JASPER CAPITAL

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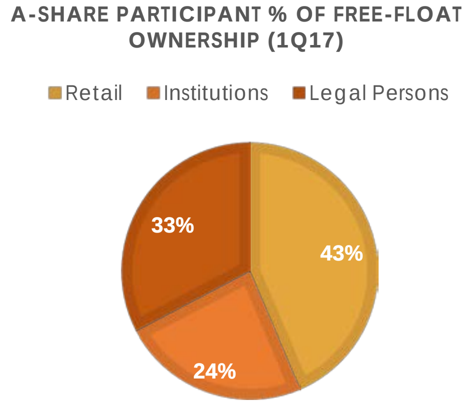
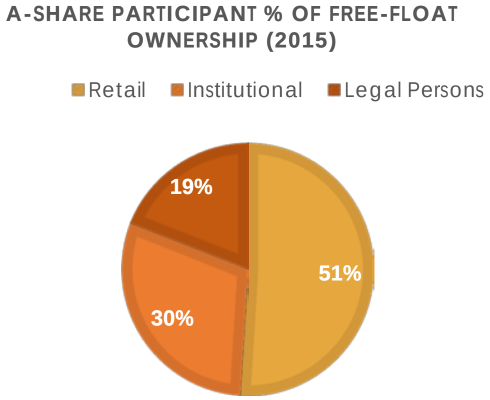
Inefficiencies in the Chinese equity markets are often attributed to the disproportionate level of retail investor participation.

In this month's China Insights Letter we focus on the changing level of retail investor participation in China and whether or not recent observed changes are having an impact on market efficiency.

Based on free-float market capitalization, we estimate retail investors accounted for roughly 43% of total shareholder ownership in 1Q17; Institutional investors accounted for 24% of total ownership; Legal Persons ("LPs") accounted for the balance of free-float market capitalization ownership.





Dr. Jason Jiang, Portfolio Manager

Compared to 2015, the level of retail investor ownership has edged lower. The decline observed has been used by some to support the argument that institutions are having a greater influence in China's equity markets, which in turn has promoted greater market efficiency.

While data shows that retail investor's proportion of shareholder ownership has declined in recent years, this data indicates that the proportion of institutional ownership has also fallen. The reduction in retail and institutional percent ownership has been countered by a rise in Legal Person's proportional ownership; Once Non-tradable Legal Person shares are now being converted into free-float shares and held by LPs. The argument that a rise in the proportional share ownership by institutional investors is ushering in greater market efficiency does not seem to be firmly supported by ownership data.

From our point of view, it is too early to conclude that, because the level of retail investor ownership has edged lower in recent years, China's markets in turn have become more efficient. This conclusion rests upon two assumptions that are difficult to make: 1) a direct, strong relationship between equity market efficiency and the level of retail ownership exists; and 2) the recent decline in the proportion of retail investor equity ownership represents a long-term trend that is unlikely to reverse.

In regards to the first assumption, we believe the trading volume and trading frequency of retail (institutional) investors holds a stronger relationship with the level of market efficiency compared to ownership. In 2016, retail investor trading volume accounted for greater than 80% of total trading volume, while retail investor turnover remains well above the average turnover of institutional investors.

As the composition of trading volume and turnover characteristics have not underwent significant changes in recent years, it seems unlikely that market efficiency has significantly improved.

In regards to the second assumption, looking back over the history of China's modern equity markets, retail investor influence has always waxed and waned. For instance, China's markets saw a period of relative calm characterized by low trading volume and a stronger institutional influence in 2012. However, less than three years later, in 2015, a surge in retail investor influence lead to greater equity market volatility and inefficiency.

Trading Volume and Daily Volatility Waxes and Wanes

	2012	2015	2017
Daily Volatility (STDV)	1.17%	3.07%	0.81%
Avg. Daily Amount (Billion ￥)	129.14	1031.17	465.344

Another factor to consider is how new technologies have eased the spread of information, which in turn has possibly allowed retail investors to become more informed and more sophisticated in their investment approaches. Technological progress could be a potential argument supporting the idea that China's markets are becoming more rational despite the still dominant stance of retail investors in the Chinese equity markets. However, technology and the ease of access to information cuts both ways. Thanks to increasingly rich data sources and continued technological improvements, institutional investors can now better track the activities of retail participants. Based on this improved tracking, institutional investors often make decisions that mimic retail investor sentiment and consensus driven investment themes. Therefore, it's extremely difficult to determine which investor grouping (retail or institutional) is exerting more influence onto the market.

In conclusion, while retail investors' proportional ownership has edged lower in recent years, it is difficult to draw a conclusion that this decline represents a reduction in the influence that retail investors exert in the Chinese equity markets. **We believe that given China's regulatory environment, lack of capital gains tax on public equity investments, absence of defined contribution benefit plans, and typical overconfidence of the average retail market participant, a significant increase in market efficiency is unlikely to occur over the next 10-15 years.**

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