Managing money for investors is the raison d'etre of an efficient stock market

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China's stock market has performed miserably this fall, with the Shanghai Composite Index lurking below 3,000 points. On October 27, 2023, it closed at 3017.78, topping 3,000 points at long last.

As the stock indices fell, talk of a bailout has been given fuel. Why should the market be bailed out? A common argument is that declining stock prices have made it harder for listed companies to secure financing, one of the market's key functions. Does talk like this ring a bell?

There may be differences in how such views are expressed, but the logic underpinning them is remarkably similar: China's economy must develop and change. New sectors and more efficient enterprises represent the way China should go, and they need the financial support of the stock market. This is the biggest reason for the stock market. If share prices fall sharply and trading volume slumps in their wake, then the market will hardly be able to serve the real economy as it should. For this reason, we have to rescue the market and maintain its stability.

This familiar view has been doing the rounds, but the author wants to make something clear: it's wrong. There is but one reason for developing the stock market, and that is to serve investors and provide the public with an effective risk management outlet. Financing enterprises is only an outcome of this approach. From this perspective, running the stock market for financing is like putting the cart before the horse.

Since the purpose of running the stock market is to provide an efficient way for investors to manage their finances, what can we do to achieve this goal? Explaining this is the main purpose of writing this article.

Asymmetric information and its consequences

Before explaining how to best run the stock market, we need to first understand what kind of market the stock market is? Where does its biggest threat come from? How should we respond?

Open the financial channel of any online portal and you will easily find stock news. You might not even trade in stocks, but the basic vocabulary such as index, market, and market capitalization will be familiar. The influence of the stock market is so profound and widespread that top policymakers cannot fail to pay attention to it. But when considered at its most basic level, the stock market is a place where stocks are bought and sold. In this respect, it is just like all other markets.

Transactions happen in the marketplace, and this is where asymmetric information comes in. When conducting transactions, one party does not have sufficient information about the other party and feels like they may be deceived into rushing a decision that impacts the efficient operation of the market. When you buy an ice cream, you usually only know its taste, appearance, and price, but little about its ingredients, and which ones might be harmful. If additives add color, flavor or extend the shelf life of ice cream to reduce costs, in a market that lacks effective supervision, ice cream sellers will compete on price for consumers. Competition on the basis of "quality" focuses on taste, but an excessive use of additives has become the norm. Who knows when some breaking news will provoke outrage, trigger lawsuits, and lead to the collapse of the ice cream market? The crisis in China's milk powder market caused by some producers adding melamine (an inorganic compound harmful to humans used to up protein content and mimic fresh milk) is a case in point. This milk is now subject to procurement quality checks that weren't there before the crisis, and the crisis has become a living case study in asymmetric information.

Generally speaking, during the transaction process, the seller knows more about the goods or services being sold than the buyer does. This characteristic of information asymmetry has led to two problems, one is adverse selection, and the other is moral hazard.

Let's look at adverse selection. This is a form of information asymmetry that occurs pre-transaction. It refers to the potential financiers who may generate credit risks often being the ones most keen on getting financing. For example, Company A is a poorly managed company on the edge of bankruptcy. In order to survive by hook or by crook, Company A will seek funds from every possible channel, regardless of costs.

Let's look at moral hazard. This happens post-transaction. Its specific meaning is that financiers may engage in activities that investors are not keen on because it harms their interests. For example, Company B went to the stock market and made RMB 1 billion through an IPO. Company B's executives should have put the money into production in an effort to earn profit for its investors, but its executives decided to buy a private jet instead.

There may also be issues with trading regulations in the stock market, such as insider trading and price manipulation. This is something China's stock market has suffered from for a long time. Delong and Xu Xiang are two such examples.

With bad money driving out good, adverse selection, moral hazard, insider trading and price manipulation, fewer and fewer good companies will list on the stock market, leaving only companies that are all too quick to harm investors' interests. Under such circumstances, investors are increasingly unwilling to put their money into the stock market, and its financing capacity starts to shrink. The stock market becomes somewhere with an even worse reputation than a casino.

Correcting the imbalances

Although all markets suffer from information asymmetry, the problem is more serious in the stock market. The stock market trades stocks, which are equity certificates, and equity includes rights to control and decide on cash flow. For small shareholders, control means participation in shareholders' meetings and voting on their resolutions. Cash flow rights mean that shareholders have ownership of a company's current and future cash flows in proportion to their shareholding. These rights may be invisible and intangible, but they are essential investor interests.

