Li Lu's Speech at Peking University (2019)

After five years, I am delighted to have this chance to return to this course at Peking University's Guanghua School of Management to speak with you all again. Today is Thanksgiving in the United States, so let me take this opportunity to thank Professor Jiang Guohua of the Guanghua School of Management, Mr. Gene Chang of
Himalaya Capital, as well as all the students and supporters of value investing in the audience.

Thanks to all of you for your help these past few years spreading the word on value investing in China and supporting its practice. I've had some regrets since my first lecture here five years ago because I focused then primarily on the basic theories of value investing and whether they suited China. So this time, I will talk about the practice of value investing.

I'd like to first discuss my understanding of value investing's practical framework and then leave lots of time afterwards for your questions. The main point is to talk about the practical problems in value investment, the basic concept of value investment.

- First, stocks are part-ownership of a business. They are not just pieces of paper to be traded.
- Secondly, Margin of Safety: At its heart, investing is about making predictions of the future. However, we can only obtain some indication of probabilities as the future is inherently unpredictable. Therefore, we must leave ourselves a margin of safety.
- The third is that Mr Market is not here to guide you. We invest mainly to predict the future, but the future cannot be predicted.
- Lastly, Circle of Competence: Investors must build their own circle of competence through long-term study and then stick within it when investing.

Through long-term study, establish a stimulus that belongs to one's own circle of competence and then widen the scope of competence circle. This is value investing's basic intellectual framework. Its logic is simple and clear, and it's not hard at all to understand.

Moreover, this is the only investment style I know which can deliver superior risk-adjusted returns to investors over the long-term. For this reason, a lot of people have some knowledge of value investing, particularly thanks to Warren Buffett, its most famous practitioner. His success over the last sixty years has attracted a phenomenal amount of attention from all over the world. There are so few practitioners of value investing. In fact, I don't think it is more than five percent of the market participants. Today we are mainly talking about this, the unity of knowing and doing. Also, why do people so easily revert to other investment styles when they encounter difficulties in their practice?

Let's analyze those four concepts together one by one.

The first concept is that stocks represent part-ownership of a business. This is in fact a question of social institutions and the rights afforded to equity. If personal property rights are protected under a given regime, then the use of personal property and the exchange of those rights should also be protected. If personal property cannot be freely exchanged, then it's hard to say you have any 'rights' over it. For example, cash is clearly a form of property because we can freely use it whenever we wish and exchange it for the things we want. In this way, the protection a society affords to the exchange of equity is an important indicator of its attitude towards personal property rights.
Value investing can only exist if a society has such an institution.

If we look around today, we can see that it does indeed exist in China, and that the exchange of equity has been permitted. The condition that stocks represent part-ownership in a business has therefore been fulfilled.

Second, the Margin of Safety. This is really a question of methodology as there isn't any ambiguity in the concept. *Price is what you pay, value is what you get*. There is nothing special about this problem. It seems that this problem is mainly based on the assumptions made by the pioneers in our market. The main difficulties in practicing value investing must therefore come from the other two concepts: Mr. Market and the circle of competence.

Let's recall Mr. Market and how Benjamin Graham first described him. Graham said that we could imagine the stock market as an energetic figure who while not necessarily

malicious, does not possess good judgement or great intelligence. The first thing he does when he wakes up each morning is to call out all sorts of prices to you, regardless of whether you're interested or not. But Mr. Market has a manic personality; there will be times when he is particularly optimistic and so his prices will be high.
Then there will be times when he is particularly pessimistic and so his prices will be low.
For the most part, you can just ignore him, but when this equipment market but when Mr. Market becomes extremely worked up (either excited or depressed) you can use his extreme emotions to buy and sell. Now here's the problem:

When you are at school and hear about Mr. Market, you might think it all sounds reasonable. But as soon as you begin work and enter the market, you will realize that there are real people on the other side of every transaction. These people are all well-educated, have more money than you, have more power than you, and have more experience than you. They are all very successful and they are all your superiors. In other words, they don't at all resemble Graham's Mr. Market. In the process of transacting with them, you will often look wrong – at least in the short-term. After some time, you will have been continuously scolded by your boss and frustrated by your mistakes. You'll begin to feel that you're the sucker at the table, and so will start to doubt everything you once believed. This is the first difficulty we encounter practicing value investing and the reason many people go no further. And you think well, when the market is changing drastically, all the things I bought are losing money compared to what others bought. So what. I know that I am correct and others are wrong. So it is not so easy if this ability is fully utilized.

