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Korean Market Offers Opportunity After Tough 2018

This article has been excerpted from a letter by MOI Global instructors Chan Lee and Albert Yong, managing partners of Petra Capital Management, based in Seoul.

The year 2018 was the worst year in our recent memory with almost all equity markets in almost all regions substantially down. In addition, the market was extremely volatile to say the least. After all, a single tweet by President Trump or a slight change in the tone of Fed Chairman's remarks caused the market to swing significantly in one direction or the other in a single trading day.

The Korean equity market was no exception and declined more than 17% (in Korean won terms) after suffering a tumultuous plunge in October. Many negative issues, including the Fed's rate hike, trade war, slowdown in China, etc. contributed to the market decline. The U.S.-China trade war was probably the main contributor affecting Korean stocks because the worst outcome of this trade war will certainly hit the Korean economy hard given the country's high dependency on trade, especially with China and the U.S. While virtually every emerging market registered steep losses, unfortunately, the Korean stock market was one of the worst performing markets in the world in 2018.

Historically, countries which successfully developed economy did so by protecting their market in some ways during the development stage and copied then advanced technology in a way which was probably unfair to existing developed countries. That is why the current actions by both the U.S. and China are totally understandable.

We think China, knowing this too well, is likely to give some concessions if it can save some face and protect its long-term national interest. Also, the U.S. is not likely to go too far because it also knows that its attempt to block China's rise completely is almost impossible and will hurt the U.S. economy severely (even if it will ultimately hurt China more).

The U.S. stock market's precipitous decline in December together with Apple's earning shock citing lackluster China sales is a timely reminder of the significant interconnection and interdependence between the world's two largest economies. That is why we believe that both countries will act more rationally with the motivation to reach some sort of compromise sooner or later. No rational fighter will try to knock out the opponent if he knows it will cripple himself at the same time.

A steep rate increase orchestrated by the Federal Reserve also contributed to the market decline in 2018. However, with signs of economic slowdown in the U.S. and still relatively low inflation, the Fed is likely to pause and exercise great patience in rate hike moves (after raising the Fed funds rate nine times since late 2015). This could also lead to a less strong U.S. dollar going forward and may take some pressure off emerging markets currencies and interest rates which would be positive news for Korean companies as well. But even if the Fed goes ahead and raises the rate steeply as originally planned, we think the long-term negative effect is already priced into the Korean equity market as evidenced by an ultra-low valuation.

Whenever a negative issue arises, the stock market initially moves assuming the worst case scenario. Thereafter, the market eventually adjusts to an appropriate level after digesting and analyzing all the relevant facts. At the current price levels in Korea, we think that most of the negative issues are already priced into the stock market. That is why we believe the recent market pull back is clearly overdone. If the market's initial assumptions are incorrect and thus, the worst case scenario does not materialize, stocks are due for a bounce.

On the other hand, even if the market's initial assumptions are correct, we still have little downside risk because the worst case scenario is fully priced into the market. Alas, the sad reality is that most investors become fearful when the market plunges as all humans are born to respond quickly to avoid danger in front of fear. That is why most investors tend to panic and sell even more after the market downfall without regard to rationality. In today's environment, money flows seem to trump all other factors in determining stock prices. Therefore, unfortunately, money flows can effectively render fundamental analysis futile in the short-term.

While most of the negative issues we mentioned above affect the market temporarily, the lack of more transparent corporate governance is perennial and by far the biggest reason for the "Korea discount" which has been prevalent in the market for a long time. The improvement has been much slower than most investors hoped. But we have always believed that companies can change only under social pressure. Through many years of the government's efforts together with several high-profile cases of awful corporate governance at some Korean *chaebols*, we feel the general public sentiment is finally changing significantly in favor of broader governance reform.

For example, even a few years ago, shareholder-friendly policy itself was thought to be detrimental to growth and viewed negatively by local investors. In the past, large Korean institutional investors typically either abstained or voted for whatever agenda forwarded by management at the shareholder meetings. But with the recent adoption of a Korean stewardship code by Korean institutional investors such as the National Pension Service, they are now bounded by stricter fiduciary duties and obliged to vote against management's agenda which is not beneficial to minority shareholders. That is why we feel more sanguine that many Korean companies will finally begin returning more cash to shareholders. Although the pace of change may be much slower than we desire, the most important factor may be the change of direction itself. Also, we noticed that several local activist funds have sprung up recently. We expect the Korean market to re-rate the valuation upwards if this trend continues.

The Korean stock market has been one of the cheapest markets in the world in terms of valuation. After a large decline in 2018, the Korean market valuation looks even more compelling for long- term value investors. In sum, as we explained above, all the negative issues that we had last year are unlikely to turn out to be as assumed even in the worst case scenario. Also, it is extremely hard to find anyone who draws a rosy picture in Korea nowadays. In fact, fear definitely prevails in the current market. However, as Sir John Templeton once famously said, "bull markets are born on pessimism", we have a contrarian view of a higher price for Korean equities in 2019. As an intelligent investor, we will use Mr. Market's mood to our benefit.

We bought many undervalued stocks during the past few years when a great many value investors have suffered. In a market dominated by money flows, the stocks of mundane companies were abandoned for those that offered more growth. In other words, "hot" sectors kept rising because investors were buying rising stocks instead of undervalued stocks. Therefore, many value stocks kept going down because investors shunned these stocks.

As a result, many value managers experienced poor performance, resulting in investor outflows. This led to more selling – cheap stocks became cheaper while expensive stocks continued to rise. However, after the market plunge last year, we believe that the market environment has finally turned in favor of value investors like us as indiscriminate selling provides a great opportunity to buy competitive companies with strong cash flow at attractive price levels.