If we know next to nothing about the additives in an ice cream, we know even less about what makes up stock in a listed company. In the stock market, counterfeiters or scammers represent delineated entities and concentrated power, while investors are often scattered. Without external intervention, it is often very difficult for investors, especially small ones, to safeguard their rights. This means that most major stock markets around the world have ways of correcting the power imbalance. Listed companies tend to have to hire independent accounting firms to issue audits, publish operating statistics and release standard quarterly and annual reports. Chinese A-shares operate under similar conditions, but the gaps between system design and implementation have had an impact on the maturity of the stock market. Demonstrating the shortcomings of China's A-share market from the perspectives of supervision, market and law, here are some examples.

First, let's consider the regulatory aspect. It is clear that the penalties imposed by regulators on violations on the A-share market are too light. For example, from June to July 2023, the stock price of Jiangsu Southern Precision Co., Ltd. (Southern Precision) fluctuated significantly. On June 19, 2023, when answering investors' questions about "whether to enter Tesla's industrial chain", Southern Precision stated that "the company is currently cooperating with the two leading domestic manufacturers to develop new reducers, and relevant samples have been sent to Tesla in the US, receiving positive test results, and high recognition."

With word of Tesla's blessing, Southern Precision's stock price soared by a cumulative 46.8% by July 4, with the stock price reaching a maximum of RMB 21.57 per share. All this came to an end on July 4 when Southern Precision admitted to an "exaggerated and misleading statement", after which its stock price plummeted.

How should regulators deal with such violations?

On July 10, 2023, Southern Precision said it had received a warning letter from the regulators saying, "You should learn your lessons, enhance awareness of responsibilities of being a public company, improve knowledge of securities laws and regulations, and standardize information disclosure," to prevent such violations from happening again, and submit a written report to our bureau within 10 working days from the date of receipt of the decision on this measure." It seemed the company had been let off the hook.

In fact, in terms of supervision, multiple supervision bodies create a certain degree of regulatory competition. China Securities Regulatory Commission and the State Financial Supervision Administration (SAFE) exist with a degree of overlap, leading to rivalry.

Secondly, let's look at the market aspect. Regulation is a key part of curbing information asymmetry and illegal transactions, but the market also has a role to play. Muddy Waters Research, founded by American Carson Block, was based on the expression "fishing in muddy waters" chosen by Block, who has a longtime experience with China and knows about its rampant fraud problem. When increasing numbers of Chinese firms started to list in the US after 2000, Block speculated that fraud was probably rife among them.

Based on this idea, he developed a profit model whereby his company would investigate Chinese companies listed in the US for fraud. If evidence was found, Muddy Waters would short-sell their stock before issuing its report. If the contents of the report was recognized by the market, the stock prices of these companies would plummet or it would be made to delist, and Muddy Waters, which short-sold its stock in advance, would profit.

Many Chinese companies have fallen under its investigation, including Luckin Coffee. It has made mistakes, for example when it short-sold New Oriental Education Technology Group Co., Ltd. (New Oriental for short) shares, before the market turned to back the company, raising share prices again.

Many people in China see short-sellers as bad people, or at least not good people, but the example of Muddy Waters tells us that the market itself can play a role in purifying the market environment. We should be more tolerant of short-selling, and even encourage its use to a certain extent.

And what about the legal aspects? The biggest difficulty for small investors when defending their rights is that they lack organization and have trouble joining together. Supervision and the market itself can make up for this to some extent, but another way is to let small investors pool together at low cost. This will let them stand up for their rights. The class action system in the US is a case in point, vastly reducing the cost and difficulty small investors have in defending their rights.

A certain degree of legal regulatory competition is to be encouraged. For example, when a case covers a wide scope, investors can appeal across various regional courts, largely stopping a court deliberately favoring a defendant. This may waste some judicial resources, but as strong supervision is necessary for the stock market, the sacrifice is worth it.

Cleaning up the source

Major stock markets around the world show us that without corrective measures, the stock market gathers detritus, becoming a place where adverse selection and moral hazard are rampant, alongside insider trading and price manipulation. And who wants to invest their hard-earned money in such a swamp?

Our criterion for measuring the success of the stock market is neither whether companies can obtain financing more conveniently nor how much their stock prices have risen, but whether the stock market has become an effective risk management channel for regular folk.

Only when we control adverse selection and moral hazard by administrative, market and legal supervision, and crack down on insider trading and price manipulation, can we really clean up the stock market. When it is operating well and companies are putting the interests of small shareholders first, investors may stop being reluctant to invest real money in it. What kind of structural issues will remain?

International experience tells us that instead of puzzling over how to control IPOs and reduce stamp taxes on stock transactions, it is better to step out of the vicious circle of short-term regulation, develop a sound system, and seek to benefit investors above all. This is the only way we can reset the stock market on the road to prosperity.

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