The second difficulty is defining our circle of competence. Where are its edges? How can you prove that you really understand something? When the market swings and all your stocks are down while everyone else's are up, how do you know that you're right and they're wrong?

Today I will focus on four questions relating to the challenges of Mr. Market and circles of competence. The first is the difference between investing and speculating. With my second question, I want to talk about what this circle of competence is and how to establish the circle of competence. The third is *"temperament", which both Warren and Charlie have said is an investor's most important attribute.* Some of your temperament is innate and some is cultivated. So what does it look like and how can you cultivate it? Fourth, how can an ordinary person protect and grow their wealth if they don't want to become a professional investor? I hope that these four questions will cover the majority of issues you will encounter in your practice.

Let me talk about these four questions. I hope I can cover the value of investment in time. When we invest in the stock market, we must first face the market. What is it? What kind of people operate there? And how do they behave? How do value investors fit in to this?

Let's first recall the history of the stock market. The modern stock market appeared about 400 years ago, which isn't a long time in the grand scheme of things. Before then, there weren't many commercial opportunities and so there wasn't a need for the stock market to exist. The most important thing to happen in that time was the discovery of the New World (i.e. the Americas) 500 years ago, which went on to bring one to two hundred years of high-speed economic growth to the whole of Europe. Along with the age of colonization, there appeared a few proto-companies. From where did the concept of a company come? Because founding colonies and trading across oceans was both risky and capital-intensive, the earliest colonial enterprises relied on the support and financing of the richest European monarchs. However, these monarchs were soon also unable to afford the money required and so partnered with the nobility. From this was born the earliest joint stock companies, whose ownership was dispersed and widely held. These companies grew fast and soon needed even more money, leading the monarchs and nobility to further disperse ownership and to allow ordinary people to use their savings and participate too.
The problem was though that ordinary people did not know how to value this equity.
They simply didn't understand how these companies made money. It was decided therefore to divide the equity into as small a unit as possible to reduce the amount required to invest, the most important design of this design caters to the human nature. It would also facilitate people to buy and sell at any time. This design suited the baser instincts of human nature: our greed, laziness and desire to get rich quick. If there is a way, we all want to use the minimum effort to gain the maximum reward. This is why we are willing to take risks and gamble, and why gambling has existed throughout human history. The earliest design of the stock market pandered to these baser instincts and proved very successful. The most important Dutch companies at the time were the East and West India Companies, with the former being especially well-positioned for a long-term period of growth. The money raised by selling equity was quickly used to grow the company's

operations, earning investors even greater profits, to invest in this, generate more profits, and form a positive cycle, so let's start this one and thus starting a virtuous cycle. However, more and more people were also attracted to the ability to trade at any time in the stock market. This liquidity created its own dynamic as people went from guessing the East India Company's results to guessing how other traders would behave.
Speculation made the early stock market very popular, and this helped more and more companies to flourish.

The stock market had another wondrous function: as more people participated in the market, more companies were attracted to list. A positive cycle. If these companies operated in a growing economy, they could raise money through the stock market to expand their production capacity, create more products and more value. The company can further develop, create more value, create more products, and give stockholders more money. The wealth this created enabled people to increase their consumption, closing the loop of the economy's virtuous cycle. Even though the stock market first made use of people's desire to gamble, once the number of participants and companies had reached a critical mass, the mechanism of this virtuous cycle could continue indefinitely as long as the economy itself could continue producing more such growing companies. About 400 years ago, another type of system slowly came into being: the modern capitalist system and its modern market economy. At this time, science and technology were themselves also undergoing revolutionary change which would continue for hundreds of years right up until today.

The combination of the Scientific Revolution and the market economy produced a phenomenon never before seen in human history: continuously compounding economic growth. Imagine a company growing its earnings every year at 6-7%. While this doesn't sound too high, after 200 years or more, those earnings will have grown by more than a million times. Just think about it. That is the power of compounding!
Where is the fear of the return of US dollars and then this kind of return will attract more and more companies recently. These kinds of returns will attract more and more people to the stock market, in turn essentially attracting more and more companies to list. This is the wondrous way in which the stock market works to mobilize all elements of society, even if it was never the original intention. Therefore, from the very start, the stock market had two types of participant: investors and speculators. Investors forecast companies' future

performance, the performance that has come is to predict the stock market participants and other people, but in a short period of time, what is the behavior of the two types of people? What is the difference? Where is the biggest difference between investment and speculation?

