Korea's Overseas Portfolio Investments in the Post-crisis Era - Recent Trends and Implications

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Overseas portfolio investments by domestic residents of Korea have expanded rapidly since the early 2000s. Excluding 2008 right after the global financial crisis, the compound annual growth rate of overseas portfolio investments stands at 40% after 2000. However, the recent growth in overseas investments is different from that of the pre-crisis era in a number of ways. First, the composition of overseas portfolio investors is shifting from the private to the public sector (e.g., pension funds). Second, destinations are changing as investments to emerging markets decrease and those to developed markets such as the US and Europe rise. In addition, asset management companies that drove the overseas portfolio investments boom in the mid 2000s now represent a smaller share, while insurance companies are increasing their exposure to overseas bonds. All these changes suggest a shift in the perception of overseas portfolio investments as a tool for improving risk-adjusted returns amid the low-rate, low-growth, and aging trends.

Overseas portfolio investments by domestic residents of Korea hit a record high, exceeding KRW 200 trillion outstanding. This is even higher than the level attained in 2007 at the height of the overseas investment funds boom, and the expansion of overseas portfolio investments continues even after the global financial crisis. A more detailed look, though, reveals a number of differences from the past trends. The private sector diminished its share in overseas portfolio investments while the public sector including pension funds is

* 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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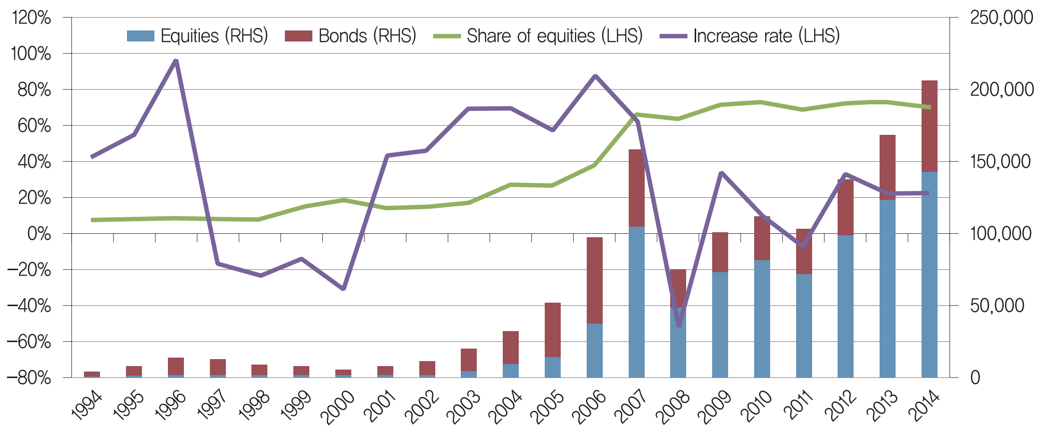
increasing its weight. Furthermore, there are changes in investment destinations and vehicles in both sectors. In this article, I explore the recent trends of overseas portfolio investments by domestic residents, and provide the implications.

Recent trends

Domestic residents of Korea steeply increased their overseas portfolio investments from 2003. Outstanding investments were just $5.5 billion in 2000 but surpassed $206 billion in 2014. After a leap between 2006 and 2007, it sharply decreased when the global financial crisis broke out. But after the second half of 2008, it quickly recovered to climb fast again. The increase in overseas portfolio investments is driven by equity investments. Before 2003, the share of equities in overseas portfolio investments was less than 20% while overseas bonds investments represented a large percentage. But after the overseas investment funds boom in 2007, the share of equities reached the 60% mark for the first time. Since then, equities have accounted for a high percentage even in the aftermath of the global financial crisis. As of 2014, about 69% of overseas portfolio investments were held in equities.

Domestic residents' overseas portfolio investments

(Unit: $ 1 million)

