STOCKS

George Yang -- Guanxi distorts China stock picks

May 20, 2016 22:10 JST

It is a common assumption that the opinions of equity analysts are subjective and that their recommendations should be taken with a grain of salt in making investment decisions. In China, where personal connections often form the basis of professional relationships, there is evidence that their opinions often serve a more specific function -- that of personal gains for the analysts and their friends in mutual fund companies.

A closer look at this phenomenon reveals how "veiled friendships" can distort market information and hurt investors. Compared with other markets, equity analysts have a particularly powerful position in China.Because of the strong influence they wield, their opinions can lead to substantial financial gains or losses for both institutional and individual investors.

When it comes to institutional investors, mutual fund managers often have close relationships with financial analysts. In fact, it is very common to find analysts speaking positively about the stocks that certain mutual fund managers have chosen for their portfolios, while withholding negative opinions even when there is bad news.

Given the lack of integrity and objectivity in stock analysis it is no surprise that Chinese financial analysts are among the world's worst performing, according to a Bloomberg report published in early May.

Analyzing the predictions of analysts and the performance of the Shanghai Composite Index -- which lost more than a third of its value in the year from the end of April 2015 -- Bloomberg found that Chinese analysts' predictions "were off by bigger margins than those of analysts researching stocks in the rest of the world's 20 largest markets." Had their forecasts been correct, the index would have ended the period 43% higher than it did.

How does this system, with its poor outcomes for investors, benefit analysts and fund managers? Why do they develop these symbiotic business relationships in the first place? The answer is related closely to economic incentives, financial disclosures and corporate governance.

Joint research by Zhaoyang Gu, a professor at The Chinese University of Hong Kong Business School; Zengquan Li, a professor at The Shanghai University of Finance and Economics; Guangqing Li from Galaxy Securities and myself found that mutually beneficial business relationships between analysts and fund managers are supported by less formal social network ties. This can be in the form of friendships forged in earlier employment, or relationships dating from school or university.

Known as *guanxi* in China, such social networks provide a solid base for mutual trust in a professional context. Since China's legal environment is relatively weak compared with more mature economies, while institutions that are meant to control irregularities in business are relatively feeble, social networks are often exploited to obtain privileged access to scarce resources or to collude against the public interest.

Our working paper, "Friends in need are friends indeed: the effect of social ties between financial analysts and mutual fund managers," investigated the benefits for analysts in publishing positive opinions about certain stocks, as well as the financial gains that fund managers get in return.

Both sides seem able to dispense rewards without being detected. Fund managers exploit their guanxi with analysts to achieve favorable analyses of the stocks they hold within a portfolio. This encourages a boost in the values of their portfolios, and directly augments their personal fortunes.

Some 1,200 funds in China managed by 70 mutual fund companies are periodically ranked on performance based on the stock prices in their portfolios. The rankings are pivotal in winning new investors, which in turn dictates the income of fund managers and their promotion chances. So the higher the value of portfolios, the more income fund managers receive.

"Star" analysts

How about the analysts? What do they get in return for writing favorable reports? We found two ways in which fund managers pay back favors from analysts.

First, they tend to cast their "star analyst" votes for the analysts with whom they have the closest connections. In fact, they play a crucial role in determining which analysts get this recognition, which can in turn bring analysts an immediate boost in publicity and a dramatic rise in income. We found that analysts with the most social ties to fund managers were more likely to be selected as "star analysts."

Another way for fund manager to return the favor is to allocate more trading through their preferred analyst's brokerage. As commission fees from institutional investors are the main form of revenue for analysts, those who are socially connected to fund managers are more likely to receive commission payments from their companies.

It is important to note that this kind of commission fee relationship is found only between certain pairs of fund companies and brokerages. Why? Evidence points to "primitive" social relationships, or guanxi, which have led eventually to transaction-based relationships.

Obviously, such social relationships can significantly distort market efficiency for investors, especially the smaller, individual investors who make up the bulk of the Chinese stock market and who are relatively unsophisticated when it comes to acquiring financial information and making investment decisions.

Unfortunately, the biases on both sides are extremely difficult to detect. And since the exchanges of interests and benefits are based on subjective opinions, it is virtually impossible to regulate this kind of activity. Unless you have hard evidence, you cannot establish deliberate bias in court. After all, opinions are not illegal.

Nonetheless, such behavior could be characterized as a type of insider trading. After all, analysts express biased opinions and managers conduct trades based on these biased opinions. In order to strengthen investor confidence, regulators must realize the severity of this issue and establish corresponding rules and regulations.

Fortunately, the biases do not seem to have gone completely unnoticed by the market. Our research showed that the market tends to discount quickly recommendations from "connected" analysts to buy certain stocks. In the months that follow, returns on such "recommended" stocks tend to drift downwards.

Analysts are aware that if this type of cheating becomes too rampant, they will eventually lose credibility. That is why we have observed that they tend to balance their biased opinions with genuine recommendations based on sound judgments. Otherwise no one would ever believe them.

Until regulators take action, we will have to rely on the market to discipline itself. However, if this kind of cloaked and unethical behavior spreads much more widely, the market will no longer trust either analysts or fund managers.

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