

Korea's Transformation

Factory Production to Innovation Generation

The Hermit Kingdom: Then and Now

The Korean Wave:
Exporting Korean Culture and Soft Products

Country at a Crossroads

Geopolitical Balancing Act

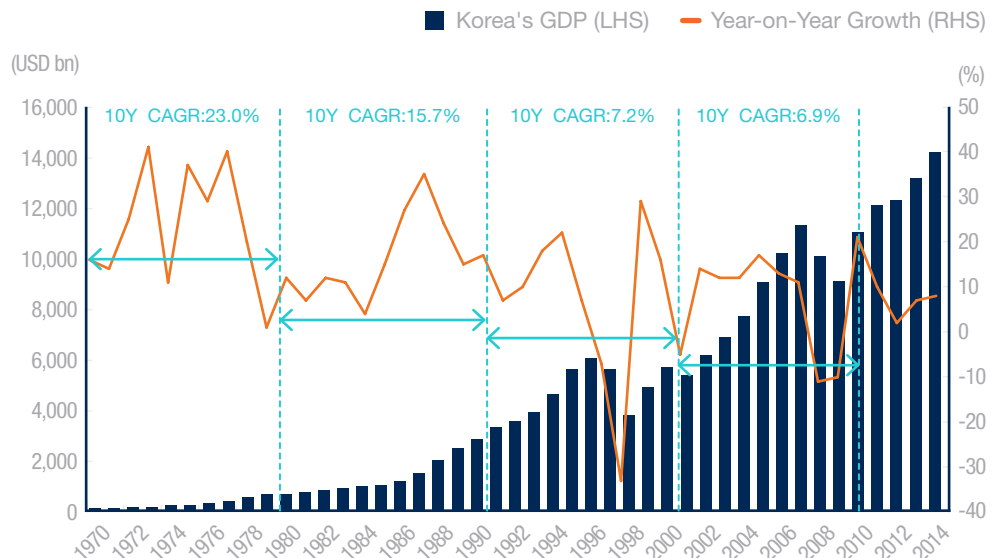
Transformation: From Goods to Ideas

The Hermit Kingdom: Then and Now

Korea has long been a traditional powerhouse in manufacturing, which has driven robust gains in social, political, and economic indicators. It has matured in its development and entered the high-income OECD club.¹ However, Korea is currently undergoing important social, economic, demographic and geo-political changes which create as many challenges as they do opportunities, and its rate of economic growth appears set for a steady decline in the coming decades.

Slowing Economic Growth in Past...

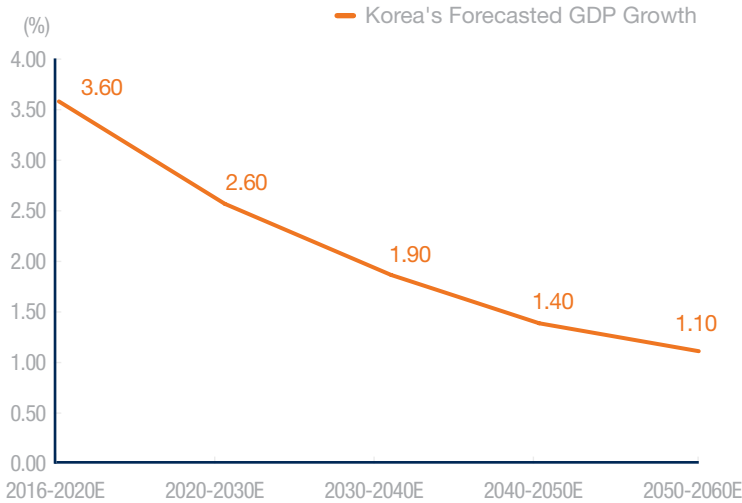
Source: The Bank of Korea, Economic Statistics System (2015)



¹ OECD stands for the Organisation for Economic Co-operation and Development comprised of 34 countries.

...And in the Forecasted Future

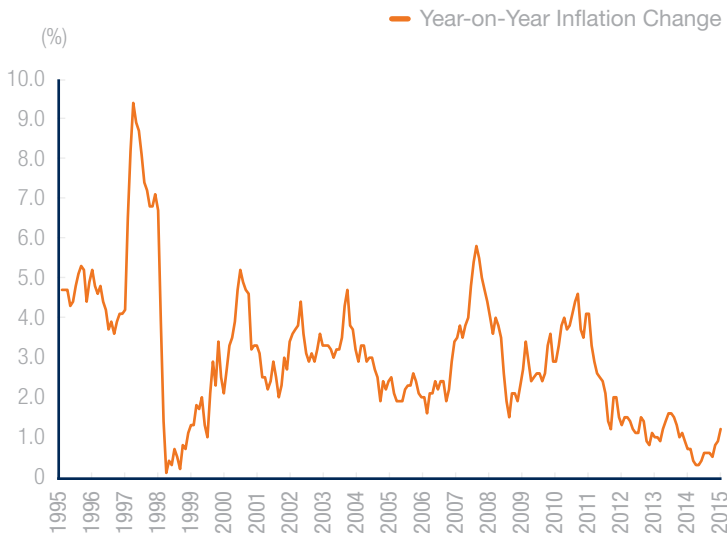
Source: Korea Institute of Public Finance (2015)



