China's Surprising Insider Tip

Academic research shows companies can have sound reasons for selective disclosure.

By Christopher Langner
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When it comes to China, it's hard to understand a company's business in depth without having a personal connection to the managers and owners. That's a statement that applies to almost every emerging market, and that investors generally accept as the price of operating in less transparent and rule-based environments.

Such a self-evident proposition may hardly seem worthy of academic proof, though a group of researchers has now sought to quantify it. More surprisingly, they conclude that such selective and limited dissemination of information can actually be good for companies and the market.

The words "limited dissemination" immediately prompt thoughts of insider tips and that's what we would be talking about in the U.S. But in the case of China -- or India, Peru, or even South Africa for that matter -- things aren't so clear-cut. At least that's what Zengquan Li, from the Shanghai University of Finance and Economics, T.J. Wong, from the Chinese University of Hong Kong, and Gwen Yu, from Harvard Business School, assert in a paper <http://www.bschool.cuhk.edu.hk/faculty/cbk/article.aspx?id=47387943> published in April. In their words:

> *Emerging markets firms "face a tradeoff where greater transparency may lead to a lower cost of capital, but at the cost of revealing proprietary information in their relational business practices."*

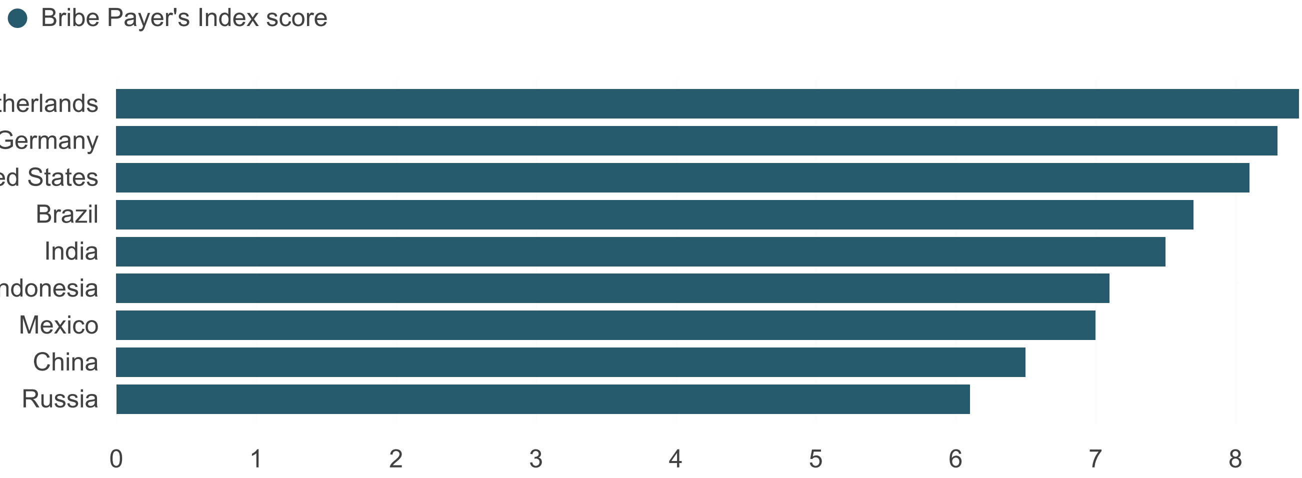
Translation: Companies could get cheaper capital if they told everyone how they got the contract to build that stadium, but if they did so they might be shut out from future deals. Instead, they tell a few trusted analysts, who pass it on to their circle of investors, and the information gradually makes its way through the market. Yes, those who heard it first probably made money, but the important thing is that everyone eventually knows something they wouldn't have otherwise. Imperfect disclosure is better than none at all.

Why does this sound wrong? Because it is. A tilted playing field means greater uncertainty, higher risk and ultimately a more expensive cost of capital. The insiders get the benefits, while the market and economy as a whole pay the price.

Wong, one of the paper's authors, concedes that everyone ideally should get the information at the same time, something that even regulators in the U.S. struggle to enforce. Such a goal may be impractical in environments such as China, where the legal and regulatory environments are more opaque and where personal connections, or guanxi, consequently play a bigger part in greasing the wheels of commerce.

Can We Cut a Deal?

China beat only Russia with the second-worst score the last time Transparency International published its Bribe Payer's Index, in 2011



Source: Transparency International

* The higher the score, the lower the likelihood that companies there pay bribes. Not all index constituents are shown.

Fairness aside, if you're investing in one of these companies you want to know whether they have the guanxi to get their plans and projects rubberstamped. The company can hardly include a note in its annual report stating that "in the course of the past year we acquired an important connection with a senior regulator who will ensure our projects continue to get approved."

Selective disclosure to trusted analysts allows the information to be disseminated, in coded form, through published reports without jeopardising the company or its connections. Examining data on 2,460 firms and 6,099 analysts from 2005 to 2014, the researchers found that when a firm is followed by more ``connected'' analysts, the consensus forecast of all analysts becomes more accurate.

Fiercer enforcement of insider dealing is unlikely to be effective, because the problem isn't who gets the information so much as what Wong calls "relationship-based contracting," a cultural tradition that runs much deeper than stock market norms.

Until companies stop needing connections to do business in these countries, investors will continue to need those relationships to get the full picture. Those who don't like it may just have to stay away.

This column does not necessarily reflect the opinion of Bloomberg LP and its owners.

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