

KOREA FUND INC
Form N-CSR
August 29, 2012
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM N-CSR

CERTIFIED SHAREHOLDER REPORT OF REGISTERED
MANAGEMENT INVESTMENT COMPANIES

Investment Company Act file number **811-04058**

The Korea Fund, Inc.

(Exact name of registrant as specified in charter)

555 Mission Street, Suite 1700, San Francisco, CA
(Address of principal executive offices)

94105
(Zip code)

Lawrence G. Altadonna

1633 Broadway,

New York, New York 10019

(Name and address of agent for service)

Registrant's telephone number, including area code: 212-739-3371

Date of fiscal year end: **June 30, 2012**

Date of reporting period: **June 30, 2012**

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Item 1. Report to Shareholders

Annual Report

June 30, 2012

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The Korea Fund, Inc. Portfolio Manager's Report

June 30, 2012 (unaudited)

During the fiscal year July 2011 to June 2012 (the Period), global equity markets went through a rollercoaster ride amid an on-going European debt crisis and a slower than expected economic recovery and policy response from the U.S. and China. The downgrade of the U.S. sovereign debt rating to AA+ by Standard & Poor's on August 8, 2011 crushed market confidence, which was standing on fragile ground amidst the prolonged European debt crisis. While global equity markets have been hit hard, the negative impact on Korean equities was worse due to emerging market currencies being sold-off in September 2011 as foreign investors withdrew money from emerging markets. Nonetheless, the Korean equity market started to rebound in the fourth quarter of 2011 on the back of the improving U.S. macro data, some progress in European Union (EU) policies, and signs of potential policy easing from China. In addition, undemanding valuation and the depreciation in the Korean Won after a sharp sell-off in August attracted foreign investors back to the Korean equity market. The market continued to ascend into the first quarter of 2012, led mostly by leading Korean exporters as they continued gaining global market share, helped by improved product quality, and competitive pricing on the back of the cheaper KRW. Then, another market sell-off came in May 2012 as risk of Greece's exit from the Euro emerged and the risk of contagion into Spanish banks and Italian sovereign debt increased in May.

Consequently, the KOSPI declined 11.74% in KRW terms and 17.73% in USD terms during the Period, flipping the previous fiscal year's 41.57% rally in USD terms. The MSCI Korea Index, the Fund's new benchmark from 2012, declined 8.23% during the Period in KRW terms and 14.46% in USD terms. The weaker performance in USD represents KRW depreciation from 1,068 to 1,145, including the 52-week low point of 1,180 during the May 2012 sell off.

Fund's Performance

For the Period, the Korea Fund's total return on an NAV basis was -15.25% (net of fees). The Fund's NAV outperformed the KOSPI by 62 basis points in USD terms for the six months ended December 31, 2011 and it underperformed the MSCI benchmark by 85 basis points in USD terms for the six months ended June 30, 2012.

Performance Attribution Review

Consumer staples and information technology were the best performing sectors while industrials and financials underperformed the Index. During the Period, stock picks in consumer discretionary and consumer staples sectors contributed to the Fund's performance while an underweight in the IT sector detracted from the Fund's performance. While the IT sector performed strongly, the Fund is subject to a fundamental investment restriction that limits concentration to a particular industry to 25% and which resulted in underperformance compared with the Fund's benchmark during the Period.

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The Korea Fund, Inc. Portfolio Manager's Report

June 30, 2012 (unaudited) (continued)

Macro-economic review

For the Period, the European debt crisis has been the center of attention, causing equity market volatilities and real economy slowdowns around the world. In the recent EU Summit, European policymakers took an important step towards breaking the negative feedback loop between banks and sovereigns by agreeing to move towards European bank supervision and eventually allow the European Stability Mechanism (ESM) to inject capital into banks directly. However, even though the journey is progressing, many risks remain and are expected to dominate market sentiment going forward.