Many of the headwinds impacting Korea come from beyond its borders. The “new normal” of lower global growth and muted inflation following the financial crisis has passed through to reduced consumer spending and lower corporate earnings and wages alike. Korea faces increased higher-end competition from Japan, where exporters have benefited from a weaker Japanese yen, and the improved expertise from China on the low-end, which is rapidly gaining market share in various sectors, especially in technology.

Inflation is Under Pressure...

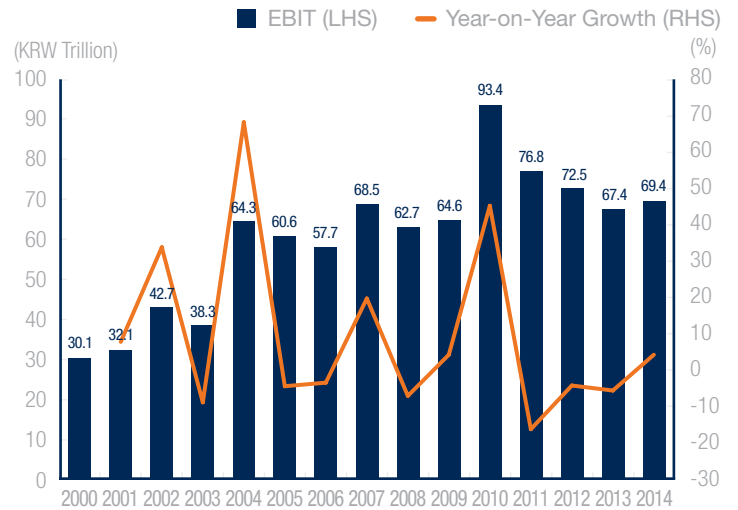
Source: KOSTAT (2016)



The rise of China has created both new competition and important new markets for Korea. China has an insatiable demand for Korean goods such as electronics, making it Korea's largest export destination. China buys 26.1% of Korea's exports – as much as the US, EU and Japan combined. Korean goods

... As Korean Corporate Earnings Flatten Out

Source: Quantwise (2015)

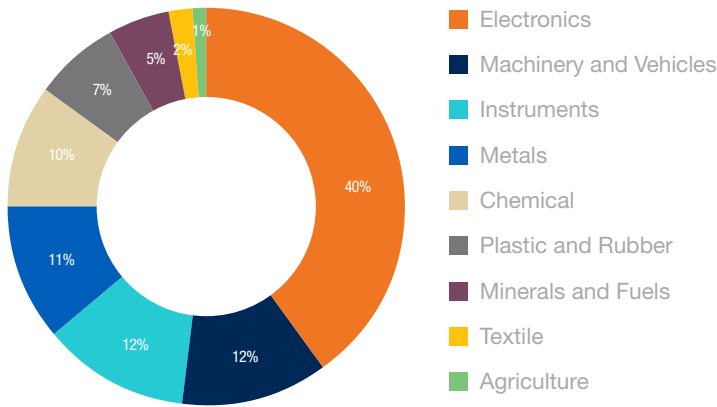


account for 9.7% of China's imports, surpassing those from Japan and second only to those from the European Union.² Linkages between the neighbors became more established with the signing of the China-Korea free trade agreement last summer that came into force in late 2015.

² World Trade Organization (2015)

Exports to China Led by Electronics

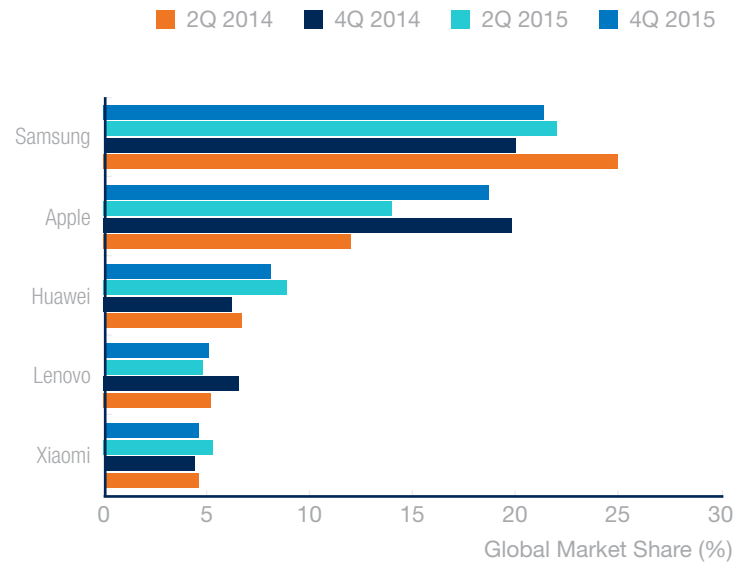
Source: CEIC, Haver, UBS estimates (2014)



However, China is rebalancing its economy towards domestic consumption and services and away from an investment and export-led economy for a more modest and sustainable pace of growth, and this has resulted in a drop in business for Korea, widely regarded as a bellwether for global trade.

