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Uncommonly preferred

"If markets were efficient," inquires colleague David Peligal, "why would Hyundai Motor's second preferred securities (005387 KS on Bloomberg) trade at 32% of the price of Hyundai's common stock (005380 KS on Bloomberg) when, for all intents and purposes, the two securities are economically identical?" There happens to be no good reason. Now unfolding is a bullish exposé on a distant market inefficiency.

Mind you, South Korea does not exactly roll out the welcome mat for foreign value seekers. Professionals will find no insuperable barrier to buying Korean preferreds that trade at anomalous discounts to the corresponding common. And neither, for that matter, will the persistent retail investor. But to complete the required documentation will require some intercontinental e-mailing. You can't just call Charles Schwab.

The analysis now unfolding deals mainly, though not exclusively, with the eccentric market in Korean preferreds. Other topics include the nature of value, corporate governance, cultural differences in this supposed age of financial globalization and the importance (or non-importance) of catalysts, market liquidity and voting rights in the delivery of superior investment returns. Buy the persistently discounted, evidently catalyst-free Korean preferreds, even without hedging through a sale of the underlying common, is our conclusion.

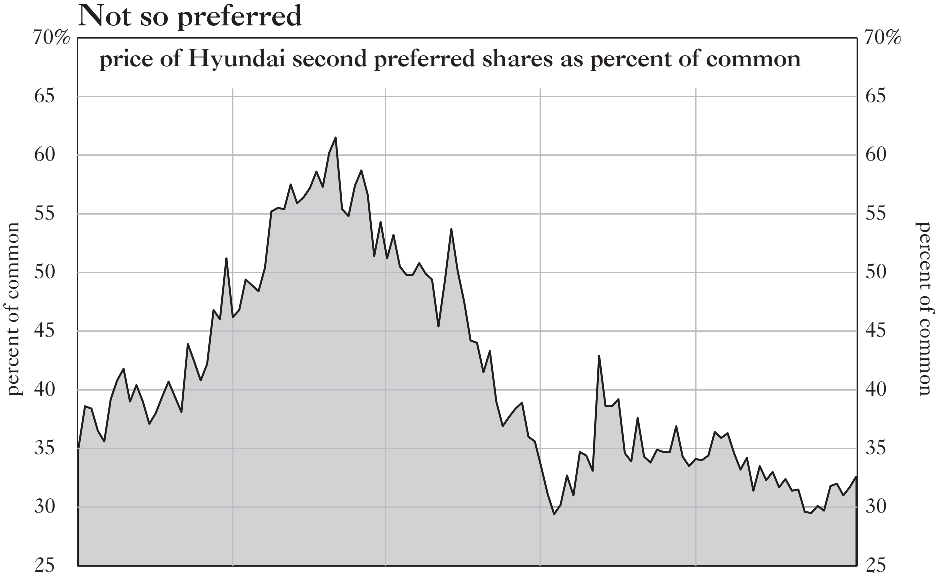
To begin at the beginning, 148 issues of Korean preferred are listed with a collective market cap of some $10 billion. While a portion of these issues are tiny and illiquid, others trade $10 million or more a day. None is listed in the MSCI Index, which means that, for the index-hugging, Korean-focused mutual funds, they might as well not exist.

"In Korea," Peligal explains, "the term 'preferred share' will appear as something of a misnomer to an investor in U.S. equities. While giving the holder full economic participation rights in the earnings stream of a business and a priority dividend, Korean preferred shares lack voting rights. One may therefore think of them as non-voting common shares. There's no question that voting rights have value, but how much of it? In Korea, the value of a vote is quite low. Investors willing to pay three times the price for a vote are paying a hefty price for a quiet vote in a country with *chaebols*, concentrated family ownership and a distinct lack of corporate activism."

Then, too, you can't buy and sell the preferreds as easily as you can the common. Besides, Korean common shares have delivered better returns than the corresponding preferreds over the past five to seven years. Furthermore, Korean managements (in general) seem in no hurry to help in closing a valuation gap that, according to a six-foot pile of CFA manuals, shouldn't even exist. Maybe the valuation anomaly wouldn't persist if more foreigners could read prospectuses written in Korean, but few can.

"But maybe," Peligal proceeds, "the sheer size of the discounts is reason enough to take the plunge. Let's go back to the Hyundai Motor example. That

Not so preferred



source: The Bloomberg

second preferred issue (the automaker has three) is trading at 79,700 won and yields 2.3%. Hyundai common is trading at 248,500 won and yields 0.7%. Ergo, a 68% discount, about as steep a discount as any in the past 10 years. Historically, Korean preferreds have traded at an average discount of 54%; it's 69% today. In fact, the preferreds, on average, are as deeply discounted as they were during the 1997 Asian financial crisis. Remember, if a discount narrows to 60% from 70%, you don't make a 10% return. You make a 33% return."