In Korea, exports remain the backbone of economic growth, although exports slowed down towards the second quarter of 2012 along with the global economic slowdown. In the third quarter of 2011, exports were strong, growing 21.5% year-on-year, and continued with a 9.1% increase in the fourth quarter 2011. However, weakening external demand, especially from Europe and a sluggish China, took a toll on Korea's export growth. While Korea's exports in automobiles and machinery remained relatively resilient, exports in vessels, LCDs, and semiconductors quickly declined due to weak external demand and the industry cycle. Automobile exports were also boosted by free trade agreements between Korea-Europe and Korea-U.S.

Korea's inflation has been on a downward trend since July 2011. Consumer Price Index inflation was still at 4.3% in the third quarter of 2011, driven by high food prices, housing rents and transport prices. However, it eased to 4.0% in the fourth quarter of 2011, 3.0% in the first quarter of 2012 and only 2.4% during the second quarter of 2012, due to stable food prices and the lowering of international commodity prices, particularly oil. Given that inflation is on a downward trend, we might see a rate cut from Bank of Korea, which kept its policy rate unchanged at 3.25% for past 12 months.

As per geopolitical issues, the sudden death of North Korean leader Kim Jung Il in December 2011 triggered a one-day equity market correction followed by a quick and sharp rebound the next day. Kim Jung Eun, the son of Kim Jung Il, was declared the new leader of North Korea. While uncertainties still remain around Kim Jung Eun's leadership direction and style, geopolitical risk is not new to Korea and the status quo is likely to remain as long as North Korean leadership remains within the Kim family.

Market Outlook

We expect the equity market will continue to remain sensitive towards macro headlines. While we may not see many positive catalysts in the near term, especially ahead of possibly a disappointing earnings season, we believe headline news has been disappointing to the point where the scope for more downside appears limited. In addition, after the sharp correction in May, equity market valuations look attractive. The MSCI Korea's forward price/earning ratio (PE) has dropped to 8.1x, which is below its long-term average of 9x. Cheap valuation, together with potential policy support and limited downside from the global economy, may trigger a

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The Korea Fund, Inc. Portfolio Manager's Report

June 30, 2012 (unaudited) (continued)

rebound in the Korean equity market during the second half of 2012, similar to what occurred during the second half of 2011. During that period, sentiment and valuation declined in August 2011 following S&P's U.S. credit rating downgrade; however, the market started to come back in October to coincide with earnings upgrades, global Purchasing Managers Index (PMI) turnaround, and policy responses in Europe with the fiscal compact and subsequent European Central Bank long-term refinancing operation. It is possible that similar catalysts may work during the second half of 2012. As such, we will look for opportunities in companies whose earnings are resilient with better visibility. As for exporters, we believe the leading exporters will continue to outperform their competitors. In 2011, 70% of Korea's exports went to emerging markets where growth is outpacing that of developed markets. Monthly data indicate that May and June 2012 exports to countries of the Association of Southeast Asian Nations (ASEAN) increased 6.9% and 13.9%, respectively, while exports to the EU and U.S. remained negative with no change in exports to China for June. Additionally, the Korean Won has remained weak against the Japanese Yen since the global financial crisis four years ago. With the FX windfall gain, Korean exporters had room to improve marketing and R&D while competitors might have been struggling to optimize cost to survive competition. We believe such focus on marketing and R&D will have a lasting impact on the competitiveness of Korean exporters' continued penetration into global markets.

The information contained herein has been obtained from sources believed to be reliable but RCM and its affiliates do not warrant the information to be accurate, complete or reliable. The opinions expressed herein are subject to change at any time and without notice. Past performance is not indicative of future results. This material is not intended as an offer or solicitation for the purchase or sale of any financial instrument. Investors should consider the investment objectives, risks, charges and expenses of any mutual fund carefully before investing. This and other information is contained in the Fund's annual and semi-annual reports, proxy statement and other Fund information, which may be obtained by contacting your financial advisor or visiting the Fund's website at www.thekoreafund.com.

