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# Psychological mechanisms of investors in Chinese Stock Markets

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**Abstract**

The study investigated the psychological mechanisms of risky investment behaviors in Chinese Stock Markets. A 42-item questionnaire was developed and distributed to 1547 individual investors recruited by stratified random sampling from Nan Fang Bond Company. A speculative orientation and a low level of risk perception among Chinese investors were revealed. The results also showed that investors were deficient in investment knowledge and skills. Structural equation modeling was used to generate a risk perception-mediated model for investment behaviors. We found that information from organizational/institutional level can precipitate low risk perception and policy-oriented speculation of investors, which could be accounted for by the collectivistic culture in China and may not be beneficial to risk management in Chinese Stock Markets. Suggestions were made regarding the further development of stock markets in China.


*JEL classification:* G15

*PsycINFO classification:* 3920; 3040

*Keywords:* Chinese Stock Markets; Psychological mechanisms; Investment behaviors; Risk perception; Individual investors

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## 1. Introduction

Since the reform and opening up in 1978, China has gone through a rapid transformation from planned to market economy at the national level, and has been confronted with increasing challenges under the current trend of globalization. Its financial system has been undergoing a radical reform after China became a member of the World Trade Organization (WTO) in 2001. The transformation process however is associated with higher risk and uncertainty in the rapidly changing economic environment. According to the guidelines for future work regarding the Chinese financial sector (Chen, 2002), the Chinese government will put more emphasis on precautions against and reduction of financial risks.

Stock markets in China (e.g., Shanghai Stock Exchange, Shenzhen Stock Exchange, etc.) have been burgeoning remarkably since their establishment at the end of 1990 in response to the efforts of the Chinese government to develop a market-oriented economy. Having developed for ten years, the proportion of the total value of Chinese Stock Markets to GDP of China was up to 45% in 2001 (Huang, Lin, & Liang, 2002). However, compared with the more developed markets such as the New York Stock Exchange (NYSE) and the Tokyo Stock Exchange (TSE), Chinese Stock Markets are still in the elementary stage of development with an array of problems.

Firstly, Policies from China's Securities Regulatory Commission lack continuity and stability which precipitated severe "policy-oriented" speculation (Cheng, 2003). It is evident from the 26 highest rates of daily return ranging from 8.08% to 28.86% and 25 lowest rates of daily return ranging from −17.91% to −7.41% of the Shanghai Stock Exchange index from 1991 to 2002. These were all caused by policies or information relevant to stock market issued by the government. For instance, the State Council and the Chinese Securities Regulatory Commission decided to implement the "three market-saving policies". This piece of policy-oriented information accounted for 28.86% of return of the Shanghai Stock Exchange index the day after (Wang, 2003). Secondly, most listed companies have evolved from formerly state-owned enterprises. To ensure the state holding dominant shares, the percentage of liquid shares of list companies is commonly constrained to less than 50% so that the function of stock market becomes mainly on raising money from investors for state-owned companies rather than estimating the value of listed companies and improving the efficiency of capital use and allocation, causing a functional bias of stock markets. Thirdly, the benefits of investors have always been ignored and impaired. On the one hand, with respect to the dividend policies, listed companies in Chinese Stock Markets are generally implementing a non-distributive dividend policy (Song, 2003). The proportion of listed companies following non-distributive dividend policy was 59.8% in 1999. Only 7.44% of listed companies had distributed dividend continuously from 1997 to 2000. On the other hand, the performance of listed companies lacks continuously developing potential. For example, the average return on net asset of all listed companies had decreased from 15% in 1993 to 7.61% in 2000. In addition, there were only two listed companies suffering financial loss in 1994 which accounted for 0.68% of listed companies, but when it came to 2000, the amount of listed companies at a loss had increased to 96, accounting for 8.5% of listed companies. Therefore, in this sense, the non-distributive dividend policy might not be a good sign here showing the firm's capacity to generate new business but a sign revealing harm to investors' benefits. Last but not least, the annual turnover rates of Shanghai Stock Exchange and Shenzhen Stock Exchange ranged from 341% to 760% and 265% to 950% respectively from 1992 to 1998. The average P/E ratios in Shanghai Stock Market and