

## OPINION

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# Retail Investors' Foreign Equity Investment: Characteristics and Implications

Retail investors' direct foreign equity investment has grown rapidly in recent years, with a significant concentration in specific regions and stocks, particularly US technology stocks. Korea's unique direct foreign equity trading structure offers a distinct advantage in terms of accessibility. However, it should be noted that retail investors in Korea exhibit greater regional and stock-specific biases compared to institutional investors. Furthermore, investments in high-risk derivatives directly traded in overseas markets—products prohibited under Korea's regulations—have been surging among retail investors, which calls for close scrutiny. Given that the accessibility of foreign equity investment for retail investors now matches that of domestically available products, it is desirable to consistently apply regulations to products of similar risk profiles, irrespective of their jurisdictions, to ensure consumer protection. In the long term, it is also worth considering introducing regulatory incentives to guide retail investors seeking outward equity investment toward more stable trading mechanisms. These incentives help mitigate risks inherent in direct foreign equity trading, particularly those arising from the complexities of cross-border transactions.

The direct investment of Korean retail investors in foreign equity has grown at a rapid pace. As of the end of 2024, the outstanding balance of their portfolio holdings in foreign equity stood at approximately \$120 billion, representing nearly half the amount of institutional investors' foreign equity holdings.<sup>1)</sup> This expansion stems from the recent robust growth in major stock markets, particularly in the US, and the heightened interest in outward equity

\* All opinions expressed in this paper represent the author's personal views and thus should not be interpreted as Korea Capital Market Institute's official position.

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1) The outstanding balance of retail investors' foreign equity investment is derived from the foreign equity holdings deposited with the KSD.

investment. Amid this trend, Korean retail investors prefer direct trading of foreign equity over indirect investment vehicles, such as foreign equity-linked funds, which are domestically available. Against this backdrop, this article explores the underlying factors and characteristics of the enhanced accessibility to outward equity investment for retail investors, and presents the implications for the Korean market.

### **Greater accessibility to foreign equity investment**

Retail investors' preference for direct foreign equity investment can be attributed to the high accessibility to such investments in Korea. In terms of transaction costs associated with foreign equity trading, the fees charged by Korea's major brokerage firms are substantially lower than those charged in other major markets.<sup>2)</sup> This cost advantage can be traced to the institutional structure unique to Korea as well as price competition resulting from the rising demand of retail investors for outward equity investment. Notably, Korea has a centralized depository system, where the Korea Securities Depository (KSD) acts as an intermediary for foreign equity settlement and custody services on behalf of brokerage firms. This centralized system enables economies of scale in asset custody, thereby reducing transaction costs. In addition, this institutional convenience allows Korea's brokerage firms to build infrastructure supporting foreign equity investment, which contributes to lower transaction costs.

In addition to the high accessibility afforded by Korea's trading structure, regulatory differences between Korea and other economies further facilitate direct investment in foreign equity. It is noteworthy that leveraged exchange-traded funds (ETFs) and other derivatives with foreign equity as their underlying assets often provide greater diversity and accessibility in overseas markets, compared to similar products available in Korea. For instance, when investing in foreign equity-linked leveraged derivatives listed in Korea, retail investors must meet regulatory requirements, such as mandatory investor education and margin deposits. By contrast, equivalent products available in overseas markets are not subject to these obligations. Furthermore, Korea imposes restrictions on the combination of underlying assets and multiples

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2) The foreign equity trading fees charged by Korea's brokerage firms range from 7 to 25 basis points (bp), which are not significantly different from domestic equity trading fees of 1 to 20 bp. In major markets such as the US, however, foreign equity trading fees are substantially higher than those charged for domestic equity trading.

for leveraged derivatives, while no explicit restrictions exist in most advanced markets.<sup>3)</sup> For instance, instruments offering higher leverage multiples, which have rapidly gained popularity among retail investors, are prohibited under Korean regulations. Accordingly, retail investors seeking exposure to such instruments need to engage in direct trading in overseas markets.

From a taxation perspective, direct investment in foreign equity also presents advantages over domestically available foreign equity-linked products. Although capital gains derived from direct foreign equity trading are subject to higher tax rates than those applied to foreign equity-linked funds listed in Korea, the basic capital gains deduction (KRW 2.5 million) and the deduction for offsetting capital losses apply to foreign equity investment. Thus, the tax burden on investors may vary depending on the size of investment returns.<sup>4)</sup> Unlike similar products available in Korea, gains from foreign equity transactions are subject to a capital gains tax but are excluded from global taxation on financial investment income. Given these factors, the Korean market offers wider access to, and greater incentives for, direct foreign equity investment, compared to other major markets. Particularly, retail investors with substantial capital and strong risk appetites may prefer direct trading in overseas markets to gain unrestricted access to a range of high-risk products.

