

KOSPI 200 Reconstitution

Estimations and strategies

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[Derivatives]

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KOSPI 200 reconstitution forecasts

This year, we expect the Korea Exchange (KRX) to replace only six constituents in the KOSPI 200. Stocks to be removed are: GS E&C, KISCO, ISU Chemical, HanAll BioPharma, Pharmicell, and Woongjin Energy, all of which are from the manufacturing sector except GS E&C. These companies are expected to be replaced by five manufacturing companies: Hankook Tire, Dong-A ST, Kolmar Korea, Samlip General Foods and Su-Heung, and one construction company: KEPCO KPS.

The upcoming reconstitution is likely to be relatively light compared to the past. This may suggest a weakening momentum of the Korean stock market, as the modest reconstitution is attributable to a short list of stocks available for addition, rather than a lack of stocks removable from the basket. Furthermore, the two major stocks (Hankook Tire and Dong-A ST) are expected to be added resulting from spin-offs, instead of their merits.

The merger between Samsung SDI and Cheil Industries are unlikely to affect the reconstitution, as the merger will close after the reconstitution. Post-merger, Kwang Dong Pharmaceutical is expected to fill the vacancy created by the merger (both Samsung SDI and Cheil Industries are current constituents of the KOSPI 200).

Table 1. Expected changes in KOSPI 200

Industry	To be added			To be deleted		
	Ticker	Company	Degree of shock	Ticker	Company	Degree of shock
Construction	051600 KS	KEPCO KPS	4.01	006360 KS	GS E&C	1.47
	161390 KS	Hankook Tire	4.94	104700 KS	KISCO	12.25
	170900 KS	Dong-A ST	3.52	005950 KS	ISU Chemical	2.50
Manufacturing	161890 KS	Kolmar Korea	3.54	009420 KS	HanAll Biopharma	3.17
	005610 KS	Samlip General Foods	3.94	005690 KS	Pharmicell	1.39
	008490 KS	Su-Heung	6.09	103130 KS	Woongjin Energy	2.48

Note: KDB Daewoo Securities projections. As of May 9, 2014
Source: Quantiwise, KDB Daewoo Securities Research

Table 2. Expected index weights and potential demand from index funds of new entrants

Industry	Ticker	Company	Free-float ratio (F, %)	Market cap (Wtr)	Free-float market cap (Wtr)	Weight in KOSPI 200 (F, %)	Rank in KOSPI 200 (F)	Potential demand from index funds (Wbn)	Average value (20 days)	Degree of shock
Construction	051600 KS	KEPCO KPS	40	3.12	1.25	0.19	90	26.36	6.57	4.01
	161390 KS	Hankook Tire	60	7.21	4.33	0.65	31	91.28	18.47	4.94
	170900 KS	Dong-A ST	75	0.78	0.58	0.09	114	12.33	3.50	3.52
Manufacturing	161890 KS	Kolmar Korea	80	0.68	0.54	0.08	121	11.41	3.23	3.54
	005610 KS	Samlip General Foods	25	0.66	0.17	0.02	181	3.50	0.89	3.94
	008490 KS	Su-Heung	50	0.44	0.22	0.03	166	4.65	0.76	6.09
Total				12.89	7.09	1.06				

Notes: KDB Daewoo Securities Research projections
Source: DART, Quantiwise, KDB Daewoo Securities Research

Table 3. Index weights and potential demand from index funds of stocks to be deleted

Industry	Ticker	Company	Free-float ratio (F, %)	Market cap (Wtr)	Free-float market cap (Wtr)	Weight in KOSPI 200 (%)	Rank in KOSPI 200	Potential demand from index funds (Wbn)	Average value (20 days)	Degree of shock
Construction	006360 KS	GS Engineering & Construction	70.00	1.82	1.27	0.19	89.00	27.07	18.44	1.47
Manufacturing	104700 KS	KISCO	45.00	0.26	0.12	0.02	196.00	2.49	0.20	12.25
	005950 KS	ISU Chemical	60.00	0.21	0.13	0.02	191.00	2.69	1.08	2.50
	009420 KS	HanAll Biopharma	65.00	0.18	0.12	0.02	197.00	2.48	0.78	3.17
	005690 KS	Pharmacell	85.00	0.18	0.15	0.02	183.00	3.19	2.30	1.39
	103130 KS	Woongjin Energy	65.00	0.17	0.11	0.02	198.00	2.31	0.93	2.48
Total				2.81	1.89	0.29				

Notes: KDB Daewoo Securities projections

Source: Quantiwise, KDB Daewoo Securities Research

Changes in free-float ratios, and impacts on index funds

We estimate a 10%p increase in free-float ratios each for Doosan Heavy Industries and Construction (DHIC), Hyundai Securities, S&T Motiv, Hansol Technics, Taihan Electric Wire. Conversely, we anticipate a decline in the ratio for Cheil Worldwide and Hyundai Hysco (-10%p each), as well as Namyang (-25%p).

