MOUNT MURRAY INVESTMENT

Weekly Blog
November 14th, 2023

Source: Allure, Jiyeun Kang

In finance and economics, we like to describe things that are outside our models as exogenous, frequently paired with the word shock, an "exogenous shock".

Government action can often be the source of such shocks. Most of us can think of a policy our own governments have put in place when we have asked ourselves "What on earth were they thinking?" We cynically refer to these as random acts of government since it is hard, if not impossible, to work out what real problem they were trying to solve.

Last week we got such a random act of government when the South Koreans banned short selling over the weekend of November 4th/5th. Memories of failed short bans, such as the one on US banks in 2008, quickly came to mind[1]. The South Korean government described it as a "temporary measure" (it is supposed to run out in June next year) aimed at "fundamentally easing the tilted playing field between institutional and retail investors." Say what?

One has to ask how a "temporary measure" thrown together over a weekend will solve a fundamental problem of any sort, but when we remember that there will be a general election in South Korea in April next year, we get a better idea of the government's true intent. Retail investors now make up 30% of the voting population, according to CLSA Korea, so a little bit of pandering may go a long way to securing their position in April. It is simply domestic politics.

---

[1] Evidence demonstrates that (non-naked) short selling improves overall market quality by contributing to price efficiency, liquidity, and corporate governance.

This is where the law of unintended consequences kicks in. South Korea is classified as an Emerging Market and is the 4th largest component of our emerging markets index at around 12.5%, despite being a global manufacturing powerhouse with several highly regarded brands such as Samsung, Hyundai, and LG. K-Pop and Squid Game, for example, are global phenomena.

Corporate governance has been poor in South Korea and we have had to work around it. For many years, the Chaebol were run more for the benefit of insiders than minority shareholders and certainly not foreign minority shareholders. Abuses were common and the responses to them were little more than "What did you expect to happen?" Caveat emptor. Korean companies suffer a valuation discount to their global peers as a direct result of this corporate governance and it is one of the main reasons, together with very onerous restrictions on foreign investment, that South Korea is still classified as an Emerging Market.

The current government has passed a series of measures to address this by making the management of major corporate groups accountable, such as the introduction of mandatory tender offers whenever a company acquires more than 25% of the shares of another company at the same price as the acquisition was made at. Standard protection of minorities in many countries. To make it easier for foreigners to invest, they have reduced some of the restrictions, such as needing only passport details or home country corporate registration numbers, and introduced omnibus accounts.

We have been very excited by these measures because there is good value in Korea. There are strong companies we want to buy directly for all of our clients. Like many investors, we were starting to build a road map for South Korea transitioning to Developed Market status and the subsequent market revaluation that would come with it. The government claims these changes are not directed at that transition, but they do remove most of the reasons South Korea is still an Emerging Market. Getting Developed Market status would be a real accolade for any government, validated by the inevitable market rally.

The short-selling ban led to a short squeeze, as you would expect. The Korean ETF EWY jumped $3/5% from $59.67 to $62.68. LG Energy Solution, one of the most shorted names on the market, jumped from KRW 402,000 to 493,500, or 22.8%! Yet, by Thursday, they had given back most of their gains, with the ETF back below $59.90 and LGES below KRW 430,000.

If any retail investor were able to gain from the initial price jumps, they are probably sitting on substantial losses now, angry at the government that had fooled them. If they just stayed on the side-lines, they are probably scratching their heads in bewilderment. If they had yet to invest in the stock market, they are probably reminding anyone who will listen that they were right all along and that the whole game is rigged! The institutions who would vote on South Korea being given Developed Market status hate that kind of unnecessary volatility. Assuming the ban is lifted next year, they are unlikely to accept government assurances that it won't come back in a hurry. They will probably increase the South Korean discount in the short-term and may well decide to leave any decision on Developed Market status until after the 2027 presidential elections, thereby delaying the whole process. The government seems to have snatched defeat from the jaws of victory on this.

For us, little has changed. Yes, the short selling ban was an exogenous shock, and we had a few choice words to say when we read about it, as we will certainly vote against any short term proposal to give Korea Developed Market status. On the other hand, we could easily get some capitulation selling as the rally peters out. We have not reinvested our profits from the sale of Posco last quarter, for instance, so we may get even better prices when we do.

Best regards,

Mount Murray Investment