If you invest in a company in a sustainably growing economy, your company's profits and your investment return will also grow beautifully. If you speculate on other people's short-term trading behavior, there can only be one result in the end: gains and losses must equal because this is a zero-sum game. If you add up the gains and losses of all speculators in the market, they will sum to zero.

This is the biggest difference between investment and speculation.

I'm not denying that there are some speculators whose chances of winning are higher and who can go on winning for longer; equally there are some who will always be the sucker at the table and never strike it rich. If you give it enough time though, when you add the winners and losers together, the net result will be zero. The reason is that speculating on short-term behavior in the market adds nothing to the economy nor to corporate earnings growth. Some people say they use a mixed model of "80% investment, 20% speculation". If they do 70-80% of their work correctly, then such participants' returns will reflect the compound growth of the modern economy. However, the remaining portion will be caught up with all the other speculators and their result will be the same – zero.

Now that you know this result, will you choose to be an investor or a speculator? This is a personal choice and there is no right or wrong answer. It's just that his impact on society is different. Investors will help all parts of society enter modernity's virtuous cycle; the stage in which it enjoys continuous compound growth. This helps this society. If you are interested and would like to learn more about this, you can refer to my monograph, "Discussions on Modernization". Relatively speaking, the speculative part of the market verges on being a casino.

From a social perspective, the most important thing is that he doesn't want the casino to be too big. Without this gambling, the market would not exist. What makes the stock market exist and develop is to invest. We should therefore see speculation as a *necessary evil* and a part of human nature which cannot be removed. We cannot deny the parts of human nature which love to gamble and speculate but we cannot let them overwhelm us. Otherwise, society will sooner or later face the consequences. The wounds of the 2008-2009 Global Financial Crisis from which we have just emerged are still fresh in our memories. And once you understand the principle of a zero-sum game, you will begin to see these speculators as Mr. Market. Now, there will be some speculators who do well in the stock market and will make a great success for a while. They will have more money than you and more influence. But you will know in your heart that everything they do will ultimately amount to nothing. If your values are to contribute to society, then there is no need to pay them any notice, even if they seem better than you in every way. This is a question of principle. However, if you don't understand this principle or don't share these values, you will always feel like you are missing out, that these people know more than you and that they are right.

Given that the aggregate results of speculation are zero and it does not create any real value, why does it continue to exist?

This goes back to a special feature of the asset management industry. Even though this is a service industry, there exists severe information asymmetry: it's hard to identify the differences between investment and speculation. Speculators possess many theories. When speculators pitch these theories, they always leave most people feeling perplexed.

The newest theory of the day is artificial intelligence, but it's no different fundamentally than theories of the past. While the principles of investing and speculation are quite straightforward, I've never seen them discussed in any academic work. Why is that?

I think most people have intentionally overlooked the investing vs speculation distinction because they have something to gain. With restaurants, another service business, it's very easy for us to judge quality. With asset management it's more difficult to judge service.

And why might that be? Well, you can collect a tax – an ignorance tax, otherwise known as an "*information exploitation tax*". This ignorance tax is the main reason the asset management industry exists. Regardless of future performance, you only need to show some short-term profits, market yourself and invite the whole world to come and invest.

After that, you can collect your 1-2% management fee. Once you've raised money, you will have a steady profit irrespective of how well you do. The industry really is like this, with all fee structures set the same. Advertise that the whole world knows it, then come and buy it, and then you don't care what the outcome of this one will be. I'll take one percent first.

If this mechanism really worked, then wouldn't the most skilled investors earn more? And the least skilled less? Unfortunately, it's not like that in reality as everyone earns the same fees, because no one can really say upfront which investment manager is better, we need a long period of time to assess.