The weights of Samsung Electronics (SEC), Hyundai Motor, and SK Hynix (in the KOSPI 200) are forecast to decline. In particular, the weight of SEC is estimated to decrease 0.1726%p from 22.24% to 22.027%.

Following the reconstitution, we estimate the weight of the 40 largest stocks in the KOSPI 200 to contract significantly. While the weight of manufacturing stocks is forecast to increase by 0.31%p thanks to newly added stocks, other sectors are likely to decline.

For investors that expect share prices of KOSPI 200 constituents to move in line with KOSPI 200 index funds, we recommend focusing on large cap stocks to be added for the "long" basket, while shorting GS E&C and stocks projected to have lower free-float ratios.

Since most of the stocks to be deleted (except GS E&C) are likely to be ranked 190th or under (based on free-float market cap) in the index, it is highly probable that they are not being held by index funds. Meanwhile, Cheil Worldwide, Hyundai Hysco, and Namyang, which are represented in index funds, are expected to see their free-float ratios adjusted down. And selling demand for these stocks is likely to outstrip those to be deleted.

Table 4. Changes in free-float ratios of existing KOSPI 200 constituents

Change of free-float ratio	Ticker	Company	Free-float ratio			Weight in KOSPI 200(%)			Notes
			Current	Revised (F)	Diff	Current	Revised (F)	Diff	
Decrease	030000 KS	Cheil Worldwide	80	70	-10	0.34	0.29	-0.04	Treasury stock buyback
	010520 KS	Hyundai HYSKO	50	40	-10	0.10	0.08	-0.02	Increase in treasury shares arising from spin-off of CRC unit
	003920 KS	Nam Yang Dairy Products	70	45	-25	0.07	0.04	-0.03	Increase in largest shareholder's stake
Increase	034020 KS	Doosan Heavy I&C	45	55	10	0.24	0.29	0.05	Disposal of treasury shares
	003450 KS	Hyundai Securities	50	60	10	0.08	0.10	0.02	Correction of calculation error (double counting of treasury shares)
	064960 KS	S&T Motiv	45	55	10	0.03	0.03	0.01	Disposal of treasury shares
	004710 KS	Hansol Technics	70	80	10	0.04	0.04	0.01	Decrease in portion of treasury shares due to rights offering
	001440 KS	Taihan Electric Wire	80	90	10	0.04	0.05	0.00	Decrease in equity stakes held by the largest shareholders and related parties due to rights offering

Source: DART, Quantiwise, KDB Daewoo Securities Research

Table 5. Changes in weights of existing KOSPI 200 constituents after adjustment of free-float ratios

