The Effectiveness and Misunderstanding of Value Investment in China’s Stock Market

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Abstract: With the development of economy and the improvement of people's knowledge level, equity-related investment plays an increasingly important role in asset allocation. Value investment is becoming more and more a concept of people's pursuit of learning. But the effectiveness of the market and understanding of the value investment accurate can become the correct application of value investing in the stock market the key to profit. Starting from the stock market of our country, this paper discusses the validity of the floating capital of market value and the misunderstanding of value investment by ordinary investors.

1. Introduction

"The stock market is a blessing for patient investors and a trap for impatient ones," buffett once said. If value investment can beat the market all the time, then there will be countless investors pouring in, which will surely lead to the failure of value investment strategy. China's a-share market was born in 1990 and has developed for 29 years. During this period, the depth, breadth and structure of the market have undergone tremendous changes.

As a value investor, you may need to hold some stocks that most investors despise. You need to get away from noisy, impetuous comments. The test of value investment is human nature, investors need patience and focus.

2. What is market effectiveness theory


Malkiel, author of a walk on Wall Street, argued in 1992: "if a market is efficient, it accurately and completely reflects all information about prices. More formally, markets are efficient if the price of a security is not affected by disclosure. Furthermore, if markets are efficient, it is impossible to obtain additional economic benefits through information analysis and discovery."

Imagine if everyone have the same information, everyone have the same way of valuing securities, what would the market look like? This is essentially the hypothesis of market efficiency. There is a definition of efficient market in finance: in the security market, the price can fully reflect all available information, all prices in the market are the most fair and reasonable price, and no investor can beat the market to obtain excess returns.

The establishment of market effectiveness is based on the following basic assumptions:

(1) All information about securities prices can be fully disclosed and disseminated so that each investor can get the same amount of information of equal quality at the same time;

(2) Investors are sufficiently rational to produce consistent analysis and trading with the same information;

(3) Securities are traded at no cost and have a smooth transmission mechanism, allowing prices to adjust quickly to the relevant information.

Market effectiveness is specific to different data sets, so there are three forms of efficient market theory:

(1) Weak form of market effectiveness: the information set only contains the historical information of stock price;

(2) Semi-strong form of market effectiveness: information set contains all publicly available market information, including stock price information and macroeconomic information;
(3) Strong form of market effectiveness: information sets contain all relevant information, not only publicly available information, but also private information.

3. **Current situation of stock market effectiveness in China**

Market effectiveness is the basic basis for value investors to operate. The first step to value investing is to understand the effectiveness of China's stock market. The effectiveness of the stock market in that year has the following three shortcomings.

3.1 **Insufficient and timely information disclosure.**

In the previous explanation of market value effectiveness, it has been mentioned that market effectiveness is closely related to information disclosure. Only when the stock price in the stock market can timely and fully reflect all the information in the market, can the market be effective.

China's stock market is far from this condition, especially the adequacy, immediacy and authenticity of information disclosure in China's stock market is far from enough. False information, misleading information, information disclosure is not in a timely manner and other phenomena often appear, making investors appear asymmetric information acquisition phenomenon.

3.2 **Investors are not structured properly.**

In the hypothesis of market effectiveness, a mature stock market has certain requirements for the proportion of medium and small investors and institutional investors. According to the requirements of the market effectiveness hypothesis, the fund amount of institutional investors accounts for more than 70%, while the fund amount of medium and small investors accounts for less than 30%.

However, according to the data shown in the statistical yearbook of Shanghai stock exchange (volume 2018), the market value of natural person investors in China was about 5944.5 billion yuan at the end of 2017, accounting for 21.17%. And professional investment institutions holding the market value of 4529.4 billion yuan, accounting for only 16.13%. The imbalance of investment proportion results in short holding period, frequent trading and short-term speculation of Chinese investors.

3.3 **Investors are not strong, there is excessive speculation.**

The unreasonable investor structure mentioned above leads to the short holding period, frequent trading and short-term speculation in China's stock market. For one thing, the structure of investors is unreasonable; for another, investors in the market are not rational enough, with weak investment ability and insufficient knowledge reserve. In the efficient market hypothesis, all investors are assumed to be completely rational, to interpret information comprehensively, and to make investment decisions that are reasonable based on the analysis of information. However, it is clear that most investors in the a-share market are unable to reach A completely rational level.

Most investors in China's stock market lack systematic investment knowledge and risk control ability, and cannot judge the impact of information on stock prices. Therefore, many investors' investment behavior is speculative, often manifested as a strong "chasing after the rise and killing the fall" mentality. When the market rises, people tend to think that the stock price will rise further, so they take an active investment strategy. When the market falls, people tend to think that the stock price will fall further, so they take a negative investment strategy, which will affect the supply and demand relationship of the stock market, thereby affecting the stock price, aggravating the risk of the market and reducing the effectiveness of the market.