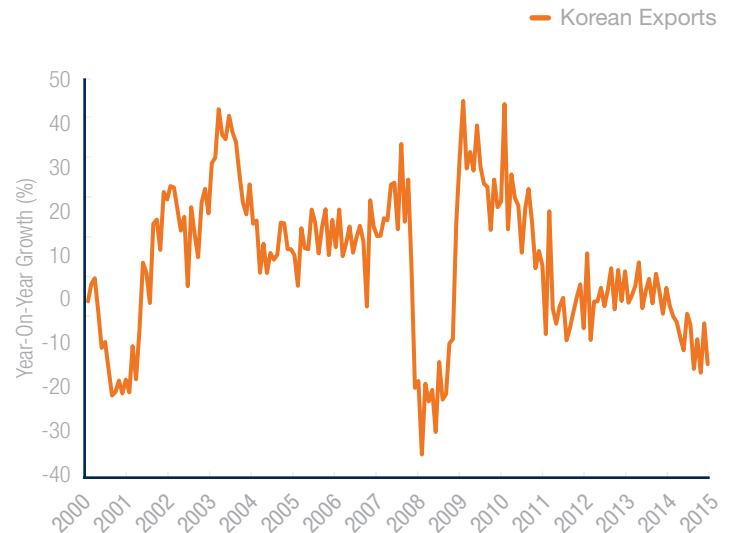
China Nibbling at Korean Market Share

Source: IDC (2016)



A Slowing China has Dragged down Korean Exports

Source: Bloomberg, Mirae Asset Global Investments (2016)



The Korean Wave: Exporting Korean Culture and Soft Products

Korea's widespread economic shift has benefited its "brand equity" via trendsetting products in entertainment, cosmetics, and fashion. Korean media content exports grew at a compound annual growth rate (CAGR) of 13.64% between 2010 and 2014.³ There is a "Korean Wave" of popular soft-based products emanating from Korea, particularly in media and entertainment, which has placed the country on the global map for business, travel, and leisure, most notably from Chinese and Southeast

Asian tourists. Chinese tourists to Korea spend an average of US\$1,431 per person, which is more than three times the per-person average for non-Chinese visitors.⁴ These newly minted "Asian Great Consumers," with newfound levels of wealth and an appetite for consumption, seek "Made in Korea" products that offer premium quality at an affordable price point. Cosmetics, apparel and handbags are at the top of their shopping lists.⁵

Chinese Tourists On The Rise

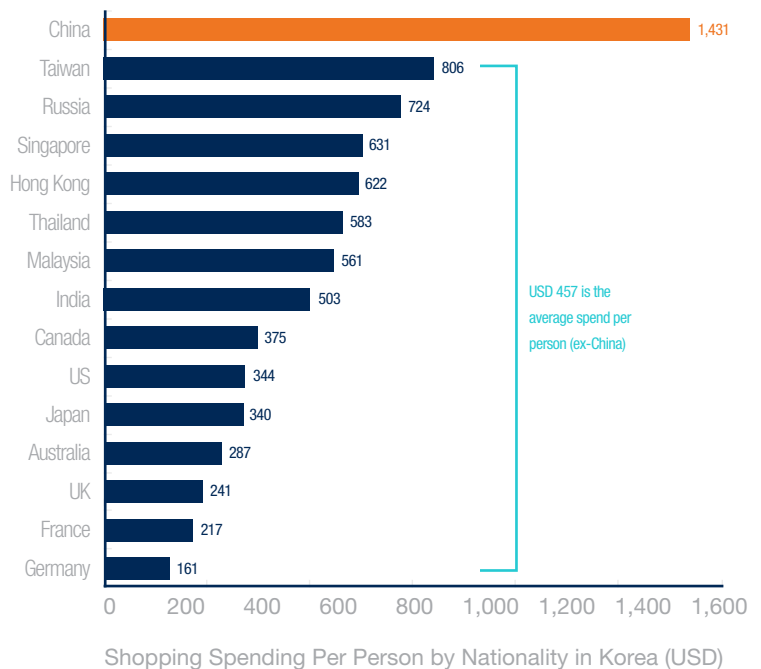
Source: Korea Tourism Organization, Mirae Asset Global Investments (2016)



Korea's structural economic shift away from industrials towards consumer goods and services has also affected sectors such as the business-to-consumer space, mobile phones and healthcare. Korea features one of the highest rates of smartphone

Who Spend 3x as Much as Global Peers

Korea Tourism Organization, CLSA (2015)



penetration in the world and the country is a world-class center of internet excellence, with average connection speeds far ahead of any other country globally.

