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Foreign managers count on China market's inefficiency for years to come
Institutional push notwithstanding, it's still a retail market in China

By Douglas Appell

Shanghai and Shenzhen's status as big, inefficient equity markets offering rich opportunities for active management appears safe for the foreseeable future, foreign money managers say, even as Beijing lays the groundwork for institutional investors to eventually eclipse China's man on the street as the market's dominant players.

Foreign managers have long cited local retail investors' roughly 80% portion of daily A-shares market turnover as a factor that's helped them beat their benchmark indexes. The past month, however, has seen Beijing ratchet up its efforts to boost institutional investor participation in China's equity markets, both in terms of quantity as well as quality.

Among recent initiatives, the one promising the greatest long-term impact came on April 21, with Beijing's long-awaited announcement of a framework for a third-pillar, private pension leg of China's retirement safety net. The voluntary system of personal retirement accounts outlined by regulators is designed to complement a Pillar 1 state pension system facing growing demographic headwinds and Pillar 2 supplementary employee pension plans that after decades still cover only a small fraction of the country's workforce.

With key details still to be announced, including the scale of tax breaks Beijing will offer, early estimates of how fast China's private pension asset pool will grow have varied widely.

Ng Sze Yoon, Singapore-based principal, distribution insights, with New York-based fintech firm Broadridge Financial Group, said the combination of a favorable regulatory environment and product innovation should prove more important in expanding private pension savings than tax breaks in a country where a large portion of the less affluent doesn't pay any taxes. She predicted Pillar 3 AUM will jump to 3 trillion yuan ($450 billion) by 2030 from roughly 120 billion yuan at present.

Z-Ben Advisors, the Shanghai-based financial sector consulting firm, is even more bullish, calling for Pillar 3 AUM to surge to 12.3 trillion yuan by 2030.

At the same time regulators were laying the groundwork for a flood of institutionally managed pension money to eventually find its way into the market, they were also exhorting big domestic institutional investors to boost their equity allocations as well as raise their games in areas such as value investing, long-term analysis of corporate earnings and governance-related engagement.

The China Securities Regulatory Commission, at an April 21 meeting attended by China's 2 trillion yuan National Social Security Fund and the principals of leading banking and insurance companies, said in a news release that it had called on that collection of the capital market's "most important sources of long-term funds" to increase their equity allocations.

Many A-shares portfolio managers in the region dismissed those calls as just the latest instance of Beijing enlisting its so-called "national team" — big, domestic institutional investors that have proved to be open to suggestion when Beijing or regulators are looking to stabilize the market or reverse a sell-off. Chinese stocks are presently in the middle of one such prolonged slump, initially set off in mid-2021 by an aggressive regulatory squeeze that brought the country's high-flying internet platform stocks down to earth. More recently, rising geopolitical tensions and the economic fallout of COVID-related lockdowns in Shanghai have weighed on stock prices.

Long-term goals

Others see longer-term policy goals in play.

In order to achieve more efficient and high-quality market development, regulators are calling on institutional investors now to enhance their investment capabilities, with a long-term perspective, noted Rachel Wang, Morningstar Inc.'s director of manager research, China. They're urging those investors to focus more on developing equity products, strengthening their equity research capabilities and boosting their engagement activities on governance-related topics, she said.

And still others see a combination of long- and short-term goals: "In the immediate term, this call for 'support' is all about mitigating plunging Chinese equity prices (but it's) also consistent with the long-term goal of reducing the share of direct retail investors in the Chinese market," said Daniel Celeghin, a New York-based managing partner with asset management strategy consultant Indefi.

At the end of the day, however, Beijing's goal of a more efficient market will require domestic institutions to step in — and not in a short-term capacity, said Jason Hsu, founder and chief investment officer of Santa Monica, Calif.-based Rayliant Global Advisors. With China's equity market at $13 trillion and growing, they will need "long-term pension capital and a lot of it," he said.

"The more interesting question is how China will balance the necessary messiness of market-based price discovery with their strong policy preference for stability and predictability," Mr. Celeghin said.

Some analysts say that desire to tame markets is one factor behind Beijing's preference for more institutional money going forward in Shanghai and Shenzhen. The government would certainly like to see greater institutional participation, said Peter Alexander, Z-Ben's managing director and founder. "It's far easier to control the market when you've got institutions involved than 130 million Chinese individuals," he noted.

While most portfolio managers concede China's A-shares market will inevitably become more institutional, many predict retail investors will continue to account for the bulk of turnover over the coming decade, leaving ample room to harvest alpha.

Making China's onshore market more institutional will be a long, multifactor process, said Claire Shen, Hong Kong-based head of China equity, investments Asia, with global investment and consulting firm Willis Towers Watson PLC. A meaningful drop in the 80% share of trading by retail investors has yet to be seen, leaving stock prices prone to "overshoot and undershoot" and creating alpha opportunities for disciplined investors, both domestic and foreign, Ms. Shen said.

Some market veterans, meanwhile, hesitate to pin the blame for Shanghai and Shenzhen's volatility and inefficiency on China's retail investors. The way institutional managers, including foreign ones, focused on the same crowded trades in technology, electric vehicle and pharmaceutical stocks over the past five years — powering gains of a few hundred percent followed by a 50% to 95% plunge over the past year — hardly reeks of efficiency, noted Wong Kok Hoi, founder and CIO of APS Asset Management Pte. Ltd., a Singapore-based boutique focused on Chinese stocks with more than $2 billion in assets under management. "It's difficult to make the case that the increasing participation of institutional managers has made the market more efficient," he said.

The market's attractions for active managers can be tied to a range of factors above and beyond the dominant role played by retail investors, such as its size and liquidity as well as the fact that it's underresearched and underowned, said Jessica Tea, a Hong Kong-based investment specialist with BNP Paribas Asset Management Asia's Greater China equities team.

But as retail investors gradually lose ground to their institutional counterparts, market volatility is likely to diminish, Ms. Tea said.

Morningstar's Ms. Wang said increased institutional activity will inevitably "make life for active managers harder," but the process will take time.