Reasons Behind the Increase in Overseas Securities Investments, and Their Implications

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Korean residents' overseas securities investments have climbed rapidly recently. This stems from various factors: Individual investors and financial institutions are increasing overseas investment demand for higher returns under the current low economic growth, low interest rate climate; and Korea's national wealth has increased. Against the backdrop, the growth trend in overseas investments is expected to continue in the near future. Hence, regulators should make policy efforts to materialize the positive effects of overseas securities investments such as portfolio diversification, reduced pressure on currency appreciation, and liquidity provision in the event of a crisis.

Since Korea opened its capital markets, foreigners' investments in Korean securities have increased. In tandem with that, Korean residents' investments in overseas equity and debt have also been growing rapidly. Japan, which already experienced population ageing and current account surplus (a similar situation that Korea now faces) in the mid 1990s, saw its outstanding investments in overseas securities also surge about seven times until recently. This suggests that Korea's investments in overseas securities are expected to grow further down the road. In this article, I examine the recent trends, the reasons behind the growth, and future outlook of Korea's investments in overseas securities. Then, I briefly mention their implications.

* All opinions expressed in this paper represent the author's personal views and thus should not be interpreted as Korea Capital Market Institute's official position.

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Recent trends of overseas securities investments

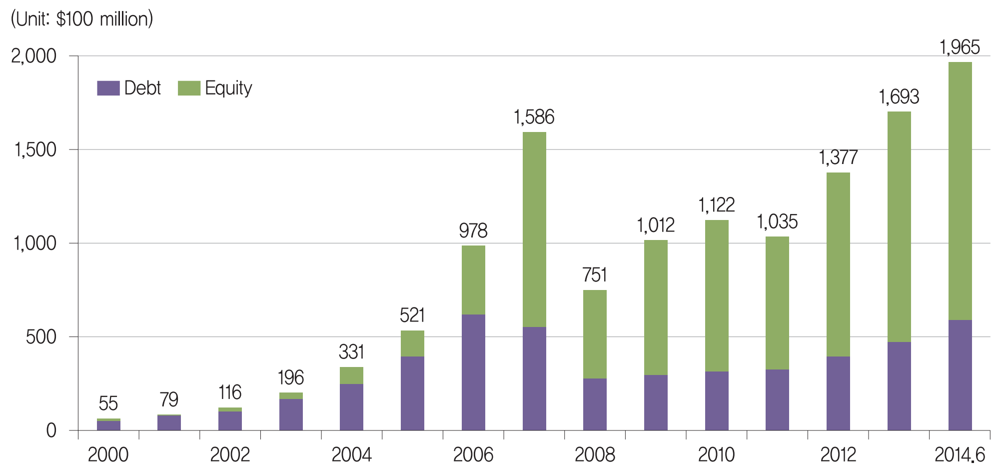
Korean residents' investments in overseas equity and debt securities grew fast since the mid 2000s, and abruptly fell in the midst of the global financial crisis. They recently began to pick up.[1)] As of June 2014, Korean residents' external assets outstanding reached nearly $1 trillion, of which $196.5 billion (according to the International Investment Position) is invested in overseas securities (about 70% in equity, and the rest in debt). This figure increased five-fold from early 2005, and almost doubled from the end of 2009 right after the global financial crisis. By investor type, both public organizations (e.g., National Pension Service, Korea Investment Corporation, etc.) and private sector investors (e.g., asset managers, insurers, etc.) increased their holdings in overseas securities. For example, the National Pension Service's overseas investments were less than KRW 1 trillion in early 2003, but reached KRW 82.6 trillion at the end of 2013, most of which are overseas securities. As a result, the share of overseas investment assets in the National Pension Fund's AUM rose to 19.4%. Overseas securities holdings in private sector institutional investors (mostly in asset managers) rapidly rose to $90.3 billion in the outstanding amount as of June 2014, and the pace of the increase is accelerating this year.

Also notable is the diversification in Korean residents' investment destinations: Not only are the investments going to developed nations such as the US and European nations, but investments in Asia and emerging nations are growing in both relative and absolute terms.

However, Korea's overseas securities investments, despite the rapid growth, are much less than foreign investors' holdings in Korean equity and debt. As of June 2014, foreign holdings in Korean securities outstanding stood at $647.2 billion, more than three-fold Korean residents' overseas securities holdings. Furthermore, given Korea's economic scale and financial market size, the relative size of its overseas securities investments is smaller than those of developed countries.

1) The dramatic increase in the mid 2000s primarily stemmed from Korea's temporary income tax exemption for the capital gains earned from overseas equity investment funds enforced in June 2007.