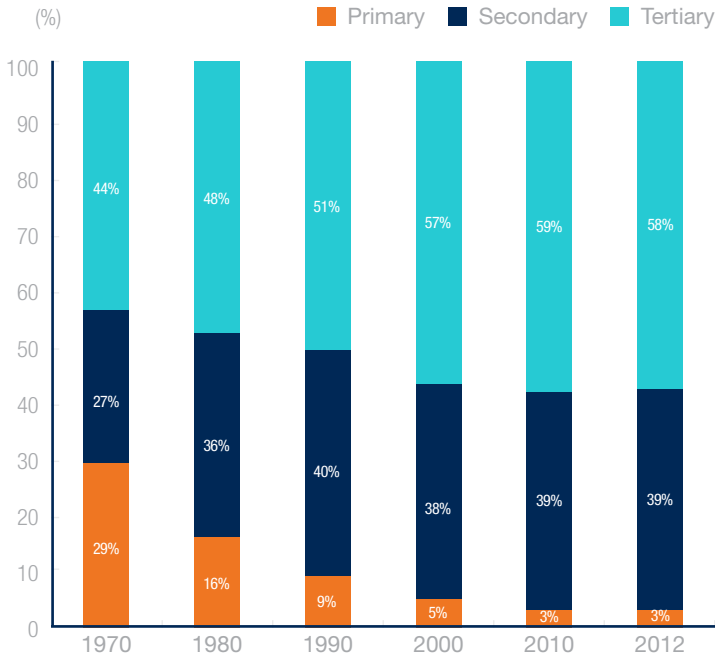
³ Korea Creative Content Agency (2015)

⁴ Korea Tourism Organization, CLSA (2015)

⁵ Source: UBS Evidence Lab (April 2015)

Gross Domestic Product Composition Undergoes Structural Shift

Source: The Bank of Korea, Economic Statistics System (2015)



Note: Three Sector Theory, primary - raw material acquisition, secondary - manufacturing and assembly, tertiary - services.

Its lack of natural resources has prompted Korea to focus on indigenous capabilities in research, education, and high tech development. These industrial policies paved the way for resilient leaders in the sectors of LCD/display, automobiles, semiconductors, and shipbuilding by the likes of Samsung, Hyundai, SK, LG, and Hanhwa.

More recently, agile and asset-light players such as Naver Corporation's LINE Messenger have capitalized on the quickly evolving digital ecosystem to build captive native messenger platforms that are expanding beyond Korea and Japan into international markets (e.g. Taiwan, Thailand, and Indonesia). They are also entering into new verticals to boost monetization, such as mobile ads, O2O⁶ (transportation), e-commerce, and content (news, games, music, video, etc.).

These investments have put Korea at Number 1 in Bloomberg's innovation index in 2014, 2015, and 2016; Number 1 in manufacturing value-added and tertiary efficiency; and Number 2 in R&D⁷, high-tech density, and patent activity.⁸

World-Leading Internet Infrastructure

Source: Akamai's State of the Internet Report (Q2 2015)

Rank	Country/Region	Q2 Average Megabits per Second (Mbps)
1	South Korea	23.1
2	Hong Kong	17.0
3	Japan	16.4
4	Sweden	16.1
5	Switzerland	15.6
6	Netherlands	15.2
7	Norway	14.3
8	Latvia	14.2
9	Finland	14.0
10	Czech Republic	13.9
	Global Average	5.1

Fostering an Indigenous Innovation Spirit

Source: Bloomberg Innovation Index (2016)

Rank	Economy	Total Score	R&D Intensity	Manufacturing Value-Added	Productivity	High-Tech Density	Tertiary Efficiency	Researcher Concentration	Patent Activity
1	South Korea	91.31	2	1	39	2	1	6	2
2	Germany	85.54	8	3	32	5	17	14	3
3	Sweden	85.21	5	16	16	9	16	5	8
4	Japan	85.07	3	13	29	5	34	9	1
5	Switzerland	84.96	7	8	3	10	25	13	5
6	Singapore	84.54	17	5	5	13	2	7	24
7	Finland	83.80	4	18	26	23	4	3	7
8	United States	82.84	10	26	8	1	37	21	4
9	Denmark	81.40	6	22	13	21	18	2	10
10	France	80.39	15	39	15	4	12	18	11
11	Israel	79.81	1	35	35	7	29	1	20
12	Russia	78.85	31	27	18	8	3	27	15
13	Austria	78.45	9	11	14	30	7	11	13
14	Norway	77.07	21	43	1	12	24	8	19
15	Ireland	76.67	24	7	12	25	6	24	22
16	Belgium	76.19	13	23	10	21	31	22	17
17	United Kingdom	74.92	22	44	30	11	9	20	14
18	Netherlands	74.90	18	28	24	15	41	16	9
19	Canada	73.44	23	40	19	17	22	12	26
20	Australia	73.42	14	47	2	16	21	15	32