### **Assessment on biases and characteristics of outbound equity investment**

Korean retail investors' foreign equity portfolios exhibit significant biases in both regional and stock-specific asset allocation. This article analyzes how Korean retail investors' foreign equity portfolios are allocated across global regions, using deviations from the theoretically optimal asset allocation. This analysis indicates a pronounced overinvestment bias toward the US market, as measured by a deviation of -0.8.<sup>5)</sup> This bias partially reflects the increased allocation to the US, driven by the strong stock market performance. However, the heightened bias among retail investors, compared to institutional investors, suggests more aggressive

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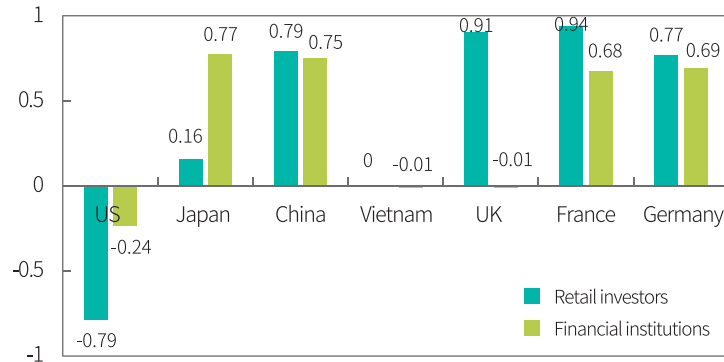
3) For domestically available financial products with foreign equity as their underlying assets, the financial investment business regulations (Articles 7-26 and 4-52) limit the proportion of a single stock (30% or more) and the leverage multiples of stock index changes (2x or less).

4) If financial income is not subject to global taxation, the tax burden on foreign equity investment is more favorable compared to domestically listed foreign equity-linked ETFs, unless capital gains exceed KRW 8.33 million.

5) The foreign equity investment bias is defined as the divergence between the actual proportion of regional asset holdings and the Capital Asset Pricing Model (CAPM). It is a normalized measure using the weight against the maximum home bias and foreign investment bias in each country, expressed on a scale from -1 (maximum overinvestment bias) to +1 (maximum underinvestment bias).

investment patterns. As illustrated in Figure 1, the regional bias of retail investors consistently exceeds that of institutional investors (financial institutions) in most regions.

**Figure 1. Comparison of foreign investment biases between retail investors and financial institutions (2023)**



Source: Korea Capital Market Institute

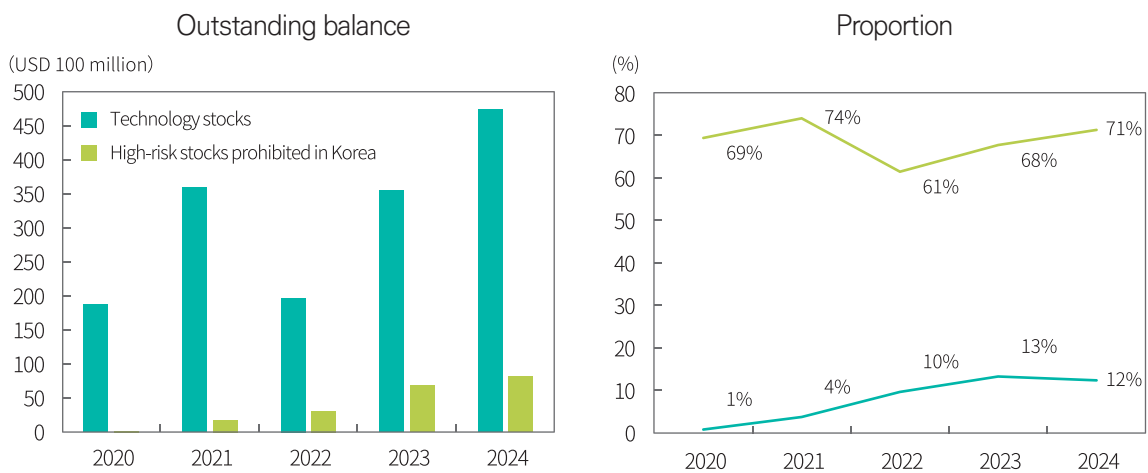
In an analysis of stock-specific asset allocation, retail investors' foreign equity portfolios are highly concentrated in large US technology stocks, with a recent surge in the proportion of high-risk stocks. Retail investors' preference for technology stocks has become apparent since outward equity investment surged in 2020. As of the end of June 2024, technology stocks accounted for about 71% of the top 50 stocks in retail investors' portfolio holdings in terms of outstanding value. In addition, high-risk products, such as leveraged derivatives, represent a pronounced share of retail investors' top holdings. Notably, these products, taking up a significant proportion in retail investors' portfolios, include several highly leveraged derivatives that are legally prohibited in Korea.<sup>6)</sup> As of the end of June 2024, such prohibited high-risk products accounted for 12% of retail investors' portfolio holdings, a dramatic increase from less than 1% in 2020.