Throughout the domestic stock investment market, the investors required by the market efficiency theory to make investment decisions completely rationally are quite different from the actual operation of investors. In practice, investors have irrational psychology such as cognitive bias, overconfidence, risk-taking psychology and herd mentality, which lead to irrational behaviors such as "herd behavior".
4. The Driving Factors of Stock Market Effectiveness in China

The increasing efficiency of China's stock market is closely related to the change of investor structure and ability. In recent years, the proportion of individual investors in the current market value of a-shares has been declining, while the proportion of generalized institutional investors, including general legal persons, has been rising. Compared with individual investors, institutional investors have advantages in professional competence and greater tolerance in terms of term and liquidity. In addition, institutional investors are often better than individual investors in information collection, analysis and understanding, and more rational and objective in price judgment. Thus, the higher the proportion of institutional investors in the market, the higher the market efficiency.

With the improvement of future income per capita, market entry barriers loosening, and perfect for the construction of the enterprise annuity system, is expected to have more assets management companies, insurance companies, pension funds and foreign institutional investors into the a-share market, institutional investors structure trends will continue to strengthen, which will further improve the effectiveness of the market.

In recent years, with the rapid development of network technology, information transmission speed and precision of the rapid, exist in the original investors gradually narrowed, "information gap" between the distribution of the information in the market tends to flatter, more investors have the ability to be more objective and accurate judgment, which in turn promoted the rising market effectiveness.

5. Value Investment Error

The year 2017 has been called the "first year of value investment" by many people in the industry. By contrast, I have no comment. Indeed, if mentioned value investment before, there are many people are very disdain for it, that value investment is "empty talk", that according to the theory of value investment can not achieve investment profits.

After 2017, however, a large number of people began to pursue value investment. While people gradually accept value investment, there are various misunderstandings in the process of understanding and time of value investment. To this end, the author summarizes some common mistakes in the process of value investment, so that everyone "demining".

5.1 Long-term holding is not a value investment

As mentioned above repeatedly, long-term holding cannot prove value investment, and many investors will unilaterally equate the two. Many investors believe that once they have bought a stock or several stocks, leaving them to rise or fall is a value investment. In fact, if you accidentally choose the wrong stock, even if you hold the stock for a long time will not help, if the stock itself has no value, or always can not reach the safety margin, then the long-term holding will only make their losses, more and more deep.

That is to say, value investment is long-term investment, but long-term investment may not represent value investment. There are plenty of misguided investors who have repeatedly cited buffett's dictum, such as "if you don't want to own a stock for 10 years, don't think about owning it for 10 minutes," as proof that they are value investors.

However, buffett also once said that "time is the friend of a good enterprise and the enemy of a bad enterprise". If investors insist on holding a stock of an enterprise without prospects, competitive advantages and industrial uniqueness, they will not only lose a lot of money, but also waste their precious time.

5.2 Buying blue chips is not a value investment

A lot of value investor think value invests to need to buy big blue chip only can, they think blue chip achievement is good, share out bonus is much, buy blue chip is equal to value investment namely. Actually, this is also wrong thinking, because:

(1) If you buy into blue-chip stocks when their overall valuations are high, you risk getting
caught if future implied yields fall.

(2) If you are buying a blue chip that is cyclical or whose fundamentals are deteriorating, you will have the same problem of volatile earnings. The characteristic of cycle type individual stock itself is "geomantic and alternate turn", very likely can appear this year market is good, next year market is bad circumstance. Blue chips whose fundamentals are deteriorating may have been affected by the turmoil in the overall industry, and may have no chance to recover once they fall.

5.3 Contrarian investment is not value investment

A lot of people confuse value investment with contrarian investment, and actually, value investment may be contrarian investment, but contrarian investment is not necessarily value investment. Value investors, who misunderstand the relationship, often cite buffet's dictum that "be greedy when you are fearful, and be fearful when you are greedy" as the basis for contrarian investing.

In my opinion, the essence of buffet's words is to remind investors to think independently and rationally at all times, and not to be blinded by greed.

Value investment is not simply to guide investors to reverse investment or unconventional, but to guide investors in understanding the enterprise, the market, the industry, based on the development of their own investment plans, choose whether to go against the trend. In fact, most of the time, there's nothing wrong with following the crowd. Even when the judgment of many people is unanimous, it often indicates that the choice is match with the situation. For example, most investors and economic commentators previously agreed that a stock was not optimistic and did not recommend investors to buy it. If you make a contrarian investment at this time, then the end of the failure of the investment in the stock will be inevitable.

References