



KIIF yields rich pickings from the Korean market

Against a backdrop of bullish predictions for the KOSPI index, Seggerman's stock-picking strategy for the Korean International Investment Fund looks set to maintain rich rewards

Back in 1992, Harry G.A. Seggerman predicted that Korea had a good chance of becoming the 'new Japan' among Asia's up and coming stockmarkets. He launched the Korea International Investment Fund (KIIF) to take advantage of the market's inefficiencies, according to his son Henry, who worked closely with him from 1996 to 2001 before taking over the running of KIIF on behalf of the Seggerman family.



Henry M Seggerman, KIIF

Investors have not been disappointed. KIIF, now with \$105 million in assets, has delivered an annualised return of 40% over the last three years. Like all single country funds invested in the region, KIIF has given investors a fairly bumpy ride, with returns reflecting the ups and downs of the Korean market. However, this is not to say that investors are benefiting only from Korean market beta. KIIF has risen 552% since 1992 versus a gain of 62% in US dollar terms for Korea's KOSPI Index.

Korean equities now appear to be on the path to strong and steadier gains, and Seggerman is bullish. Volatility has fallen, on the back of support from foreign investors, and a domestic investment industry is now enjoying a dramatic resumption of growth. The fund is

also better equipped to protect itself from downside shocks, thanks to increased hedging opportunities.

In October's turbulent markets, the fund was down 2% (compared with a fall of 5% for Korea's KOSPI Index), but it bounced back with a 13% gain in November and a further 10% in December (when the KOSPI rose 13% and 9%, respectively).

When KIIF was launched 13 years ago, Korea's KOSPI Index was trading below 700. It has now moved above 1,300, which is a record high. But market watchers predict that the KOSPI has much further to go. Despite the market's 112% surge since mid-2004, current P/Es are 12x. This contrasts sharply with the precarious nature of previous highs in 1995 and 2000, when P/Es were pushed up to an unsustainable 17x or 18x before the market lost half its value or more.

This compelling story, combined with KIIF's long track record and excess capacity, is attracting strong interest from investors. Asia funds with this type of profile are relatively rare, and KIIF's assets have doubled in the past few months, with an outpouring of new interest.

An added attraction for investors is the transparency of KIIF's strategy. Performance is built on old-fashioned stock picking within the Korean equity universe. The fund uses no leverage, while its New York-based investment advisory company, International Investment Advisers (IIA), has been SEC-registered for 11 years. Seggerman is president of IIA, while the portfolio is run by managing director Yong Kim, who joined IIA in 2000, having set up Korean equity operations in New York for WI Carr and Samsung Securities. IIA also has two analysts based in Seoul.

For the first five years of its life, KIIF was a long-only fund, with cash (and sound stock picking) as its only means of downside protection. The fund began shorting the Korean won during the Asian

currency crisis of 1997. It began shorting the index in 2000, and individual stocks in 2001.

But the fund is still typically invested in equities and cash (currently 99% equities and just 1% cash), and cash remains its first line of defence. This makes sense, Seggerman says, given the investment team's belief that Korean equities are due for an upward re-rating. "We believe the Korean market should be trading at a P/E similar to that of Singapore or the Philippines," he says. "We only use short positions as a selective defensive strategy in times of volatility."

Last year Credit Lyonnais cited a Samsung listing on the New York Stock Exchange as a crucial trigger for its prediction that the KOSPI index would rise to 2,000 (up 52% from its current level). Goldman Sachs is even more bullish, forecasting that the KOSPI will rise 80% in three or four years, while local broker Woori Securities (formerly LG Securities) predicts that it will surge more than 100% to reach 2,880 by 2010

Yong Kim and his team dig deep into Korea's 1,400 stock universe to find companies with outstanding growth prospects. This includes examining financial statements to unearth hidden risks or accounting discrepancies. Company financials are modelled and redefined in terms of US GAAP accounting principles, adjusting for various items before being analysed. Nearly all the companies in the portfolio have been visited.

Important triggers at the idea generation stage are companies with competitive business models. Seggerman says: "We like companies whose products and services have 'first mover' advantage, or where there is a high entry barrier to the sector, leading to higher margins."

Performance profile

Turnaround stories also yield rich pickings. "Korea has had 30 years of rapid growth, with a lot of carnage along the roadside," Seggerman notes. Many of these formerly derelict and indebted companies have been rejuvenated, with the fat cut out of their operations. The result is that they are "not only springing back to life but have a huge advantage over the competition," he says.

