

Over the past 20 years, the economic bridge from the U.S. to Asia has broadened, able to bear the weight of millions of imports and exports, including cars, CD players, textiles and toys. As trade relations between the U.S. and Asia have strengthened, so inevitably have *trading* relations. More and more non-physical exports, such as liquid futures and options contracts, have (and will continue to) become available to Americans as regulatory barriers evaporate.

With any luck, U.S. traders soon may be able to trade index contracts that see more trading activity than even S&P index futures contracts, one of the granddaddies of trading success. But these smaller and lower-out-of-pocket contracts may come from a place Americans might least expect – South Korea – which suffered through Asia’s economic crisis between 1997 and 1999.

This country, just slightly larger than Indiana, has rebounded successfully from the crisis, paying back all of its \$13.5 billion rescue loan to the International Monetary Fund and establishing itself as the number six auto maker in the world, with more than three million cars produced in 2002. Now, the country once famous for exporting Tae Kwon Do, South Korea soon may be able to “export” its most popular contracts, the Kospi 200 futures contract and the Kospi 200 options contract. [Kospi is short for the Korean Stock Price Index.] They have put on quite a “show” in Korea, and investors and traders on other shores are starting to take notice.

The Kospi Show:

South Koreans Uncage *the* Tiger

With a Roaring Equity Index

By George Shinn



Kospi Earns High “Ratings”

Since the introduction of the Kospi 200 futures contract in May 1996 and the Kospi 200 options contract in July 1997, this dynamic derivative duo has catapulted its way to the top of the most actively traded global stock index futures list. The “200” contracts are smaller subsets of the Korean Stock Price Index, the main composite index.

The stocks that comprise the Kospi 200 index, created just two years prior to the launch of the futures contract, are determined once a year by what is known as the Kospi Maintenance Committee. This committee selects 200 companies from eight industry groups based on the company’s market capitalization and trading volume. Some of the current constituents of the index are Samsung, Hyundai, KIA and LG, names that are as familiar to Americans as to Asians.

TABLE 1 Notional Value (Kospi Futures and Options)*

Year	Trading Value (in trillions)
First half of 2003	\$10.0
2002	\$15.0
2001	\$7.1
2000	\$2.1
1999	\$1.2
1997	\$0.88

* Value estimates based on average monthly price

TABLE 2 Trading Volume (Kospi Futures and Options)

	Futures and Options Combined	Percentage Growth Over Previous Year
First half of 2003	1.4 billion	—
2002	1.9 billion	124.23
2001	855 million	300.38
2000	214 million	119.79
1999	97 million	93.48
1998	50.2 million	—

Although Kospi contracts are not available to U.S. traders yet, they are contracts that bear watching. The total notional value of the Kospi futures and options contracts through the first half of 2003 was roughly \$10 trillion vs. \$3.3 trillion for the large-sized S&P futures and options contracts. During that same time period, 1.37 billion Kospi options contracts and 33.4 million Kospi futures contracts were traded (And this is in a country with a population of 48.3 million, less than one-fifth the population of the U.S.). Since 1998, the first full year together for the Kospi futures and options contracts, the combined

A Thumbnail Sketch — Korea’s Exchanges

Korea Stock Exchange

The KSE, where the Kospi 200 futures and options contracts currently are listed, was established in 1956 with contributions from banks, insurance companies and securities firms. In 1984, the KSE started developing a plan for a stock index futures contract but it would take 12 years to the launch of the Kospi 200 contract. Most of the delay was due to time spent convincing the government and regulatory agencies of the need for such a financial instrument. Keep in mind that in 1984, the Korea Futures Exchange was still 15 years away from opening. Beginning January of next year, the Kospi 200 contracts will be officially transferred to the Korea Futures Exchange. This will open the contract up to FCMs as well as to securities firms, but the impact will probably be minimal due to the fact that most of the FCMs already have sister securities firms owned by the same parent company. Also, with the government’s decision earlier this year to consolidate the three exchanges in Korea – the KSE, Kosdaq and Kofex – FCMs and securities firms that are owned by the same parent company are also likely to merge into one financial firm. As at least semi-apparent by its name, the Kosdaq is the tech-laden secondary market in Korea, operated by the Korea Securities Dealers.

Korea Futures Exchange

The Korea Futures Exchange (KOFEX) was incorporated as a not-for-profit membership organization on February 1, 1999, under the Futures Trading Act. It is a fully electronic exchange that currently offers nine products, including: U.S. Dollar futures and options, CD interest rate futures, gold futures, Korea Treasury bond futures and options, Kosdaq 50 futures and options, and Monetary Stabilization Bond interest rate futures. There also are plans to launch new products such as crude oil futures by the year-end. These existing and new contracts, in addition to the transfer of the Kospi contracts, should boost the KOFEX’s current world ranking as the 18th largest exchange in terms of futures volume.

