China's Retail-driven Equity Market a Wild Ride  
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by Inbok Song  
of Thornburg Investment Management  

Household equity market exposure still a small fraction of total household assets. For institutional investors, opportunities in companies benefitting from long-term, structural growth.

A year ago, as China's domestic A-share market roller coaster was ascending, I was in China meeting with executives from various companies. One of them told me how much money his wife had made in a single week. A few months later, I was back in China, and asked an Uber driver whether he was interested in stock market investing. “No, I think it is too risky, for sure. And you need money to invest.” As we are going through another round of volatility, with the Shanghai SE Composite Index (SHCOMP) down more than 20% since the start of January, I wonder how those two gentlemen are feeling about the stock market these days.

Compared to developed-country equity markets, China's stock market is dominated by retail, not institutional, investors. Individual investors account for around 80% of daily trading volume, the highest such level in emerging markets. Accordingly, trading infrastructure for retail investors is well developed. You can find many software apps dedicated to providing stock market news in real time. The largest trading platform and IT backbone service provider is a domestic company. Service providers need to please retail investors by cutting online trading commission fees to as low as a few basis points. Mobile plays a big role here, as well. One online broker told me that 20% to 30% of trading volume is already executed through mobile, and more than 95% of new accounts are opened through mobile terminals.

Clearly, China’s retail investors have yet to find their footing, and are not yet willing to step back into the market. Having fallen more than 30% since the beginning of the month, losses on the Shenzhen Stock Exchange Composite Index (SZCOMP) have exceeded those on the SHCOMP, which includes many of China's more established firms, including state-owned enterprises (SOE). The SZCOMP is dominated by retail investors, as it is composed of small- and medium-sized companies, not SOEs. If we go back to the start of the A-share rally since the end of 2014, SHCOMP has given back all its gains, and the SZOMP most of its, as well. What really drove China's equity rally was domestic liquidity and domestic retail investors, rather than mainland institutional and foreign investors.

While there is certainly a negative wealth effect from the stock market's fall, overall the impact is limited as Chinese households generally have high savings and low debt obligations. As of mid-2015, more than 55% of household financial assets were in bank savings accounts: 18% was in cash; 15.5% in stock; 4.1% in mutual funds; and 2.4% in other bank financial products, according to the
International Monetary Fund. Household financial assets, excluding property holdings, represent just 5% of total household assets. Therefore, overall household equity market exposure remains manageable.

So where are these active investors looking these days? They are heading into less risky and overseas investments. According to the Asset Management Association of China, money market and bond fund inflows rose more than 20% in December from the previous month, while funds with a qualified domestic institutional investor quota—which allows them to invest offshore—saw inflows of more than 9%. Tellingly, stock funds only logged a 1% monthly inflow in December 2015.

Nonetheless, structural developments provide interesting opportunities for long-term investors. Domestically, insurance industry assets continue to grow as premium-paying clients increase sharply in number. That’s because these products offer protection and are investment-linked. This represents a long-term positive trend, as it will help institutionalize overall stock market investing. For wealthier individuals, overseas investment and asset diversification is a new trend. Increasingly, they want professional wealth management services, including good mutual fund selection. Wealth management firms are experiencing impressive growth in clients and assets under management. They have started to team up with global asset management companies that want to tap into China’s pool of high-net-worth individuals.

China’s current market volatility is a challenge to its retail and institutional investors, as well as to foreign investors, including the Thornburg Developing World strategy. But, we continue to find companies in China that benefit from long-term, structural tailwinds, well beyond insurance and wealth management firms, to include e-commerce, Internet service and networking providers, health care, home appliance manufacturers, among others. A long-term focus is helpful in managing and capitalizing on the volatility.

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