	Ticker	Company	Market cap (Wtr)	Free-float ratio			Free-float market cap (Wtr)			Weight in KOSPI 200 (%)			Rank		
				Cur	Rev (F)		Current	Revised (F)	Diff	Current	Revised (F)	Diff	Cur	Rev (F)	Diff
Weight gainers	034020 KS	Doosan Heavy I&C	3.5	45	55	1.57	1.92	22.22	0.24	0.29	0.051	73	67	6	
	003450 KS	Hyundai Securities	1.08	50	60	0.54	0.65	20.00	0.08	0.10	0.016	118	112	6	
	064960 KS	S&T Motiv	0.41	45	55	0.18	0.22	22.22	0.03	0.03	0.006	172	165	7	
	004710 KS	Hansol Technics	0.35	70	80	0.25	0.28	14.29	0.04	0.04	0.005	157	154	3	
	001440 KS	Taihan Electric Wire	0.34	80	90	0.27	0.31	12.50	0.04	0.05	0.005	150	147	3	
Top 20 weight losers	005930 KS	Samsung Electronics	196.64	75	75	147.48	147.48	0.00	22.24	22.07	-0.173	1	1	0	
	030000 KS	Cheil Worldwide	2.78	80	70	2.22	1.94	-12.50	0.34	0.29	-0.044	60	66	-6	
	005380 KS	Hyundai Motor	50.99	70	70	35.70	35.70	0.00	5.38	5.34	-0.042	2	2	0	
	000660 KS	SK Hynix	29.22	80	80	23.38	23.38	0.00	3.53	3.50	-0.027	3	3	0	
	005490 KS	POSCO	26.77	85	85	22.75	22.75	0.00	3.43	3.40	-0.027	4	4	0	
	003920 KS	Nam Yang Dairy Products	0.66	70	45	0.46	0.30	-35.71	0.07	0.04	-0.025	126	150	-24	
	035420 KS	NAVER	22.78	90	90	20.50	20.50	0.00	3.09	3.07	-0.024	5	5	0	
	012330 KS	Hyundai Mobis	28.28	70	70	19.79	19.79	0.00	2.99	2.96	-0.023	6	6	0	
	055550 KS	Shinhan Financial Group	21.67	90	90	19.50	19.50	0.00	2.94	2.92	-0.023	7	7	0	
	010520 KS	Hyundai HYSKO	1.37	50	40	0.69	0.55	-20.00	0.10	0.08	-0.021	108	118	-10	
	000270 KS	Kia Motors	23.27	65	65	15.12	15.12	0.00	2.28	2.26	-0.018	8	8	0	
	015760 KS	KEPCO	26.55	50	50	13.27	13.27	0.00	2.00	1.99	-0.016	9	9	0	
	105560 KS	KB Financial Group	13.73	95	95	13.05	13.05	0.00	1.97	1.95	-0.015	10	10	0	
	017670 KS	SK Telecom	17.8	70	70	12.46	12.46	0.00	1.88	1.87	-0.015	11	11	0	
	051910 KS	LG Chem	16.9	70	70	11.83	11.83	0.00	1.78	1.77	-0.014	12	12	0	
	086790 KS	Hana Financial Group	10.49	95	95	9.97	9.97	0.00	1.50	1.49	-0.012	13	13	0	
	033780 KS	KT&G	12.07	80	80	9.65	9.65	0.00	1.46	1.44	-0.011	14	14	0	
032830 KS	Samsung Life Insurance	18.8	50	50	9.40	9.40	0.00	1.42	1.41	-0.011	15	15	0		
009540 KS	Hyundai Heavy Industries	14.29	65	65	9.29	9.29	0.00	1.40	1.39	-0.011	16	16	0		
000810 KS	Samsung F&M	12.36	75	75	9.27	9.27	0.00	1.40	1.39	-0.011	17	17	0		

Notes: As of May 9, 2013

Source: Quantwise, KDB Daewoo Securities Research

Table 6. Top weight gainers and losers assuming an index fund basket with 120 constituents

	Ticker	Company	Rank		Weight in index funds (%,%p)			Average trading value (20 days)	Potential demand from index funds	Degree of shock
			Current	Revised (F)	Current	Revised (F)	Diff			
Sell Shock Top 10	006360 KS	GS E&C	89	-	0.20	0.00	-0.20	18.44	-27.93	-1.51
	030000 KS	Cheil Worldwide	60	66	0.35	0.30	-0.05	10.25	-6.35	-0.62
	010520 KS	Hyundai HYSKO	108	118	0.11	0.09	-0.02	6.15	-3.08	-0.50
	088350 KS	Hanwha Life Insurance	43	44	0.45	0.45	0.00	2.13	-0.38	-0.18
	004990 KS	Lotte Confectionery	91	92	0.19	0.19	0.00	1.39	-0.16	-0.12
	003410 KS	Ssangyong Cement	117	120	0.09	0.08	0.00	0.70	-0.07	-0.10
	055550 KS	Shinhan Financial Group	7	7	3.04	3.02	-0.02	32.04	-2.55	-0.08
	071050 KS	Korea Investment Holdings	76	77	0.24	0.24	0.00	2.70	-0.20	-0.08
	003550 KS	LG	23	23	0.84	0.83	-0.01	10.25	-0.71	-0.07
006280 KS	Green Cross	106	107	0.12	0.12	0.00	1.44	-0.10	-0.07	
Buy Shock Top 5	161390 KS	Hankook Tire	-	31	0.00	0.67	0.67	18.48	94.35	5.11
	051600 KS	KEPCO KPS	-	90	0.00	0.19	0.19	6.57	27.25	4.15
	170900 KS	Dong-A ST	-	114	0.00	0.09	0.09	3.50	12.75	3.64
	034020 KS	Doosan Heavy I&C	73	67	0.25	0.30	0.05	14.97	7.42	0.50
	003450 KS	Hyundai Securities	118	112	0.08	0.10	0.02	11.78	2.29	0.19

Notes: 1) As of April 9, 2014

2) Assuming that an index fund includes 120 stocks

3) Degree of shock = Potential demand from KOSPI 200 index funds/average trading value (20 days)