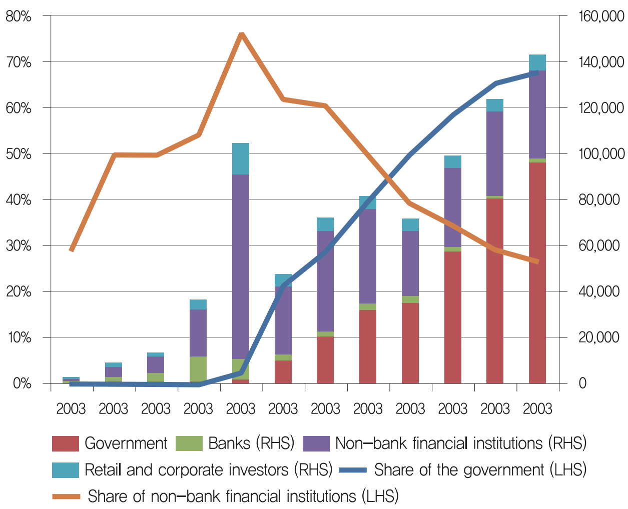


Source: International Investment Position, Bank of Korea

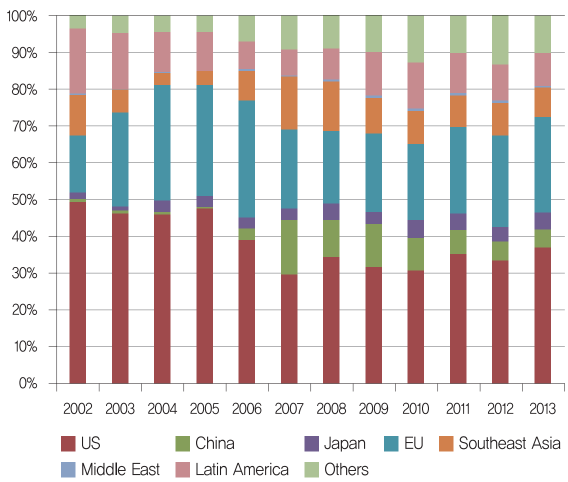
One of the most notable aspects of the post-crisis era is the shift in investor composition. From 2006 to the first half of 2008, inflows into overseas equity funds abruptly rose thanks to China's stock market boom and Korea's tax exemption on overseas investment funds. Those two factors were the primary drivers that expanded overseas portfolio investments by Korean asset management companies, while the recent growth is mostly fueled by pension funds. The percentage of non-bank financial institutions[1] rapidly fell from 70% in 2007 to 35% at the end of 2014. However, the proportion of the government (pension funds) surged from 13% to 52% during the same period, showing that the central pillar of overseas portfolio investors shifted from the private to the public sector after 2008.

As of the end of 2014, domestic financial institutions (including banks) held about $59.8 billion, roughly 60% of the 2007 level, in outstanding overseas portfolio investments. It is also clear that the main vehicle domestic financial institutions use to invest overseas is shifting from equities to bonds. In 2007, domestic financial institutions' share of equities in overseas portfolio investments reached 75% but fell to the 55% range in 2014. That change is a result of the asset management companies reducing their weight in overseas portfolio investments while insurance companies increased theirs. At the end of 2014, insurance companies' share in overseas portfolio investments by all financial institutions stood at 29%, a sharp increase from 17% in 2007. But the share of asset management companies shrank from 75% to 63%.

Overseas portfolio investments by investor type



A regional breakdown



Source: International Investment Position, Bank of Korea

1) Non-bank financial institutions include asset management, securities, and insurance companies. As of the end of 2014, asset management companies account for about 67% of overseas portfolio investments by non-bank financial institutions.

A regional breakdown also reveals significant changes before and after the global financial crisis. Investments in risky markets such as China and Southeast Asia contracted from 45% in 2007 to 31% in 2013 while exposure to developed markets including the US, Europe, and Japan increased from 54% to 68% during the same period. It is noteworthy that retail investors show different risk preferences from institutional investors. More specifically, retail investors tend to invest in Japan and China more heavily, and more recently are increasing direct investments in overseas equities. No significant change was seen in retail investors' direct equity investments since 2008 until they recorded more than a 15% quarter-over-quarter growth as of the first quarter of 2015.

Implications

The recent trend of public sector-led overseas portfolio investments aims at two goals: enhance investment returns under the low interest rate and aging trends, and distribute risk by building a diversified portfolio. This is a distinct aspect that clearly differentiates the post-crisis era from the pre-crisis expansion period when high-risk, high-return investment demand from the private sector boosted overseas portfolio investments. This investment behavior that seeks higher risk-adjusted returns is also evident in the regional breakdown shown above. The increased weight of developed markets including Europe and the US after the crisis demonstrates the changes in risk preferences. On the other side, retail investors are increasing direct investments in overseas equities, reinforcing the presumption that high-return demand is rising due to Korea's low interest rate and stock market stagnation.

Arguably, the fundamental purpose of overseas portfolio investments is to seek relatively high returns. But those investments should not necessarily be high-risk investments because the heterogeneity across countries reduces investment risk through portfolio diversification. It is important to note that domestic investors in Korea are no exception to the home bias observed in most countries. Korea needs to establish an investment culture where investors, instead of narrowly focusing on the home country or a limited region, perceive overseas portfolio investments as a way to build a global portfolio through which they can attain risk management and higher returns. In this regard, the recent trend of public sector-led overseas portfolio investments should help such an investment culture to take hold in Korea.