A Thought on Revival of Tax Reliefs on Foreign Portfolio Investment Funds

Kwon, Min Kyeong*

If Korea launches "foreign portfolio investment funds" sometime next year, investments up to KRW 30 million in foreign equity funds will be subject to temporary tax reliefs on capital gains (trading and valuation profits) and foreign exchange gains. Although Korea's investments in foreign equities are currently at a low level compared to major developed countries, the demand seems to be rising with the easing of factors restraining foreign equity investments, e.g., information asymmetry, high transaction costs, expectations for a home stock market rally, and inflation hedging demand. Adopting foreign portfolio investment funds under the circumstances is expected to not only improve supply and demand conditions for foreign currencies, but also improve the long-standing slump in mutual funds as well as expand the role of Korea's ETF market. But those outcomes are hard to be realized in the short run, requiring a long-term, persistent policy stance to encourage overseas investments. Also necessary are the asset management industry's efforts to renew their investment behavior: Rather than concentrating on limited areas for high returns, the industry should strive for maximizing the benefits of diversification.

Korea's foreign equity investments are low compared to developed countries. According to IMF data, Korea's equity and investment funds in portfolio investments stood at $142.8 billion or 10.1% of GDP at the end of 2014. This is far below that of developed countries; 38.7% in the

---

* 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.

* Ph.D., Research Fellow, Fund & Pension Department, Tel: 82-2-3771-0681, E-mail: mkkwon@kcmi.re.kr

US, 25.8% in Japan, 24.3% in Germany, 28.1% in Australia, 52.7% in Canada, and 59.3% in the UK. Also notable is the significant portion of Korea's foreign equity investments coming from the government and pension funds. Their combined share in Korea's foreign equity investments stood at 67.5% as of end-2014 according to the Bank of Korea. But the share of the private sector was just 32.5%.

To boost private sector investments in foreign equities, the Korean government unveiled its plan in June 2015 to grant a tax relief on capital gains from "foreign portfolio investment funds" that invest over 60% of the assets in foreign equities. More specifically, those funds are exempt from the 15.4% dividend income tax on capital gains from equity trading and valuation as well as foreign exchange gains. Each investor can invest up to KRW 30 million in the fund to which can be subscribed for two years from the launch, allowing additional contributions to be made for 10 years. The government also expressed its intention to help households accumulate financial assets and to improve the foreign currency demand and supply conditions by inducing retail investors to invest in foreign equities.

Against the backdrop, this article explores the extent of demand Korean investors have for foreign equities, and then attempts to forecast the impact of the foreign portfolio investment funds on Korea's asset management market.

Korean investors' conditions for foreign equity investments

According to traditional financial theory, investors can significantly lower return volatility by diversifying their investment assets. Hence, they can expect their returns to become more stabilized as their portfolio includes more diverse foreign assets. Another effect is the enhanced expected return when investing in high-growth countries. Nevertheless, a substantial number of investors tend to hold no foreign equities at all, or invest only a small portion in foreign equities, a phenomenon referred to as a home country bias.

The reasons behind the home country bias vary, including lack of information on foreign equities, high trading costs, foreign exchange risk, and geopolitical risk to name a few. Another driver is the expectation for a home stock market rally,[1] and demand for hedging home country inflation.[2]

1) Strong, N., X. Xu, 2003, Understanding the equity home bias: evidence from survey data, The Review of Economics and Statistics 85, 307-312.

2) Adler, M., B. Dumas, 1983, International portfolio choice and corporation finance: a synthesis, Journal of Finance 38, 925-984.

But recently, those factors restraining portfolio investments have been eased substantially. First of all, access to information on foreign equities has improved greatly compared to the past due to financial industry internationalization and IFRS expansion. Also, as exchange-traded funds (ETFs) and other index-tracking funds have gained popularity, investments in indices instead of individual stocks have significantly risen. Accordingly, efforts and costs consumed to analyze and invest in each stock were lowered, which in turn eased overall restrictions in portfolio investments. From 2012 to 2014, the increase in foreign equity investments has risen globally to reach 49.6% in the US, 78.8% in Japan, 45.2% in Germany, 62.8% in Canada, 66.6% in the UK, and 42.2% in Netherlands.

Notably, expectations for Korea's stock market were high in the past because of Korea's solid economic growth relative to developed countries. But as Korea's economic growth slowed and the KOSPI was tucked in a limited range recently, the expectations for a rally substantially fell. Furthermore, hedging demand also declined considerably as Korea's inflation remained in the 1% range this year, both of which helped facilitate investments in foreign equities. This suggests substantial improvements in Korea's conditions for domestic investors' foreign equity investments. Korea's foreign equity investments rose persistently from 2012 to 2014, growing 99.3%. Most of the growth stemmed from pension funds' expansion in portfolio investments, but the private sector also showed continuous growth of 29.2%.

However, other factors such as exchange risk and geopolitical growth are still restraining foreign equity investments. Changes in interest rates and monetary policies in key developed countries as well as the possibility of sudden capital outflows from emerging markets could lead to abrupt fluctuations in some currencies, which might cause adverse impacts on investment performance. Also, the threats of terror and political risk in a country could make the stock market less attractive. Also notable in this vein is that most of the increases in foreign equity investments were concentrated in stable, developed countries such as the US or European nations.

