BARRON'S

Chinese Small-Caps Join Global Stock Swoon

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China's down 26% from last year -- even buoyant small-caps have fizzled.

THE BEAR CLAWED ASIA'S MARKETS last week, and Chinese shares are down 26% from their August peak. The continent, as measured by the Standard & Poor's Asia 50, is off 13%, pummeled by political risk, Europe's woes, and tightening regimes in the region. Until last week Chinese small-caps were buoyant, but Hong Kong's S&P GEM index board finally fell, giving it a 17% decline from late April, compared to a 15% drop for the Hang Seng.

"Investors have been wishfully believing that the small-caps in TMT [telecom, media and tech], retailing and pharmaceutical sectors wouldn't be affected by the tightening measures," says James Yuan, chief investment officer for Everbright Pramerica Fund Management in Shanghai. Clearly they were wrong. And the premium of small-caps over large-caps remains at record highs, Yuan says: Late last week, the CSI Small & Midcap 700 index traded at 23.4 times 2010 consensus earnings, versus 15.9 times for the CSI 300.

Not Immune: Asian stocks shared in the global equity downdraft last week.

Small U.S.-listed Chinese companies have also been popular with those betting on the China story, but they may be about to lose fans, thanks to a move by Russell Investments to reconstitute its indexes. That's because of Russell's so-called country-rule change, which it announced on March 1, and which takes effect in late June.

Russell outlines its thinking in a March paper entitled "Identifying Country of Risk in the Wave of Globalization." Globalization has "strengthened" the competitive position of companies but has also "complicated country risk assessment" for stock investors, says the paper. The problems are more acute for companies with customers in one market that are incorporated in another "where the legal system or business environment is most friendly." Baidu.com (BIDU), the Internet-search provider, is one example: It does business in China, is incorporated in the Caymans, and listed its depositary shares on Nasdaq, though the underlying shares are unlisted in China. "For security analysts and index providers, divergence in a company's legal and financial risks causes conflict in assigning a stock to a single country," says Russell. Another example, it says: Sohu.com (SOHU), which gets 100% of revenue from China, but trades and has headquarters stateside.

Among the companies that might be affected, according to a May 10 report by Roth Capital Partners, are a raft of U.S.-listed China stocks in the Russell 3000, including Sohu. Some $590 billion is benchmarked to the Russell 3000. The names include some prominent Chinese reverse mergers, including American Oriental Bioengineering (AOB), and American Dairy (ADY). The Roth analysts suggested that "event-driven weakness" in the stocks "could present a buying opportunity."

The Roth report makes interesting reading, particularly beside a front-page story that appeared May 13 in the bible of shell-company transactions, "The Reverse Merger Report." The story, entitled "China Shorts Face Uphill Battle to Out Fraud," described the "increasing" sophistication of investors shorting Chinese stocks: "They are starting to collect hard evidence of malfeasance on the part of Chinese companies." Though "regulators are quiet and [company] management seems almost wholly unconcerned," the story continues, the "information does raise a lot of good questions."

Some of those questions are about China Sky One Medical (CSKI), which John Bird, who posts on waldomushman.com, has criticized for alleged regulatory deficiencies. The company also happens to be on the Roth list. Bird looks for divergences between the company's filings on the mainland (with the State Administration for Industry and Commerce, or SAIC) and with U.S. regulators, identifying, among other things, big discrepancies in the cash balances the company reports to the U.S. and to mainland authorities. A spokeswoman said China Sky had addressed all questions in previous releases and conference calls, and that the company has corrected and resubmitted its SAIC reports.

Another company on the Roth list is copper-wire manufacturer Lihua International (LIWA). The Reverse Merger Report relates that a Michigan accountant named Steven Chapski, who is short the shares, claims to have found discrepancies in its accounts via a Chinese credit-rating agency, namely a net loss reported to the SAIC in '09 and a net profit to the SEC. A Lihua spokesman says the company has just filed its latest SAIC report and intends to provide more color.

The Reverse Merger Report says that "one investigator believes that almost one in three Nasdaq-listed Chinese companies has fraudulent underpinnings." Still, the article continues, infractions "may at times be the result of relatively innocent mistakes," citing that "connected-party transactions are common in China" and "two sets of books are standard practice." Buyer beware.