Source: KDB Daewoo Securities Research

Table 7. Top weight gainers and losers assuming an index fund basket with 170 constituents

	Ticker	Company	Rank		Weight in index funds (%,%p)			Average trading value (20 days)	Potential demand from index funds	Degree of shock
			Current	Revised (F)	Current	Revised (F)	Diff			
Sell Shock Top 10	003920 KS	Nam Yang Dairy Products	126	150	0.07	0.05	-0.03	0.83	-3.58	-4.30
	006360 KS	GS E&C	89	-	0.19	0.00	-0.19	18.44	-27.24	-1.48
	030000 KS	Cheil Worldwide	60	66	0.34	0.29	-0.04	10.25	-6.25	-0.61
	010520 KS	Hyundai HYSCO	108	118	0.10	0.08	-0.02	6.15	-3.02	-0.49
	000430 KS	Dae Won Kang Up	155	159	0.04	0.04	0.00	0.14	-0.04	-0.29
	088350 KS	Hanwha Life Insurance	43	44	0.44	0.43	0.00	2.13	-0.45	-0.21
	004990 KS	Lotte Confectionery	91	92	0.19	0.19	0.00	1.39	-0.19	-0.14
	003410 KS	Ssangyong Cement	117	120	0.08	0.08	0.00	0.70	-0.08	-0.12
	000070 KS	Samyang Holdings	149	153	0.04	0.04	0.00	0.38	-0.05	-0.12
003240 KS	Taekwang	130	132	0.07	0.06	0.00	0.59	-0.07	-0.11	
Buy Shock Top 10	008490 KS	Su-Heung	-	166	0.00	0.03	0.03	0.76	4.68	6.13
	161390 KS	Hankook Tire	-	31	0.00	0.65	0.65	18.48	91.91	4.97
	064960 KS	S&T Motiv	172	165	0.00	0.03	0.03	1.08	4.75	4.41
	051600 KS	KEPCO KPS	-	90	0.00	0.19	0.19	6.57	26.54	4.04
	161890 KS	Kolmar Korea	-	121	0.00	0.08	0.08	3.23	11.49	3.56
	170900 KS	Dong-A ST	-	114	0.00	0.09	0.09	3.50	12.42	3.55
	034020 KS	Doosan Heavy I&C	73	67	0.24	0.29	0.05	14.97	7.19	0.48
	001440 KS	Taihan Electric Wire	150	147	0.04	0.05	0.01	1.82	0.68	0.37
	003450 KS	Hyundai Securities	118	112	0.08	0.10	0.02	11.78	2.21	0.19
004710 KS	Hansol Technics	157	154	0.04	0.04	0.01	5.15	0.72	0.14	

Note: 1) As of April 9, 2014

2) Assuming that an index fund includes 170 stocks

3) Degree of shock = Potential demand from KOSPI 200 index funds/average trading value (20 days)

Source: KDB Daewoo Securities Research

Table 8. Top weight gainers and losers assuming an index fund basket with 200 constituents

	Ticker	Company	Rank		Weight in KOSPI 200 (%)			Average trading value (20 days)	Potential demand from index funds	Degree of shock
			Current	Revised (F)	Current	Revised (F)	Diff			
Sell Shock Top 10	104700 KS	KISCO	196	-	0.02	-	-0.02	0.20	-2.49	-12.24
	003920 KS	Nam Yang Dairy Products	126	150	0.07	0.04	-0.03	0.83	-3.56	-4.28
	009420 KS	HanAll Biopharma	197	-	0.02	-	-0.02	0.78	-2.48	-3.17
	005950 KS	ISU Chemical	191	-	0.02	-	-0.02	1.08	-2.69	-2.50
	103130 KS	Woongjin Energy	198	-	0.02	-	-0.02	0.93	-2.31	-2.48
	006360 KS	GS E&C	89	-	0.19	-	-0.19	18.44	-27.07	-1.47
	005690 KS	Pharmicell	183	-	0.02	-	-0.02	2.30	-3.19	-1.39
	030000 KS	Cheil Worldwide	60	66	0.34	0.29	-0.04	10.25	-6.23	-0.61
	010520 KS	Hyundai HYSCO	108	118	0.10	0.08	-0.02	6.15	-3.01	-0.49
	025000 KS	KPX Chemical	188	192	0.02	0.02	0.00	0.07	-0.02	-0.34
Buy Shock Top 10	008490 KS	Su-Heung	-	166	-	0.03	0.03	0.76	4.65	6.09
	161390 KS	Hankook Tire	-	31	-	0.65	0.65	18.48	91.28	4.94
	051600 KS	KEPCO KPS	-	90	-	0.19	0.19	6.57	26.36	4.01
	005610 KS	Samlip General Foods	-	181	-	0.03	0.03	0.89	3.50	3.94
	161890 KS	Kolmar Korea	-	121	-	0.08	0.08	3.23	11.41	3.54
	170900 KS	Dong-A ST	-	114	-	0.09	0.09	3.50	12.33	3.52
	064960 KS	S&T Motiv	172	165	0.03	0.03	0.01	1.08	0.83	0.77
	034020 KS	Doosan Heavy I&C	73	67	0.24	0.29	0.05	14.97	7.12	0.48
	001440 KS	Taihan Electric Wire	150	147	0.04	0.05	0.01	1.82	0.67	0.37
	003450 KS	Hyundai Securities	118	112	0.08	0.10	0.02	11.78	2.19	0.19

