

Outward Equity Portfolio Investment by Korean Residents: Destinations and Its Implications

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Korea's outward portfolio investment in foreign equity securities has persistently risen as it has taken hold as an investment alternative in the low interest rate era. Distributing risks throughout a wide range of investment destinations is a key element to reap the benefits of portfolio diversification via overseas investments. In domestic residents' outward equity investment, the proportion of developed countries has gradually picked up perhaps because the central pillar of such investment is moving away from the private sector toward the public sector. In the private sector, a regional bias towards a certain region such as China has been continuously observed. Furthermore, the regional bias including the home bias among overall domestic residents is higher than that of developed countries. Going forward, domestic residents' outward investment in foreign equity will continue to increase. This requires the effort to break away from the old perception viewing outward equity investment as just a high-risk, high-return opportunity, and eventually to head in the direction seeking higher risk-adjusted returns. In particular, product diversification for global asset allocation is a must to help ordinary investors build an international portfolio and fully tap into the benefits of portfolio diversification.

Domestic residents' outward portfolio investment in foreign equity has been on the rapid rise. Under the reality of low interest rates, low growth, and population ageing, more and more domestic residents are changing the way they manage their investments and assets. Especially,

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public sector players, e.g., the National Pension Fund (NPF) with KRW 500 trillion AUM, are rapidly expanding outward equity investments. Such an upward trend is followed more recently by the private sector with Korea's tax exemption on international funds. As suggested by the capital asset pricing model (CAPM), a diversification of asset allocation across different regions could optimize the risk-adjusted returns on outward equity investments. Hence, this article explores the current state and trend of domestic residents' outward equity investment by destination, and then draws out the implications.

Outward equity investments by destination

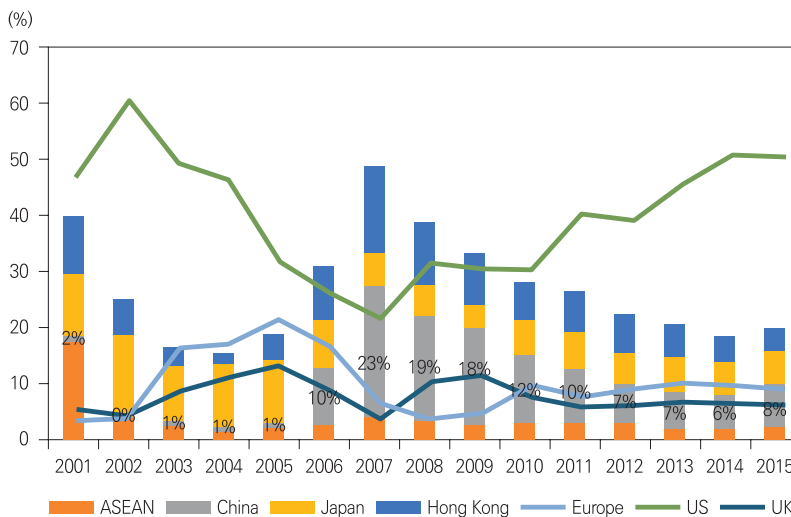
According to the Bank of Korea (BOK), the outstanding balance of Korean residents' outward portfolio investment in equity securities stood at about \$159.3 billion in the second quarter of 2016, marking a 3.8-fold increase from the first quarter of 2009 right after the global financial crisis. The public sector, especially the NPF, has been the main driver for such expansion. As of the second quarter of 2016, the public sector accounted for approximately 66% in the outstanding equity portfolio investment by domestic residents, a dramatic increase from below 24% at the end of 2007. However, the private sector portion of that investment excluding banks recorded \$46.2 billion, a 42% fall during the same period. Those data well evidence the public sector's lead in the striking expansion.

By investment destination, US equities accounted for 50.7% of the investment as of June 2015, with the eurozone for 9.0% and the UK for 6.2%. High income countries combined accounted for 83.6%.¹⁾ The remaining 16.4% was invested in emerging markets, especially in China (7.8%). The share of high income areas in the investment has rapidly risen after the global financial crisis, which had largely resulted from the public sector such as the NPF. In the NPF's outward equity investment managed externally, the share of emerging markets stands at less than 6%. By contrast, China and other emerging markets are estimated to take up a high proportion in retail investors' outward equity investments.