Korea's outstanding investments in overseas securities (As of year-end)



Source: Bank of Korea

Reasons behind the increase

The rapid increase in Korean residents' overseas securities investments results from compounding reasons: Individual investors and financial institutions are developing their overseas investments demand for higher returns under the macro-economic changes such as low economic growth and low interest rate trends; and institutional investors have more money to invest due to Korea's persistent current account surpluses and subsequently growing national wealth.

First, the global economy has been plagued by concerns that the low economic growth trend might be prolonged due to the delayed recovery in developed nations and dull growth momentum in emerging countries. Amid the expectation that the US might begin its rate hike next year, Japan and European nations maintain their quantitative easing policy. In Korea, the low rate trend persists due to the slump in aggregate demand where both private consumption and investments have been sluggish. Coupled with population ageing, Korea's household debt problem hinders the recovery of domestic demand. All of those changes are bringing down the expected investment return in Korea's financial markets, while serving as a cause to increase overseas investment demand for higher returns.

Second, the ever-worsening profitability of Korea's financial institutions under the low interest rate trend is another reason. Under the low interest rate climate, it gets more and more difficult for banks to generate profits out of the loan-deposit interest rate margins. In addition, insurance companies face reverse margins where investment returns are lower than the interest rate guaranteed by their products. At the same time, financial investment firms such as securities companies see their profitability deteriorate because the fall in economic growth, the contraction in investment activities, and the decrease in the expected return on financial products. Against the backdrop, Korea's institutional investors and financial institutions face the increasing need to improve their profitability and enjoy a boon of portfolio diversification by investing in overseas securities. This trend is especially evident in equity investments: Although home bias is high in the Korean stock market because of the risk of overseas investments and the lack of overseas investment experience, Korea has thin financial markets. This is why large investors (e.g., National Pension Service) want to expand their overseas investments.

Third, individual investors are growing their appetite for high-return financial investment vehicles in order to prepare for the future. Korea's household asset composition reveals a relatively large proportion of non-financial assets among the total assets. And cash and deposits represent a relatively large portion in financial assets, compared to financial investment assets. Given the expectation that individual investors will increase their financial investment assets to heighten investment returns, the proportion of overseas securities investments is likely to pick up further. It is believed that such a behavioral shift among investors is well reflected in the recent increase in the sales of funds investing in overseas assets.

Fourth, Korea's national wealth has continued to grow. Korea has sustained its current account surplus since the Asian financial crisis, and accordingly, its public sector foreign reserves and private sector foreign currency assets have dramatically increased. Especially, the current account had a surplus for the 16 consecutive years after 1998, and surpassed 6% of GDP after 2012. Another factor is the persistent increase in foreigners' investments in Korean securities thanks to Korea's sound economic fundamentals. This increased the size of foreign currency assets held and managed in Korea, which consequently led to growing the size of assets invested abroad by Korean financial institutions (e.g., overseas securities investments).

Future outlook and implications

Going forward, Korean residents' investments in overseas securities are expected to grow continuously due to the extended low economic growth, low interest rate trends, and the growing demand for higher returns among financial institutions and individual investors.

The increase in overseas securities investments seems to have several benefits: portfolio diversification, less pressure on currency appreciation, liquidity provision in the event of a crisis, and the transfer of today's current account surplus to overseas assets for the future. However, the following considerations will be necessary to fully materialize the benefits.

First, in order for investments in overseas securities to take hold as a new revenue source for financial institutions and a means to improve investment returns of individual investors, investors should exert multi-faceted efforts to improve profitability and reduce risk associated with such investments by, for example, constantly monitoring the economic and financial markets trends of investment destinations and developing the appropriate investment techniques. Together with this, financial institutions should develop new financial products taking into account the shift in investor behavior.

Second, the exchange rate risk should be managed properly. Overseas investments inevitably accompany exchange rate risk in addition to the risk of price volatility. But one has to be mindful that it is difficult to maximize the expected return on overseas investments when their exchange rate risk is fully hedged. Even when an interest rate differential exists, the hedging process of buying the currency of an investment destination incurs costs, which offset the expected return on overseas investments. It is necessary to think through why most foreigners investing in the Korean market regard exchange rate volatility as a primary source of profit, together with price volatility of equity and debt.

Third, regulators should reflect on the 2007 experience when the income tax exemption for overseas equity funds failed to produce intended impacts on the exchange rate. Based on this, their policy efforts should focus on helping overseas securities investments offset the currency appreciation pressure. It is worth considering a differentiated taxation system for overseas investments with and without hedging. The most important thing is to induce investors to have a balanced portfolio that enables natural hedging, and thus to maximize the portfolio diversification effect at the national level. Also necessary is examining whether any complimentary action is necessary to induce the money invested overseas to flow back immediately into Korea when Korea encounters a foreign currency liquidity problem.