⁶ O2O denotes "online-to-offline"

⁷ R&D denotes "research and development"

⁸ Bloomberg, "These Are the World's Most Innovative Economies" (January 19, 2016) <http://www.bloomberg.com/news/articles/2016-01-19/these-are-the-world-s-most-innovative-economies>

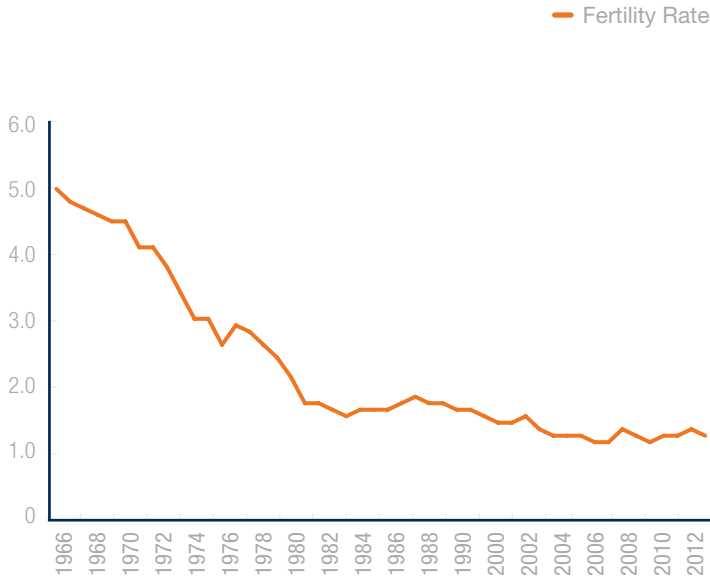
Country at a Crossroads

The industrialization and modernization of Korea has been accompanied by a marked decline in fertility rates over the past several decades, creating a rapidly ageing society. Fertility rates are down to nearly one-fifth what they were fifty years ago.⁹ At the same time, life expectancy has elongated, resulting in a shrinking labor force and growing number of senior citizens,

sapping productivity and economic growth rates. The median age in Korea has gone from 19 in the early 1970s to around 40 today, and is projected to rise to 53 by 2050.¹⁰ One of the few benefits of this demographic shift has been the growth in business for pharma and healthcare companies, which are expanding their top lines to meet growing demand.

Fertility Rates have Plummeted

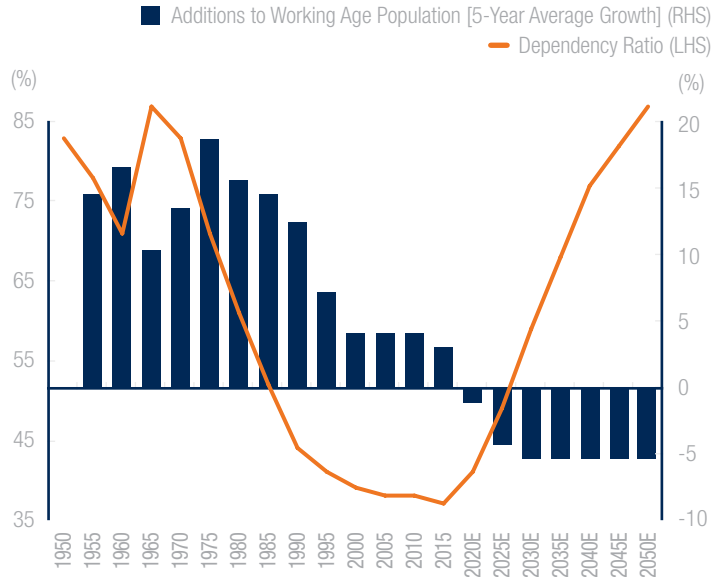
Source: World Bank Development Indicators (Accessed in 2016)



The country also faces a high stakes leadership handover from the second to third generation of Chaebol families. Technology-driven citizen advocacy movements favoring transparency and opposing elitist special interests pose a daunting test for a government that is increasingly under pressure to tackle thorny social and economic issues such as stagnant wages, higher youth unemployment, female gender equality, mounting household debt levels, elevated senior citizen poverty rates, deflationary forces, subdued economic growth and persistent social inequality.