Daewoo Shipbuilding and Marine Engineering was one such stock that IIA bought after it had emerged from bankruptcy in 2000 with a cleaner balance sheet than other shipbuilders. This gave it a competitive edge, and the stock soared over the next two years, when IIA sold it.

The portfolio can be relatively concentrated, with up to 25% in one company, though it is typically invested in at least 25 stocks which are usually held for 12 months or so. Core stocks are large and liquid, and IIA aims to be able to liquidate most of the holdings in two trading sessions, and the entire portfolio within four trading sessions.

Despite this, the portfolio is anything but an MSCI clone. "We are not a crypto index trading fund, we have no particular affinity for foreign favourites," Seggerman says.

While these can be part of the portfolio, Kim and his team prefer undiscovered companies with little foreign investment.

Some 15% of the portfolio consists of companies that are not covered by English language research, and 5% are not covered by any research at all. "Maybe one analyst - the guy who drove us there - is aware of the company and what they do," Seggerman notes.

One undiscovered gem that the team bought in June 2005 was Emerson Pacific, a company that builds golf courses and has no analyst coverage. The stock proceeded to rise 106% in three months, outperforming the KOSPI by 97%.

Seggerman points out that IIA is not afraid to own no Samsung Electronics, which accounts for 20% of the KOSPI. At present, the fund also holds the preferred shares, which were bought four years ago when they were trading

at a very wide discount to the price of the common shares. They have since risen 342%, outperforming the KOSPI by 237%, thanks to appreciation of the common shares and narrowing of the spread between the two. The preferred shares are not included in FTSE Korea or the KRX Index, although they are the most liquid preferred stock in Korea.

According to Seggerman, IIA's best investment decision of the past two years has been in pharmaceuticals. The team bought into Hanmi Pharmaceutical Company towards the end of 2003, when the sector was out of favour. Since then, the stock has outperformed the market by 324%. Hanmi has been rated by only one international broker this year. "Most of our pharmaceutical picks have these eye-popping outperformance rates," he says.

There are 15 Korean pharmaceutical stocks, and IIA maintains its exposure to the sector (currently 7%) by bringing new ideas into the portfolio and retiring stocks that are close to target.

Returns of this magnitude have brought foreign money flooding into the Korean market - it is now 39% owned by foreign investors (foreign ownership was limited to 10% per company until 1998). However, Seggerman has no worries about this level of foreign involvement, as the market's low P/Es offer investors an attractive risk/reward payoff. "I think foreigners are in for the long haul," he says.

The previous pull-outs by foreigners followed market euphoria that saw some Korean companies trading on triple digit P/Es at the height of the tech bubble. At the same time, a local market scandal sent domestic retail investors fleeing.

Despite a 41% run up in the KOSDAQ (Korea's NASDAQ equivalent) since September, "I haven't heard the slightest whisper of analysts talking about price to sales ratios," Seggerman says.

Korea's FSS, the financial market regulator, is now intent on developing the country's asset management business, with the recent growth of equity funds and higher equity allocations for retirement pension funds.

Seggerman notes that Samsung Electronics has stated its intention

(with assumed government approval) to be listed on the New York Stock Exchange, and that Credit Lyonnais last year cited a Samsung listing as a crucial trigger for its prediction that the KOSPI index would rise to 2,000 (up 52% from its current level).

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Against this background, the KIIF is starting to see more interest from funds of funds, as well as from its traditional base of high-net-worth individuals, which includes Sir John Templeton. Recent additions to the client list include City of London Investment Trust, which has been a big investor in the 20-year old \$1.3 billion long-only Korea Fund run by Deutsche Asset Management.

Even so, IIA has no plans to expand the business, and does not intend to grow the KIIF beyond \$250 million. "Above that, you start to have issues about moving the market too much," Seggerman says.

KOREA INTERNATIONAL INVESTMENT FUND: AT A GLANCE

Inception Date: Nov 1992
Manager: Yong Kim
Offices: New York, USA
Strategy: Asia Excluding Japan - Korea
Assets in strategy: \$105 million
Minimum investment: \$100,000
Prime Broker: None
Administrator: Bank of Butterfield
Currency: USD
Open to investment: Yes

PERFORMANCE: KOREA INTERNATIONAL INVESTMENT FUND