Note: 1) As of April 9, 2014

2) Assuming that an index fund includes 200 stocks

3) Degree of shock = Potential demand from KOSPI 200 index funds/average trading value (20 days)

Source: KDB Daewoo Securities Research

Event-driven strategy

Over the past several years, shares of companies expected to be included in the KOSPI 200 have typically outperformed the KOSPI 200 before and after the public disclosure of the reconstitution plan and the June futures expiration date. Meanwhile, stocks anticipated to be deleted from the index have underperformed the market. As such, investors who bought the basket of new entrants, sold the basket of outgoing stocks, or adopted a long-short strategy—"long new entrants + short outgoing"—were able to outperform the KOSPI 200.

The ideal time to enter into the long basket was 15 days before the reconstitution date, and that of unwinding the basket was on average five days before reconstitution (vs. the June expiration date for 2013). In comparison, the best time to short the outgoing basket was on average 25 days before reconstitution (vs. 10 days before expiration in 2013), and that of covering the short position was between the expiration date and 10 days after expiration. The most opportune time to take a long-short strategy was 45 days before expiration, and the best time to unwind these positions was the June expiration date.

For the long-short positions, excess returns on long baskets occurred earlier, while those of short baskets were concentrated just before and after expiration. As such, early entry and late closeout of the long-short positions led to higher returns.

The returns for long-short baskets recorded lower volatility than baskets comprised of only long or short baskets. In 2013, however, relatively late entry and closeout around expiration recorded higher returns as long-only baskets mostly generated returns during the week of expiration and returns of short-only baskets increased earlier than in previous years.

However, it should be noted that the excess returns of baskets against the KOSPI 200 near the public announcement of the reconstitution are trending down. In addition, recent strategies have not always panned out well. We also note increased volatility of returns, depending on the composition of the baskets or the timing of entry and closeout.

To determine the most effective way to pick stocks for the baskets, we analyzed past performances of stocks based on six factors – price, trading volume, trading value, market cap, free-float market cap, and degree of impact from rebalancing.

Among these factors, we found free-float market cap to have the most impact on share performance. As such, we project relative strength of Hankook Tire and KEPCO KPS, and relative weakness of KISCO and Woongjin Energy.

Table 9. Long/short baskets based on free-float market cap

	Ticker	Company	Stock price	Trading volume	Average value	Marker Cap	Free-float market cap	Degree of shock
Added	161390 KS	Hankook Tire	58,939	315,332	185.39	7.3	4.38	4.95
	051600 KS	KEPCO KPS	67,461	81,690	55.03	3.04	1.21	4.62
	170900 KS	Dong-A ST	108,556	34,291	37.04	0.8	0.6	3.38
	161890 KS	Kolmar Korea	31,533	100,121	32.47	0.61	0.49	3.17
	008490 KS	Su-Heung	38,639	18,980	7.34	0.45	0.22	6.38
	005610 KS	Samlip General Foods	75,283	11,145	8.39	0.65	0.16	4.06
Excluded	006360 KS	GS E&C	35,205	502,882	184.08	1.86	1.3	1.48
	005690 KS	Pharmicell	4,081	539,760	22.24	0.18	0.16	1.47
	005950 KS	ISU Chemical	13,797	71,865	9.88	0.21	0.13	2.68
	009420 KS	HanAll Biopharma	4,408	166,049	7.4	0.18	0.12	3.39
	104700 KS	KISCO	28,258	6,669	1.91	0.26	0.12	12.86
	103130 KS	Woongjin Energy	2,238	440,685	9.9	0.15	0.1	2.11

Note: Based on six-average data over recent 40 days

Source: Quantiwise, KDB Daewoo Securities Research

APPENDIX 1

Important Disclosures & Disclaimers

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