Draining the Size of the Labor Force

Source: United Nations Department of Economic and Social Affairs, World Population Prospects (2015 Revision)



Note: Dependency ratio refers to the population aged 65 years and older as a % of labor force (aged 15-64)

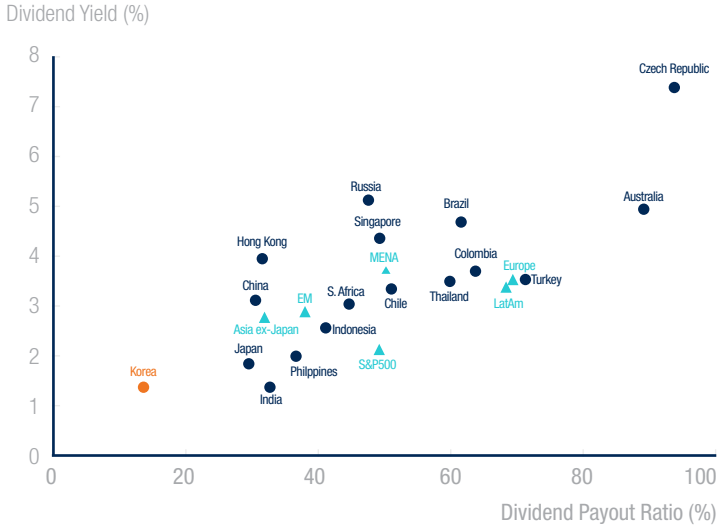
Accelerated information diffusion from widespread social media utilization and mobile adoption in Korea means corporate governance issues are high on the agenda for all stakeholders – government, industry, investors, civil society, and consumers. Hot button issues include the push for higher dividends and eliminating conflicts of interest against shareholders. Korea was ranked eighth in corporate governance scores by the Asian Corporate Governance Association in 2014, trailing countries such as India, Malaysia and Thailand.

⁹ World Bank Development Indicators (Accessed in 2016)

¹⁰ United Nations Department of Economic and Social Affairs, World Population Prospects (2015 Revision)

“Korea Discount” of Paying Out Low Dividends

Source: Bloomberg, Mirae Asset Global Investments (December 2015)



As Korea Trails Regional Peers in Corporate Governance Scores

Source: Asian Corporate Governance Association (2014)

Rank	Country	Total	CG Rules & Practices	Enforcement	Political & Regulatory	ICGAAP	CG Culture
1	Hong Kong	65	61	71	69	72	51
1	Singapore	64	63	56	64	85	54
3	Japan	60	48	62	61	72	55
4	Thailand	58	62	51	48	80	50
4	Malaysia	58	55	47	59	85	43
6	Taiwan	56	48	47	63	75	47
7	India	54	57	46	58	57	51
8	Korea	49	46	46	45	72	34
9	China	45	42	40	44	67	34
10	Philippines	40	40	18	42	65	33
10	Indonesia	39	34	24	44	62	32

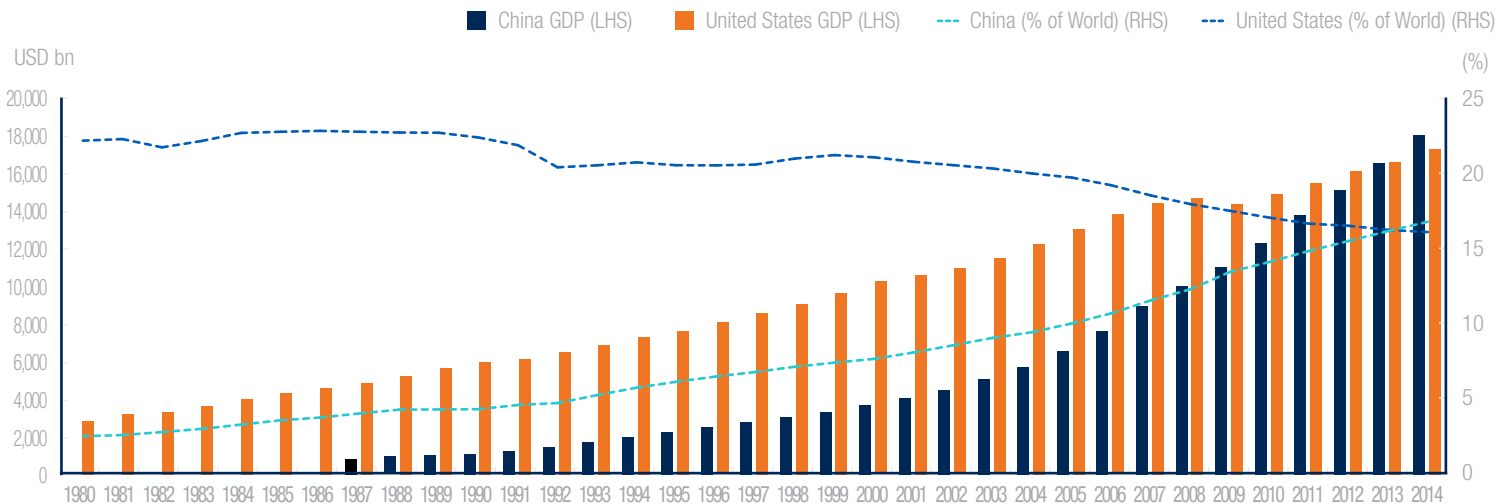
Geopolitical Balancing Act

Korea must strike a balance between a close economic interdependence with China and its traditional US alliance with its related security umbrella. Neither relationship has been without its episodes of strain. This balancing act is proving to be all the more daunting as Sino-American interests in Asia diverge and sharpen