1) The figures are from CPIS data by the IMF. Investments in major offshore financial regions are estimates calculated based on the share of each region in a country's outward portfolio investments. Those data are also used for a global analysis hereinafter.



Figure. Korean residents’ portfolio investment in equity



Source: Author’s calculation based on the IMF’s CPIS data

Korea’s data widely deviate from global investors’ asset allocation in terms of the following aspects. First, an analysis on the share of each destination in a country’s total outward equity portfolio investment reveals that most developed countries invest heavily in Europe, whereas the US is Korea’s top investment destination. It is found that global investors allocate about 46% of their outstanding equity portfolio investment in the European region. Especially, the bias toward Europe is higher among US and European investors. However, Korean and Japanese investors tend to invest more heavily in the US, while their investment in Europe remains relatively low.

Second, Korean residents’ outward equity portfolio investment is highly biased toward China. Especially in 2007 at the height of the international investment fund boom, about 23% of the outstanding equity portfolio investment went to Chinese equities, making China the most attractive investment destination. Such a phenomenon stemmed from Korean retail investors’ herding towards China. Although this has been somewhat eased since the public sector began expanding their equity portfolio investment in 2011, China’s share is still high compared to developed countries.

Lastly, Korean investors’ bias toward outward investments (the difference between a theoretical investment amount and the actual one) is found higher compared to developed countries. That is to say that Korean residents’ actual asset allocation is far from what the optimal portfolio theory suggests (46% for the US, 29% for Asia-Pacific, 14.8% for Europe, and 10.4% for others, as of 2014). Although a home bias is universally observed in most countries,

each country has a unique regional bias pattern. Investors in developed countries such as the US and the UK tend to invest in Europe as close as the optimal weight, while European investors' onshore investment well exceeds the optimal weight. In the case of Japan, its investment in the US takes up 18.3%, which is relatively high considering the country's market capitalization. However, its investment in Europe is relatively low. Korea's investment in almost every destination is lower than the respective optimal weight, suggesting a high home bias as well as regional bias among residents in Korea.

Implications

According to the analysis on Korean residents' equity portfolio investments by destination, they tend to be biased toward the US as well as the Asian region. Although recently on the decline, their investment in China is at a fairly high level. Since the global financial crisis, Korean residents have expanded their weight in developed markets partly because the central pillar of Korea's portfolio investment shifted toward the public sector. However, the private sector still has a herding problem, e.g., a bias toward China.

The biggest merit of foreign portfolio investment is maximizing risk-adjusted returns by allocating assets throughout different regions. In other words, a globally diversified portfolio enables investors to evenly distribute potential geopolitical risk and concentration risk for achieving higher risk-adjusted returns. Ideally, such diversification is only effective in risk sharing should investments be allocated in dissimilar regions, rather than in economically interconnected regions. In this respect, a question mark falls on whether Korean residents' behavior in foreign equity portfolio investments is fully taking advantage of the benefits of international diversification or not. Especially, the excessive herding among retail investors toward a certain region such as China calls for a revisit to the pervasive misconception that views overseas investments as a mere high-return instrument.

To induce diversification in foreign portfolio investments requires the development of diverse investment products. As the recent trend demonstrates, the public sector such as the NPF invests heavily in developed markets similarly to global investors' asset allocation, whereas regional herding is observed in private sector investors. Such a phenomenon seemingly stems from ordinary investors' limited access to the optimal portfolio. Already, investment banks in developed markets have offered global index funds and other diverse tools for allocating assets



to developed equity markets. Global asset allocation funds have recently gained popularity in Korea as well, hopefully heralding a change in public perception on overseas investments. Going forward, it is expected that product diversity could help equity portfolio investments take hold as a stable alternative in the low-interest-rate and low-growth era. However, unexpected risks will increase in the course of diversifying investment destinations, which necessitates further action to analyze target markets and develop more sophisticated investment strategies.