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Classifying South Korea as a Developed Market

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The success of FTSE's market indices is founded on a combination of expert research and analysis, clear methodology, and its unique ability to reflect the perceptions and real-world experience of its clients and investors worldwide. FTSE's attention to the views of market practitioners was an important factor in the 2009 decision by its external governing committees to reclassify South Korea as a Developed Market. It remains a key reason for maintaining this classification today. FTSE believes that to include South Korea in an Emerging Market index creates distortions that fail to reflect the intentions of investors.

Investors have long divided the world into several categories of markets to help simplify their investment decisions. One of the fundamental divisions has traditionally been between Developed Markets (DM) and Emerging Markets (EM). For a long time, the classification of countries was generally based on a few over-arching metrics, such as Gross Domestic Product or Gross National Income per capita, and the individual judgment of the investor.

With the advent of indexing, however, the classification process has become more systematized and 'rationalized'. In order to introduce a greater degree of objectivity into the classification process, index providers have created more precise and uniform definitions by which to categorize economies. These new definitions generally include a wider range of technical considerations such as market access, market quality, liquidity and so forth, into their country classification methodologies. While this has certainly brought more sophistication to classification decisions, it has not created universal agreement.

Different indexers have developed different methodologies by which to classify certain countries. Currently, the classification of South Korea is the focus of considerable debate. In 2009, FTSE reclassified South Korea as a Developed Market. Some competitors agree with this classification, but others – notably MSCI – continue to classify it as an Emerging Market. The difference in classification can make a significant difference to the behavior of the relevant indices. For instance, after China, South Korea is the second-largest component of the MSCI Emerging Market index, with a weighting of 15%, giving the index a significantly different character from FTSE's Emerging Markets index where South Korea is not present.

To better understand these differences, it is worth looking in some detail at FTSE's methodology for classifying countries. The core of the FTSE process is a governance structure consisting of specialized external committees of market professionals and practitioners. FTSE's independent committees benefit from the experience and expertise of a wide range of market professionals, including members from the largest asset owners and institutional investors from around the world, issuers and users of traded products as well as representatives from pension funds, trustees and consultants. This structure seeks to ensure that FTSE's indices reflect the actual experience of the practitioners who know the markets best.

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It's also notable that FTSE was the first major index provider to move to a formal process for classifying countries. In 2004, FTSE's external oversight committee refined its process to bring more objectivity and precision to the classification process, introducing a set of principles by which to evaluate how developed a particular market had become. These included:

- Quality of market (regulation, custody and settlement procedures, etc)
- Materiality (was the market of a material size to warrant inclusion)
- Liquidity
- Consistency and predictability (a predictable pathway for classification changes, including a "Watch List" of countries whose status might change)
- Stability (a country's change in status would only reflect permanent changes in market status and global acceptance)
- Market access (no discrimination against non-domestic investors)

FTSE established a new Country Classification Committee to assess the information and adopted a transparent Quality of Markets matrix to objectively judge and compare markets and to provide consistency and add predictability to the classification change process. In addition, FTSE adopted a "Watch List" for countries potentially approaching re-classification as well as a policy of engagement with the markets in such countries, to help them understand the steps they would have to take to make themselves eligible for promotion. On these bases, the Country Classification Committee makes recommendations to FTSE's Policy Group regarding country classification changes, and the FTSE Policy Group makes the final decision on classifications.

In 2009, employing this governance structure, FTSE's Policy Group, comprised of index experts and users drawn from senior levels of practitioner firms, promoted South Korea from Emerging to Developed status. The decision reflected the size and sophistication of the South Korean market at the time, and what the Policy Group believed to be the general market perception that it was now a Developed Market.

South Korea:

- is the **15th** largest economy measured by GDP, industrial output and services
- is the **12th** largest economy in terms of purchasing power parity
- is the **7th** largest exporter and **10th** largest importer in the world
- is the world's **13th** largest stock market and the **3rd** largest in the Pacific Rim (after Japan and Australia)
- is home to some of the world's biggest and most successful corporations, such as Samsung and Hyundai Motors, and it is the world's **4th** largest car producer and worlds largest shipbuilder
- has a thriving high-tech industry and a high-tech population, being the first country to achieve more than **50%** internet broadband adoption among the population and is the most wired country on the planet in terms of internet use and speed
- is a member of the OECD, and the World Bank classifies South Korea as a high-income developed country with a developed market

The strength and size of its economy rank it among the G-20 major economies.

Source: The World Bank, The Economist

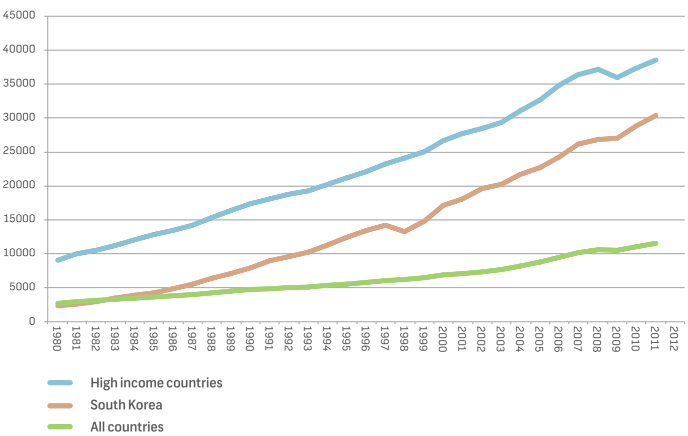
"The manifest economic strength of South Korea is a key consideration to asset owners and investors in forming their perceptions."

