korea Discount refers to the low valuations placed on South Korea's stocks relative to those in other countries. Observers may logically point the finger at the nuclear threat posed by the North Korean regime as a key driver of this discount, but we believe there is more to it than just that.

In figure 2, I put South Korea's valuations in the context of valuations in the United States and Japan. Price-to-book is a ratio we do not cite too often at WisdomTree, but I'll do so here because it is the primary metric being cited by *Japan's reform-minded* *leadership at the Tokyo Stock Exchange (TSE)*. We think the Korea Exchange will follow Japan's lead, spending 2024 willing its member firms' price-to-book ratios higher.

Figure 2: Price-to-Book Ratio: "The Korea Discount"



Sources: Refinitiv, Datastream Total Market Indexes for each respective country, as of 2/28/24.

With Japan, the major driver of bullishness on the country has been its ["Name and Shame" initiative](). The Tokyo Stock Exchange basically said to Corporate Japan: "Get your price-to-book ratio up or we are going to put your company on a list of firms that aren't serious about reforming their corporate governance. We will shame you."

Many Japanese corporations called the TSE's bluff, so the exchange went ahead and published the list in January. Others took the warning to heart, outlining plans to boost profitability. The result: the price-weighted Nikkei 225 Index has melted up from 26,094 at the end of 2022 to 33,464 at last year's close. It recently broke through 40,000.

Korea's Financial Services Commission (FSC) is watching Japan's rally and asking itself how it can get in on the game. The solution: bring "Name and Shame" to Seoul.

This initiative has a specific title that I think will be splashing headlines all year: the "Corporate Value-Up Program." Whenever you want to Google Korea's reforms, type that into the search bar.

Figure 3: South Korea Is Playing Japan's Governance Card

Sources: Bloomberg, Financial Times.

Shareholder activists have their targets set on Asia too. Hedge funds are prowling in both Japan and Korea because about half of each country's stocks trade below book value. Before the COVID-19 years, activists' sights were on Europe. Not anymore.

Figure 4: Investor Activist Activity, Europe vs. Asia

Source: The Economist, The Rise of the Asian Activist Investor, 8/31/23.

Perhaps most important for the stock market is whether the Corporate Value-Up Program can reform the lumbering *chaebol* system. The chaebol are family-run companies that own controlling stakes in Korea's conglomerates. Because of their sheer power, the result is very little voice for everyday stockholders or even for some large institutions.

While it is a slam dunk that small shareholders wish for stock prices to rise, the investor in Korean stocks needs to get their mind around the concept of controlling families wishing to keep valuations low. Who wouldn't want the price of their largest asset to rise?

Chaebol scions who are subject to a 60% inheritance tax.

South Korea is a geriatric society; chaebol families are incentivized by the confiscatory inheritance tax to do everything in their power to keep valuations in the basement so that heirs do not get stuck with a large tax bill. President Yoon Suk Yeol floated the idea of an inheritance tax cut in January. But keep in mind that his popularity is nothing like FDR or Reagan. His approval rating is very low, so this could very well be a lame-duck situation, especially with the country engaged in parliamentary elections coming in a few weeks.

Meantime, there is another reform in store.

South Korea has a shot at following Japan's lead on retirement contribution limit increases. On January 1, Japan tripled the annual maximum that an individual could put into a Nippon Individual Savings Account (NISA), which you can think of as Japan's equivalent of a traditional IRA.

President Yoon seems to be taking a page from his neighbor's playbook:

We will sharply expand eligibility for Individual Savings Accounts (ISAs) and increase the limit on the non-taxable amount. In order for the state and society to prevent the solidification of classes and increase society's dynamism, the financial investment sector must be vitalized.

– Yoon Suk Yeol, President of South Korea, January 17, 2024

Another related matter: Korea is supposed to go forward with a capital gains tax hike this year, but Yoon has promised to eliminate it. The jury is still out on this, so keep an eye on this matter to see if he can pull it off.

In summary, the bullish catalysts for Korean stocks are:

- The Korea Discount becoming more overtly political.
- Japan's "Name and Shame" arriving in Korea via the "Corporate Value-Up Program."
- Hedge funds swirling.
- Possible inheritance tax cuts influencing chaebol families to be open to a bull market.
- Expanding retirement contributions and capital gains friendliness.

Some emerging markets funds own South Korea because they classify it as an emerging market, while others who view it as a developed economy may have as little as zero percent in the country. The WisdomTree strategies that hold big chunks in the country are XC, EMMF, XSOE, DGRE and DGS.

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DEFINITIONS

Emerging market : Characterized by greater market access and less potential for operational risks when compared to frontier markets, which leads to a larger base of potentially eligible investors.

Alpha : Can be discussed as both risk-adjusted excess return relative to a specific benchmark, or absolute excess return relative to a benchmark. It is sometimes more generally referred to as excess returns in general.

Valuation : Refers to metrics that relate financial statistics for equities to their price levels to determine if certain attributes, such as earnings or dividends, are cheap or expensive.

Price-to-book ratio : Share price divided by book value per share. Lower numbers indicate an ability to access greater amounts of earnings per dollar invested.

Bullish : a position that benefits when asset prices rise.