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What's it going to take for Vietnam to become an "Emerging Market"?

Vietnam's stock market has developed significantly over the past few years, fueling speculation that the country's "graduation" from frontier to emerging market (EM) status by MSCI is imminent. Pakistan made the grade in 2017 (although Bloomberg reported in March that it could face downgrade back to frontier after falling below several thresholds; its current market cap stands at USD54 billion) while Argentina, a country that seems to be regularly on the financial brink and whose stock market cap was USD140 billion, could join the EM index this year. Meanwhile, Kuwait, whose stock market cap was about USD96 billion in 2018, may be put on the watchlist for possible upgrade to EM status next year.

Barring a surprise, Vietnam (2018 stock market cap: USD170 billion) is unlikely to join Kuwait on the watchlist in 2019. Vietnam already meets most of MSCI's quantitative requirements for EM index inclusion, including market size, sufficient number of large cap stocks with sufficient daily trading liquidity, and other metrics. However, Vietnam still has some work to do to meet the MSCI's qualitative guidelines, which focus on openness to foreign investment and the ease of capital inflows and outflows in the country.

Why is MSCI-EM inclusion important?

- There are about USD200 billion of ETFs that track the MSCI-EM index, and probably a comparable amount of money invested in mutual funds that are "closet indexers" which more-or-less track the MSCI. When Vietnam gets included in the MSCI-EM index it will almost certainly trigger over USD3 billion of inflows to Vietnam's stock market.
- Stock markets go up by about 30% in the 12 months preceding EM index inclusion – although Indonesia and Russia went up by about 150%.
- If Argentina is upgraded to the EM index, Vietnam's weight in the FM index will increase from about 16% at present to 30%, which would also trigger inflows to Vietnam's stock market, although the amount money tracking the FM index is far less than the EM index.
- FTSE put Vietnam on the watch list for upgrade to its EM index late last year, with the next review to occur in September 2019. While less money tracks the FTSE EM index, it could still prompt USD1 billion of new inflows to Vietnam's stock market (average annual inflows over the last three years were USD1 billion).

<u>What needs to change?</u>

Perhaps the biggest hurdles to EM index inclusion are related to Vietnam's Foreign Ownership Limits (FOL), which impede investors' abilities to buy all of the individual stocks that they want, and also presents serious operational issues for foreign fund managers.

When a stock has reached its FOL, the only way a foreigner can buy the stock is by purchasing from another foreigner, which would typically be done at a 7-10% premium to the prevailing market price.

The main problem this presents to the buyer is that this stock that he now owns will be "marked-to-market (MTM)" at the prevailing market price, so this investor will immediately suffer a 7-10% loss on that transaction (although he would make a gain equivalent to the prevailing FOL premium when he sells the stock).

The MTM problem can only be alleviated by setting up a separate “foreign board” on which stocks bought and sold between foreigners can be marked-to-market, or by introducing “Non-Voting Depository Receipts (NVDR), which have been very successful in Thailand, for example.

Another problem the FOL introduces is that many of these trades between foreign investors that are done with an FOL premium are done off exchange, which entails seeking case-by-case approval for those transactions.

Until 2015, FOLs on all industrial companies were 49%. That year, the Vietnamese government began letting most companies (except for those in certain sensitive sectors) choose their own FOL, but to date, only a small number – just 33 of nearly 750 listed companies – have elected to entirely remove their FOLs. Banks were and continue to be limited at 30% foreign ownership.

In November 2018, the government released a draft of a new securities law that could potentially set the default FOL to 100% for most listed companies (excluding banks). This legislation was not discussed at the most recent meeting of the National Assembly, which could mean that the soonest it will be discussed is at the *May 2020* National Assembly. We believe that the passage of this law is probably a prerequisite for Vietnam to be put on the watchlist for MSCI-EM index inclusion.

Beyond FOLs, Vietnam continues to fall short in a few other key areas:

- FX Liberalization: It needs to be easier for investors to take money in and out of Vietnam, and to hedge the FX risk on investments that foreigners made in Vietnam.

- English language issues: Listed companies’ annual reports, accounts and other materials are mostly in Vietnamese. Furthermore, not all information from the stock exchange or even regulations is available in English.

- Short Selling: Not allowed.

- Clearing House: The Vietnam Securities Depository (VSD) needs improvement because trades currently need to be pre-funded, there are no overdraft facilities, and other technical issues.

Given the number of changes that have to occur and the slow pace of legal reform, we believe that Vietnam’s promotion to EM status will occur in the next two years.