in their differences, most notably regarding the region’s peace and security framework. The widening positions between the two superpowers mirrors a new era from a neoliberal American hegemony to global political pluralism comprised of several major powers, both in economic and military clout.

Total GDP¹¹ and Share of World (current prices, 2015)

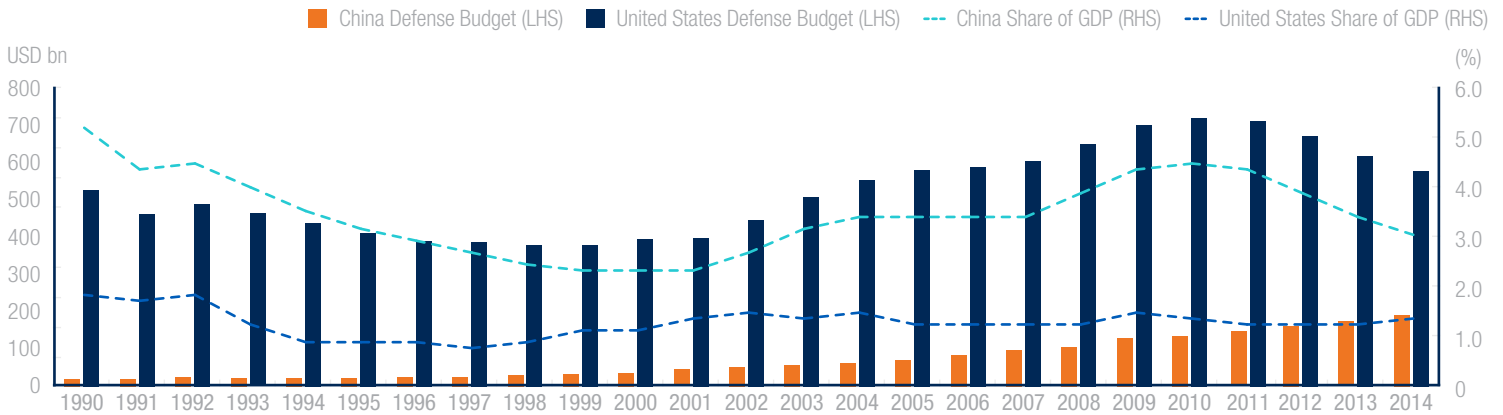
Source: International Monetary Fund, World Economic Outlook Database, Mirae Asset Global Investments (2015)



¹¹ GDP denotes “gross domestic product”

Defense Spending of the Eagle and the Dragon (constant prices, 2011)

Source: Stockholm International Peace Research Institute, Mirae Asset Global Investments (November 2015)

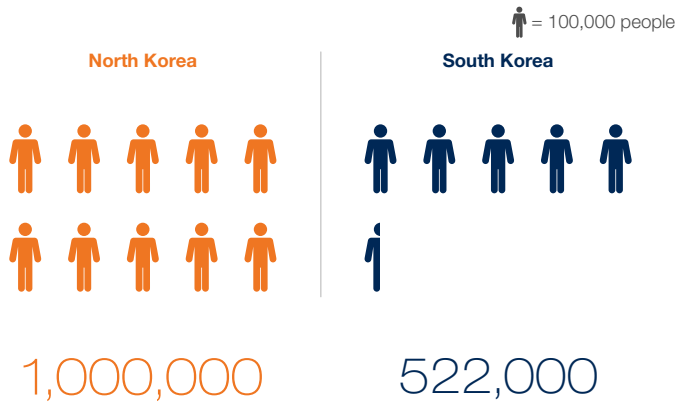


Geopolitical risks involving North Korea have flared in recent years and cannot be ruled out in the future, as the isolated North Korean regime continues to flaunt U.N. sanctions and make

seemingly erratic decisions. North Korea once more ratcheted up tensions with the announcement of a nuclear test in January 2016 — the fourth of such controlled experiments.