Possible impacts on the asset management market

Korea's market for publicly offered funds has contracted since the global financial crisis. According to the data released by the Korea Financial Investment Association (KOFIA), AUM of mutual funds excluding money market funds dramatically fell from KRW 188 trillion in August

2008 to KRW 136 trillion in October 2015. Such a slump is actually more drastic than it looks given the expansion of the overall asset management market to KRW 825 trillion from KRW 491 trillion during the same period. A closer look reveals that a large part of the slump in mutual funds stems from international equity funds. While AMU of equity-type mutual funds fell from KRW 134 trillion to KRW 69 trillion during the same period, that of international equity funds decreased to KRW 16 trillion from KRW 59 trillion. In other words, the slump in international equity funds accounted for 84%, and 66% of the decrease in mutual funds and equity-type mutual funds, respectively.

Table. Post-crisis AUM of publicly offered funds

(Unit: KRW 1 trillion)

	Domestic Investments			Overseas Investments			Others	Total
	Equity	Hybrid	Debt	Equity	Hybrid	Bonds		
August 2008	75	14	5	59	7	1	27	188
October 2015	53	20	16	16	3	4	25	136
Changes	-23	7	11	-43	-4	3	-2	-52

Note: The figures exclude money market funds
Source: KOFIA

Under the circumstances, Korea's revival of tax reliefs on international equity funds can be a positive turnaround for the slump in mutual funds. Because demand for foreign equities has picked up as mentioned above, capital flows to international equity funds are expected to increase slowly, but continuously for the period of the tax relief. The fact that the mutual fund slump was primarily caused by net outflows from international equity funds gives rise to positive expectations that the tax relief would eventually break the slump and revitalize the mutual fund market. However, this takes substantial time and efforts of the industry because some investors are still traumatized by drastic losses they experienced during the global financial crisis.

Of other mutual funds, index-tracking ETFs are expected to enjoy larger benefits than others from the tax relief. The market for ETFs has grown persistently despite the slowdown in mutual funds because ETFs are easily bought and sold online without a visit to an offline branch, and because they charge low costs for trading. Notably, Korean investors recently appear to prefer ETFs over other vehicles for investing overseas. ETFs tracking overseas indices and listed on the Korean bourse have surged with their AUM skyrocketing from KRW 12.1 billion in 2011 to over KRW 1 trillion in September 2015. Some investors invest overseas via offshore-listed ETFs showing a steep increase from $0.10 billion in 2011 to $0.81 billion in August 2015.[3)] Such a steep rise seems to have been backed by tax advantages. Although offshore-listed ETFs' trading profits are subject to the 22% capital gains tax and the dividend income to the 15.4% dividend income tax, those ETFs, unlike Korea-listed ETFs, can enjoy capital gains and loss netting and separate taxation from financial income tax.

Against the backdrop, the Financial Services Commission in this October announced that it would extend the tax relief on foreign portfolio investment funds to Korea-listed ETFs. Consequently, Korea-listed ETFs are expected to be increasingly used as overseas investment tools. In addition to the recent growth trend, they will be able to absorb Korean investors' demand for offshore-listed ETFs. If Korea-listed ETFs are eligible for the proposed tax relief, this will offset the existing tax advantages enjoyed by offshore ETFs (netting and separate taxation), providing competitive edges to Korea-listed ETFs. Hence, the size of Korea-listed ETF market tracking foreign indices is expected to grow further, contributing to revitalizing Korea's mutual fund market.

Conclusion and future challenges

Taking into account that Korean investors enjoy improved conditions for investing in foreign equities, the revival of tax reliefs on foreign equity funds is highly likely to achieve the intended policy objective of expanding domestic investors' foreign equity holdings. This provides investors with benefits from portfolio diversification, and higher returns on investments in high-growth countries. Also expected are positive outcomes, e.g., improving demand and supply conditions for foreign currencies, breaking the mutual fund market slump, and expanding the Korean ETF market's function for overseas investments. But those outcomes are hard to be realized in the short run, which requires Korea's persistent policy stance to encourage overseas investments. Also necessary are industry efforts to renew their investment behavior: Rather than concentrating on limited areas for high returns, the industry should strive for maximizing the benefits of diversification.

Additionally, discussions should take place to grant tax reliefs on synthetic ETFs tracking foreign equity indices. Korea's synthetic ETFs are likely to be excluded from the current plan

3) The figures are from Korea Securities Depository data including ETN and ETC. Hong Kong-listed ETFs are excluded because they are mostly traded by liquidity providers of Korean securities firms for the purpose of hedging their Chinese investments.

because equities account for only a small portion of their assets. Of 26 Korean synthetic ETFs (excluding leverage/inverse ETFs), more than a half, 16 ETFs to be more precise, are synthetic using swaps. They track global equity indices such as the MSCI World, MSCI Developed Markets, MSCI Emerging Markets, S&P Biotechnology, etc. Not only that those indices are globally utilized as major tools for overseas investments, but ETFs tracking those indices are ranked high in offshore-listed ETFs invested by Korean investors. Korean asset managers choose the form of a synthetic ETF because it is not technically easy to duplicate the performance of those underlying indices due to insufficient fund size. But in substance, synthetic ETFs do track global equity indices and thus have a positive function of increasing opportunities for global portfolio diversification. Therefore, it is desirable to extend the proposed tax relief to synthetic ETFs tracking global equity indices. Last, regulators should pay thorough attention in advance to disparate ratios arising from time differences and different management styles across ETFs as the number of ETFs investing overseas is expected to rise further.