This information is unaudited and is intended for informational purposes only. It is presented only to provide information on investment strategies and opportunities. The Fund seeks long-term capital appreciation through investment in securities, primarily equity securities, of Korean companies. Investing in non-U.S. securities entails additional risks, including political and economic risk and the risk of currency fluctuations, as well as lower liquidity. These risks, which can result in greater price volatility, will generally be enhanced in less diversified funds that concentrate investments in a particular geographic region. The Fund is a closed-end exchange traded management investment company. This material is presented only to provide information and is not intended for trading purposes. Closed-end funds, unlike open-end funds, are not continuously offered. After the initial public offering, shares are sold on the open market through a stock exchange, where shares may trade at a premium or a discount. Holdings are subject to change daily.

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June 30, 2012 (unaudited)

Total Return⁽¹⁾	1 Year	5 Year	10 Year
Market Price	-15.59%	-1.99%	11.46%
Net Asset Value (NAV ⁽²⁾)	-15.25%	-2.61%	9.45%
KOSPI ⁽³⁾	-17.73%	-3.02%	10.01%
MSCI Korea (Total Return) ⁽⁴⁾	-14.46%	-0.44%	11.60%
MSCI Korea (Price Return) ⁽⁴⁾	-15.24%	-1.52%	10.13%

Premium (Discount) to NAV:

June 30, 2002 to June 30, 2012

Industry Breakdown (as a % of net assets):**Market Price/NAV:**

Market Price	\$36.56
NAV	\$40.51
Discount to NAV	-9.75%

Ten Largest Holdings (as a % of net assets):

Samsung Electronics Co., Ltd.	
Manufacturer of electronic parts	22.0%
Kia Motors Corp.	
Manufacturer of automobiles	4.8%
Hyundai Motor Co.	
Manufacturer of automobiles	4.8%
Hyundai Mobis	
Manufacturer of automobile components	3.7%
POSCO	
Manufacturer of steel	3.2%
LG Chemical Ltd.	
Manufacturer of petrochemical goods and electronics materials	2.9%
Korea Zinc Co., Ltd.	
Manufacturer and refiner of non-ferrous metals	2.8%
Samsung C&T Corp.	
Construction and trading businesses	2.6%
Hotel Shilla Co., Ltd.	
Operates hotels and duty free shops	2.6%
LG Household & Health Care Ltd.	
Manufacturer of consumer goods	2.5%

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- (1) **Past performance is no guarantee of future results.** Total return is calculated by determining the percentage change in NAV or market price (as applicable) in the specified period. The calculation assumes that all income dividends and capital gain distributions, if any, have been reinvested. Total return does not reflect broker commissions or sales charges in connection with the purchase or sale of Fund shares. Total return for a period of more than one year represents the average annual total return.
Performance at market price will differ from its results at NAV. Although market price returns typically reflect investment results over time, during shorter periods returns at market price can also be influenced by factors such as changing views about the Fund, market conditions, supply and demand for the Fund's shares, or changes in the Fund's dividends.
An investment in the Fund involves risk, including the loss of principal. Total return, market price and NAV will fluctuate with changes in market conditions. This data is provided for information purposes only and is not intended for trading purposes. Closed-end funds, unlike open-end funds, are not continuously offered. There is a onetime public offering and once issued, shares of closed-end funds are traded in the open market through a stock exchange. NAV is equal to total assets less total liabilities divided by the number of shares outstanding. Holdings are subject to change daily.
- (2) See Note 8 in the Notes to Financial Statements.
- (3) The Korea Composite Stock Price Index (KOSPI) is an unmanaged capitalization-weighted index of all common shares on the Stock Market Division of the Korea Exchange (formerly the Korea Stock Exchange). The KOSPI returns, unlike Fund returns, do not reflect any fees or expenses. It is not possible to invest directly in the index. Total return for a period of more than one year represents the average annual return.
- (4) Morgan Stanley Capital International (MSCI) Korea Index is a market capitalization-weighted index of equity securities of companies domiciled in Korea. The index is designed to represent the performance of the Korean stock market and excludes certain market segments unavailable to U.S. based investors. The MSCI Korea (Total Return) returns assume reinvestment of dividends (net of foreign withholding taxes) while the MSCI Korea (Price Return) returns do not and, unlike Fund returns, do not reflect any fees or expenses. It is not possible to invest directly in the index. Total return for a period of more than one year represents the average annual return.