The FTSE Policy Group recognized at the time that the South Korea market had some trading and implementation limitations. For example, in the FTSE Quality of Markets evaluation process, while South Korea achieved a 'Pass' rating on 18 of the 21 criteria , on three criteria it remained "Restricted": the convertibility of the currency (i.e., the won) outside domestic banking hours; difficulties with free-delivery transfers of stock, particularly in pooled funds; and a facility for foreigners to trade among themselves in securities that have reached a foreign-ownership limit. Nevertheless, in line with the expectations of international market professionals, the FTSE Policy Group took the view that these outstanding issues would be addressed as the South Korean market evolved and foreign participation increased.

In the event, the financial crisis intervened to make many governments around the world more cautious about opening their markets to foreign investors. Although this has delayed the expected final improvements in South Korea's markets, the FTSE Policy Group continues to believe South Korea is a Developed Market. This is because, while the use of detailed technical market criteria to assess the development of markets has helped to give additional objectivity to the creation of indices, such criteria are not the only considerations at FTSE. Unlike some other indexers, FTSE does not regard country classification as merely an exercise in box-ticking. Broader considerations of a country's overall standing in the global economy, and the perceptions of investors, are also essential to the final decision.

South Korean Gross National Income Per Capita

South Korean GNI growth closely tracks other High Income/ Developed Markets.



Source: World Bank

The manifest economic strength of South Korea is a key consideration to asset owners and investors in forming their opinion of how the country should be classified, and FTSE believes that the majority of such users no longer classify the country alongside the likes of China, India and Brazil. This perception, together with the objective economic and market factors, informs the decision of FTSE's market practitioner-based governance structure to classify South Korea as a Developed Market. When investors think of investing in Emerging Markets, FTSE believes it is developing countries they mean to target. An Emerging Market index that includes an economy as advanced as South Korea would simply create, in FTSE's view, unwanted distortions that fail to serve investors' purposes.

It is no surprise, therefore, that the classification of South Korea as a Developed Market is so widely accepted in the investment universe. Other leading financial indexing and financial data companies also take this view – for example, S&P classifies South Korea as a Developed Market. Jim O'Neill, the Goldman Sachs analyst who coined the term "BRICs", was recently quoted as saying that regarding South Korea "as an emerging market is absolutely ridiculous."

Among investors, market leaders such as Fidelity and Charles Schwab Investment Management use FTSE's Emerging Market Index as the benchmark for their emerging market index funds and ETFs, as will Vanguard when it completes its transition to FTSE's benchmarks later this year. The world's largest emerging bond ETF, the JP Morgan US Dollar Emerging Markets Bond Fund, issued by iShares, does not include South Korea debt. Most broad-based emerging market equity ETFs in the US (currently 12 out of 19 funds) do not have exposure to South Korea.

The classification of countries is, of course, a dynamic and constantly evolving process dependent on economic facts, market practice and the experience of investors. In 2008, for example, FTSE promoted Israel to Developed status in line with its objective measures and general client perception that the country was ready for an upgrade. Other major index providers followed suit soon after, in 2010. As the economies and markets of other countries evolve and meet the criteria for promotion, they too will be reclassified as Developed.

However, our established indexing methodology and governance process lead us to two firm conclusions: that although South Korea has yet to fully satisfy a small minority of detailed criteria, in all essential respects it meets the definitions and standards of a developed market; and that most investors and asset owners already view the country that way. This, in our view, is ample justification to classify South Korea as Developed.

Country Classification

Developed	Advanced Emerging	Secondary Emerging	Frontier
Australia	Brazil	Chile	Argentina
Austria	Czech Republic	China	Bahrain
Belgium/ Luxembourg	Hungary	Colombia	Bangladesh
Canada	Malaysia	Egypt	Botswana
Denmark	Mexico	India	Bulgaria
Finland	Poland	Indonesia	Côte d'Ivoire
France	South Africa	Morocco	Croatia
Germany	Thailand	Pakistan	Cyprus
Greece	Taiwan	Peru	Estonia
Hong Kong	Turkey	Philippines	Ghana
Ireland		Russia	Jordan
Israel		UAE	Kenya
Italy			Lithuania
Japan			Macedonia
Netherlands			Malta
New Zealand			Mauritius
Norway			Nigeria
Portugal			Oman
Singapore			Qatar
South Korea			Romania
Spain			Serbia
Sweden			Slovakia
Switzerland			Slovenia
UK			Sri Lanka
USA			Tunisia
			Vietnam

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