Arbitrageurs might choose to go long the preferreds and short the underlying common. "Sticking with Hyundai," Peligal notes, "such a strategy would deliver an after-tax carry of 1.4%, although there are good reasons to buy the preferreds outright. So doing, one would not necessarily be trusting in the market to close an unreasonably (say we) wide discount, but rather in the tendency for good things to happen to cheap stocks."

"Korean preferreds," an anonymity-seeking, buy-side analyst informs Peligal, "are a bizarre exception to the phenomena we see with investors overpaying for yield without regard for NAV. It would seem prudent that Korean investors aren't reaching for yield. However, in this instance, it's actually incredibly imprudent, because an investor could basically buy the same economic claim at a much cheaper price. This behavior is so inconsistent with what we, as a fund, are seeing elsewhere in the world."

Unusual, too, are Korean preferred valuations in comparison with those of similar securities in other countries. Whether set against Indian differential voting-rights shares, Italian savings shares, Swiss participation certificates or German preferred shares, Korean discounts vis-à-vis the relevant common shares are in a league of their own.

There's no guarantee, of course, that cheap securities can't become cheaper (it happens all the time in Value Land). But, as discounts widen, other things being the same, yields increase. "Thus," Peligal observes, "if the Hyundai second preferred securities were to trade at a 90% discount, their yield would jump to roughly 8%. By comparison, short-dated Hyundai corporate debt—the 4s of 2017, for instance—are priced to yield less than 3%. The Korean government's two-year note fetches 2.87%, its 10-year note 3.08%."

"At a 60% discount," Peligal's afore-quoted informant says, "you might have said that it would never go to a 70% discount. But when we buy something cheap enough, our experience has been that we are more likely to be positively surprised than negatively surprised."

Armor Capital, a New York-headquartered hedge fund with $382 million under management, has had its share of pleasant preferred-induced surprises. Boris Zhilin, principal (and, let the record show, a paid-up subscriber to *Grant's*), says that two such issues have been in the fund's portfolio since the mid-2000s. They are Amorepacific Corp. (090435 KS on Bloomberg) and LG Household and Healthcare (051905 KS on Bloomberg), the former trading at six times, the latter nine times, Armor's estimate of 2013 earnings, and at discounts to the underlying common of 72% and 69%, respectively.

"One has to be happy with a return that comes from dividends and reinvestment decisions by management and not from people waking up and realizing, 'My God, these discounts are crazy,'" Zhilin says. "If people do come to this realization, great. But one shouldn't invest expecting that to happen. The other big takeaway is that high-quality businesses, the ones that tend to become intrinsically more valuable over time, are the best investments when it comes to deeply discounted preferred shares. These businesses turn time, as an investment parameter, from a potential detractor to a very helpful friend and ally. This allows one to earn attractive absolute returns, even in periods like the past five to seven years, when the multiples of many preferred shares contracted and the discount to the common shares widened."

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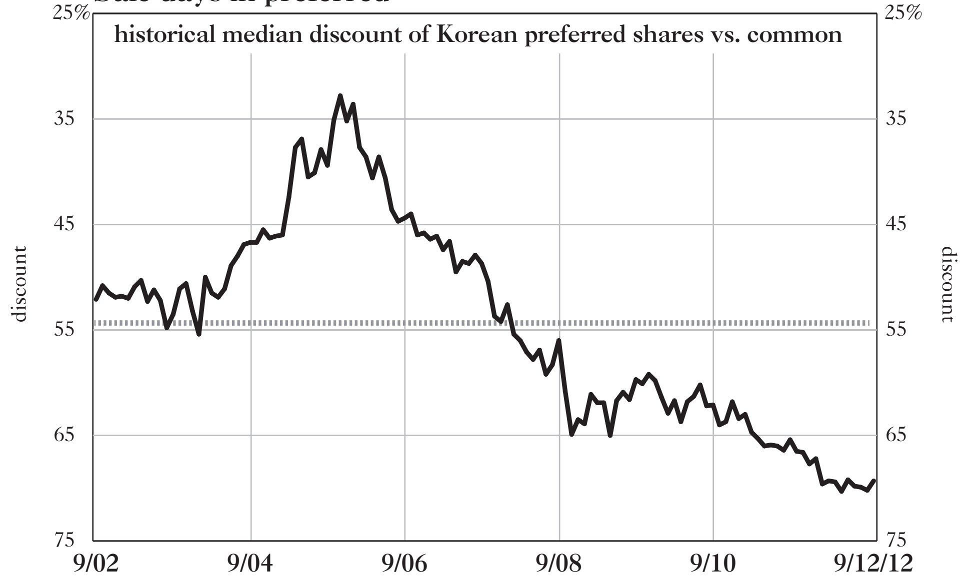
Sale days in preferred



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