A Million Man Army

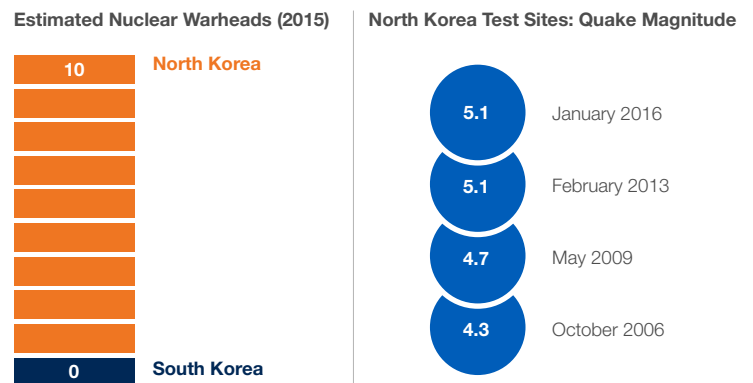
Source: Military Balance 2015, International Institute of Strategic Studies



Sentiment on the peninsula itself has hardened into a status quo following decades of sustained military standoff, with North Korea maintaining a standing army that is almost twice as large as South Korea's. While the consensus is that reunification remains

The Manhattan Project in Pyongyang

Source: The Economist, United States Geological Survey (January 2016)



far off, the pros and cons for such an event would be mixed, although it would likely exact an onerous short-term cost on South Korea's economy.

¹² United Nations Department of Economic and Social Affairs, World Population Prospects (2015 Revision)



Over the medium and longer term, however, South Korean industry would benefit from the North's cheap and younger labor pool coupled to an unsaturated client base of approximately 25 million people.¹²

Economy & Industry: North vs. South Korea

Source: Bank of Korea, Statistics Korea, The Economist (2015)

Gross National Income (2014, USD bn)



Gross National Income per Person (2014, USD '000)



Total Trade of Goods



Mobile Phones (2014, Millions of Subscriptions)



Transformation: From Goods to Ideas

Korea embodies the notion of an economic miracle, successfully reinventing itself from a factory floor into a world-class high-tech innovation hub with national champions competing globally. The country has risen from the poverty and ashes of the Korean War in the early 1950s to the world's 13th largest economy in 2015.¹³ This remarkable progress is testament to the sheer willpower and enduring work ethic instilled throughout society, translating into vigorous competitiveness for select firms within sectors that benefit from positive secular growth trends.

Despite the headwinds the country is facing, the subdued topline growth rate masks pockets of resilience. We believe that there are ample opportunities for active investors and stock pickers who can manage risk and identify business models built on solid fundamentals with proven track records: high barriers to entry, strong competitive dynamics, limited reliance on outside support,

Together with more natural resources and a larger land mass, reunification would provide structural drivers to the peninsula as a whole.

Divergent Resource Endowments

Source: CIA World Factbook, The Economist (2015)

Population (millions of people)



Median Age (2015 Estimated)



Iron-Ore Production (2013, Million of Tonnes)



Land Mass (Square Kilometers, '000)



sustainable returns, and talented management.

The speed of change in Korea is accelerating on existing 21st century world-class infrastructure with an early adopter, nimble population. In such a setting, we believe winners will emerge in cloud, online-to-offline, smart devices, biotech, and software segments that are not yet entirely reflected in the KOSPI equity index, as many of these new players are not listed or have yet to realize their full potential. In addition, a glut of high-skilled graduates confronted with diminished job prospects will endeavor in entrepreneurial projects, providing impetus toward flourishing start-ups and unicorns in the years ahead.

As Korea continues to transform, investing in sustainable business models at reasonable valuations will remain paramount in our view.

¹³ International Monetary Fund, World Economic Outlook Database (2015)



Global Offices

Mirae Asset Global Investments

East Tower 26F, Mirae Asset CENTER1 Bldg,
67, Suha-dong, Jung-gu,
Seoul, Korea (100-210)
Tel.+82-2-3774-8200

Mirae Asset Global Investments (HK)

Level 15, Three Pacific Place, 1 Queen's
Road East, Hong Kong, HK
Tel.+852-2295-1500

Mirae Asset Global Investments (UK)

4-6 Royal Exchange Buildings,
London, EC3V 3NL, United Kingdom
Tel. +44-20-7715-9900

Mirae Asset Global Investments (USA)

1350 Avenue of the Americas,
33rd Floor, New York, NY, 10019, USA
Tel. +1-212-205-8300

Mirae Asset Global Investments (Taiwan)

6F, NO. 42, Sec.2 Zhongshan N. Rd.,
Taipei City 10445, Taiwan (R.O.C)
Tel. +886-2-7725-7555

Mirae Asset Global Investments (India)

Unit No. 606, 6th Floor, Windsor Building
Off. C.S.T Road, Vidyanagari Marg.
Kalina, Sanatacruz (East), Mumbai
400 098, India
Tel. +91-22-6780-0300

Mirae Asset Global Investments (Brazil)

Rua Olimpíadas, 194/200,
12 Andar, CJ 121, Vila Olímpia
São Paulo, CEP 04551-000, Brazil
Tel: +55-11-2608-8500

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