The investment behavior of retail investors widely diverges from that of institutional investors, particularly in outward equity investment. Notably, the growth of retail investors' foreign equity investment seems less influenced by the evolving global financial environment. According to a recent analysis by the Bank of Korea, institutional investors tend to curtail their net investment during periods of heightened market volatility, as measured by the Chicago

6) High-risk instruments not permitted in Korea include 2x leveraged single-stock products, highly leveraged derivatives offering 3x or higher and Bitcoin-related products.

Board Options Exchange Volatility Index (VIX), while retail investors demonstrate an inverse relationship between their net investment and the VIX.<sup>7)</sup> Moreover, studies analyzing the determinants of Korean investors’ outward equity investment unveil that risk management considerations, such as portfolio risk diversification, rarely affect retail investors’ decisions.<sup>8)</sup> This contrasts sharply with institutional investors who employ diverse portfolio risk management strategies.

**Figure 2. Outstanding balance and proportion by stock type**



Note: Technology stocks refer to the total balance of individual stocks listed on the US stock market. High-risk stocks not permitted in Korea include 3x leveraged products, 2x single-stock leveraged products and cryptocurrency-related products. The proportion is calculated related to the balance of the top 50 stock holdings.

Source: Korea Capital Market Institute

### Implications

Recently, the growth of retail investors’ direct investment in foreign equity can be largely attributed to the robust performance of stock markets in major economies, particularly in the US, and greater market accessibility in Korea. Korea’s unique structure facilitating direct foreign equity investment offers a significant advantage of enhanced accessibility. However, retail investors often exhibit a pronounced concentration in specific regions and stocks compared to institutional investors, which calls for caution. Additionally, it should be noted that retail investors’ asset allocation in foreign equity portfolios is not guided by portfolio risk

7) Bank of Korea, March 14, 2024, Characteristics and assessment of retail investors’ foreign equity investment, Bank of Korea blog.

8) Kim, H.S., 2020, Korean retail investors’ foreign equity investment across regions: Overview and characteristics, KCMI Issue Papers 20-02.

management principles, such as risk diversification, which also seems unaffected by changes in the global financial market. This suggests that outward equity investment by retail investors hardly optimizes risk-adjusted returns—a fundamental benefit of portfolio investment.

Another area of growing concern is the surge in investments in high-risk derivatives directly traded in overseas markets, which are prohibited under Korean regulations. This trend has gained momentum since the latter half of 2020, when stricter consumer protection measures were introduced for leveraged derivatives available in Korea.<sup>9)</sup> As relevant regulations tightened, many investors turned to foreign markets for access to leveraged derivatives not subject to Korea's regulatory oversight, resulting in increased investment in highly leveraged derivatives, which are legally prohibited in Korea. Given that the accessibility of direct foreign equity investment has enhanced to a level comparable to domestically available products, it is advisable to apply consistent consumer protection regulations to products with similar risk profiles, irrespective of their jurisdiction.

In the long term, it is necessary to promote indirect investment pathways for retail investors seeking foreign equity exposure. The complicated structure of cross-border transactions, coupled with the trading mechanisms of foreign markets significantly different from those in Korea, may pose various risks to direct foreign equity investment. For instance, a US-based alternative stock exchange was forced to halt overnight trading during a recent downturn in the US stock market, leaving Korean retail investors exposed to unexpected disruptions.<sup>10)</sup> To address this challenge, the government can consider introducing regulatory incentives that encourage retail investors to adopt safer investment vehicles, drawing on its past experiences in guiding them toward indirect foreign equity investment.

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9) In July 2020, the Korean government implemented stricter regulations mandating margin deposits and pre-investment for investments in domestically available leveraged derivatives.

10) Blue Ocean ATS, an alternative trading platform facilitating overnight trading for the US stock market, experienced a system failure on August 5, 2024. This resulted in the abrupt cancellation of transactions worth KRW 630 billion across 19 Korean brokerage firms.