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June 30, 2012

Shares		Value
COMMON STOCK 97.4%		
Auto Components 8.8%		
182,070	Hankook Tire Co., Ltd.	\$ 7,260,825
59,223	Hyundai Mobis	14,355,415
367,820	Nexen Tire Corp. (d)	6,547,247
340,692	Pyeong Hwa Automotive Co., Ltd.	5,795,808
		33,959,295
Automobiles 9.6%		
90,419	Hyundai Motor Co.	18,562,500
283,112	Kia Motors Corp.	18,659,822
		37,222,322
Chemicals 6.2%		
22,676	Honam Petrochemical Corp.	4,766,176
44,169	LG Chemical Ltd.	11,434,267
205,531	SKC Co., Ltd. (d)	8,000,933
		24,201,376
Commercial Banks 7.0%		
334,414	DGB Financial Group, Inc.	4,089,219
194,900	Hana Financial Group, Inc.	6,230,596
229,440	KB Financial Group, Inc.	7,495,089
264,262	Shinhan Financial Group Co., Ltd.	9,264,381
		27,079,285
Construction & Engineering 5.1%		
420,620	Hyundai Development Co.	8,997,125
110,273	Hyundai Engineering & Construction Co., Ltd.	6,341,115
27,129	Samsung Engineering Co., Ltd.	4,304,519
		19,642,759
Consumer Finance 0.6%		
81,988	Samsung Card Co. Ltd.	2,301,122
Electronic Equipment, Instruments & Components 1.3%		
272,115	LG Display Co., Ltd. (b)	5,137,371
Food Products 0.8%		
2,292	Lotte Confectionery Co., Ltd.	3,133,315
Hotels, Restaurants & Leisure 2.6%		
207,952	Hotel Shilla Co., Ltd.	10,177,896
Household Durables 1.7%		
120,585	LG Electronics, Inc. (d)	6,497,426

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Household Products 2.5%		
17,833	LG Household & Health Care Ltd. (d)	9,621,229
Industrial Conglomerates 1.3%		
104,026	LG Corp.	5,052,817
Insurance 2.9%		
21,155	Samsung Fire & Marine Insurance Co., Ltd.	4,198,015
88,339	Samsung Life Insurance Co., Ltd.	7,218,818
		11,416,833
Internet & Catalog Retail 1.6%		
63,953	Hyundai Home Shopping Network Corp.	6,258,638

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June 30, 2012 (continued)

Shares		Value
	Machinery 2.7%	
32,384	Hyundai Heavy Industries Co., Ltd.	\$ 7,389,332
94,050	Samsung Heavy Industries Co., Ltd.	3,114,556
		10,503,888
	Metals & Mining 7.1%	
54,444	Hyundai Steel Co.	4,053,058
32,277	Korea Zinc Co., Ltd.	10,980,072
38,852	POSCO	12,438,545
		27,471,675
	Multiline Retail 1.2%	
329,065	Hyundai Greenfood Co., Ltd.	4,790,971
	Oil, Gas & Consumable Fuels 0.9%	
73,165	GS Holdings	3,375,641
	Pharmaceuticals 1.0%	
52,233	Dong-A Pharmaceutical Co., Ltd. (d)	3,847,859
	Semiconductors & Semiconductor Equipment 23.9%	
347,321	SK Hynix, Inc. (b)	7,334,045
80,541	Samsung Electronics Co., Ltd.	85,291,841
		92,625,886
	Software 1.8%	
28,511	NCSOFT Corp.	6,839,785
	Textiles, Apparel & Luxury Goods 1.8%	
100,273	Fila Korea Ltd.	6,847,738
	Tobacco 1.5%	
83,682	KT&G Corp.	5,932,665
	Trading Companies & Distributors 3.5%	
173,270	Hyundai Corp.	3,279,111