Links to the Exchanges:

Korea Stock Exchange — www.kse.or.kr (click the upper right-hand corner to convert to English)

Korea Futures Exchange – www.kofex.com (also can convert to English with a simple click)

Links to Korean Financial Media (in English):

www.korea.net

www.koreaherald.co.kr

volume for the contracts has experienced an average growth of 137 percent each year.

Korea also joined the ETF scene last October with the launch of four exchange traded funds (ETFs) by four different investment trust management companies. There are two based on the Kospi 200, listed by Samsung ITMC and LG ITMC, and two based on the Kospi 50, listed by Korea ITMC and CJ ITMC. The value of the Korean ETF market is currently

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\$400 million. In comparison, at the end of 2002, the Japanese market was valued at \$21 billion and the Hong Kong market at \$24.9 billion. These three countries already represent a third of \$141-billion global ETF

market. The Korean market is poised for further growth with plans for introducing bond index ETFs, sector ETFs, as well as other varieties in the near future. This, coupled with a projected increase in institutional participation as the markets mature, could spell an optimistic road ahead for the Korean ETF market.

Reaching a Broad Audience of Traders

While professional traders may look forward to trading an increased number of liquid contracts if they fit a need, retail participants also can benefit should these contracts reach U.S. shores. The latest figures place retail domestic participation in Kospi at around 60 percent, a tremendously high percentage of retail business for any contract. What is driving this trend of retail participation? There are at least four factors, ranging from Internet use to the acceptance of futures and options as viable investments:

- **A “wired” country.** Of the total population of 48.3 million people in Korea, more than 26 million have Internet access, and nearly half of those are broadband users. As an electronic exchange, the KSE has responded to the needs of its customers with almost 60 percent of the orders being placed directly online by customers. The remainder are phoned into brokers who then enter the orders electronically.
- **The relatively small size of the contract.** Based on a recent index value of 89, an exchange rate of 1180 and a contract value of

500,000 won, the notional value of one futures contract is about \$38,000. The options contract is one-fifth of that, or roughly \$7,500.

- **The dip in interest rates below double digits.** For a majority of the 1990s, investors in Korea enjoyed interest income from banks of as high as 20 percent in some years. Now that this well has dried up, many investors are looking for other opportunities to generate income.
- **The acceptance of futures and options trading.** The trading of futures and options is a common topic among Koreans these days, particularly because they seem to be very comfortable with short-term investing. Three to five years is considered *long term* by Korean standards. There are even weekly TV shows on the major networks and the cable channels that discuss and teach strategies for trading futures and options.

An American Debut?

Americans cannot trade Kospi futures or options. Currently, they are a Commodity Futures Trading Commission (CFTC)-restricted item. The process for becoming approved must begin with the exchange offering the contract actually making a request to the CFTC for “No-Action Relief in Connection with the Offer and Sale of its Futures Contract ...in the United States.”

According to Dr. Sung-Hee Hong, a senior vice president at the Korea Stock Exchange (KSE), “The KSE has every intention of petitioning for no-action relief to allow the trading of the Kospi futures and options contracts in the U.S., but questions about whether the KSE or the KOFEX (Korea Futures Exchange) would house the contracts have led to the delay in petitioning. Once the contract is transferred to the KOFEX next year, we will move forward with the petition.” Of the 60 foreign products currently approved for

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trading by the CFTC, none are from the KSE or the KOFEX.

Dennis Holden, a spokesperson for the general counsel of the CFTC, reassures that, "Once a completed petition is received, the CFTC moves expeditiously to process the request." There are no statutory time requirements, so it is possible that the Kospi products will be on the CFTC's approved list by some time next year.

So, the question is, once approved for trading in the U.S., will the Kospi futures and options products be accepted and put on a show *away* from their shores? Much of that will depend on how familiar the name Kospi becomes and how

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traders respond to a smaller-sized contract from a country about which they may know little. Nonetheless, a smaller-sized contract and adjoining smaller margins may be a fetching idea as U.S. indexes increase in value. After all, many people chuckled out loud when they learned that the Chicago Mercantile Exchange was launching a mini-sized S&P futures contract to butt up against the Chicago Board of Trade's Dow futures contract, the blue-chip leader. And no one's laughing now. The

Kospi could be one of those little-known products that has the size and liquidity to make it a hit.

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