Moreover, everyone's investment principles are complicated, making it hard to judge immediately if they are right or wrong. Therefore, it is very important to understand the difference between investment and speculation, as well as how to identify Mr. Market.
If you don't want to pay the "information exploitation tax" or if you don't want to make your living by it, then you must endure and persevere. If you believe in reasonable returns and contributing to society, you will be willing to be an investor from the get-go.
If I can't do it, I don't want to be a speculator.
That's why it's important to understand this concept.
This is why it is so important to understand the concept of Mr. Market.
Because when you start work, you will be bombarded by other ideas.
And if you don't understand this concept now, you will think that what other people are saying sounds right and what you thought you knew must be wrong.
You will be led astray by Mr. Market.
If you can just understand why speculation is a zero-sum game, you will understand why there are no speculators with long-term track records or who manage large amounts of money. There are some who do well in the short-run but most of these rely on legalized front-running. You can always make money through market manipulation but it is illegal. You can use AI to anticipate what people are going to trade. For example, you might purchase stocks before they are included in an index fund like before A-shares were added to the MSCI indices. This might earn you some money but you won't be able to scale it up. Even if you could scale it up, society wouldn't be very happy with you.

So you see, all speculative strategies are limited in size and can't work over the long-term. In general, investors are the only people who can scale up and have long-term track records. Let me just comment as to why index investing is acceptable. Index investing is basically the summation of investing and speculation. If the investor's final result is zero, then the result of index investment is actually the mirror result of the investor.
Isn't that right, mathematically? Long-term index investing works therefore but only in some places, namely those that have entered the modern age and can endogenously

produce continuous compound growth. Moreover, for this to work, the index must represent all companies in the economy to capture its overall economic and commercial performance. This is one question we should ask but there are still more to cover. Then we will come back and talk about the market.

Next, I'd like to discuss a question: assuming you don't want to collect the "information exploitation tax" or participate in a zero-sum game, the way forward is to become a proper investor. But how do you do it? This goes back to the concept of a circle of competence. What the capitalist is going to do is predict the general economic performance of a company in the future using fundamental analysis. It's just a basic analysis, right? It's just to say that this one understands why the company makes money and how does it make money? How much money will he make in the future? What is the state of the competition in the economy? What is his position in the competition?

I call this process building your circle of competence.

The next question is, how do you start building your circle of competence if you have only just started studying value investing? How do you learn to analyze a company?

Even after looking at lots of different companies, how do you know from where to start? And after doing some research, you will have built up a certain understanding of a company. But how will you know if it's enough? How long do you have to wait before you buy shares? And at what price should you buy them? This question is also very specific.

The questions students ask like this are all very specific. Even practitioners will have similar questions. Can you use the valuations issued by sell-side analysts? From a sell-side analyst's point of view, they will use whatever price they think can get you interested in the stock. It doesn't matter if it's right or wrong because it's not their money. But your money is your money and you won't feel the same. So you can see that the circle of competence really is the core issue for investors. When will you have built your circle of competence? This will be different for every person because everyone's competencies are different.

I stumbled into this profession, about 27 or 28 years ago when I was studying at Columbia University. I had just gone to America and was under a mountain of student loans. I didn't know anything about business or how to earn money, so every day I worried about how I was going to repay my debts. None of the students from China at that time had any money so when we suddenly arrived in America and started racking up these student loans in US dollars, the numbers just seemed astronomical. Therefore, I always mulled over how to make money. One day a classmate told me that someone was coming to give a guest lecture on how to earn money, and that this guy really knew what he was talking about. The poster mentioned a free lunch, so I decided to go.

But when I went, the classroom looked like the one we're in today and nothing like what I'd seen before when there was a free lunch. Those normally would have long tables for 20 or 30 people with lunch on the side and the speaker at the front. I asked where the lunch was and my classmate told me that that was the speaker's name. I had just started studying English and confused the spelling of buffet with the speaker's actual name, Buffett, which had an extra 't'. But I stayed anyway since I thought that if this guy had the audacity to call himself "Free Lunch", he must know something. After listening for a while, I suddenly felt that what he was saying was far better than any free lunch. Before, I understood the stock market to be like what was described in Cao Yu's play "Sunrise" that is, the dog eat dog world of stock traders in 1930s Shanghai. I thought anyone who dealt in stocks must be a bad person. But this Mr. Free Lunch didn't seem like a bad guy at all. He seemed smart and what he said was very interesting. His principles were clear and easy to understand. Speaking wisely, it is very *spiritual*. I can listen to and understand this in one day. Just in the course of this lecture, I suddenly felt that this one seemed to be possible.
And that would be fine because coming from China, my mathematics, physics and chemistry were all OK.

The first thing I did after the lecture was to go to the library to study Mr. Buffett. The more I studied, the more I felt like this was something I could do. He was strong in theory and in practice, and I could understand everything he wrote in his shareholder letters. I started thinking of ways to find companies offering a margin of safety which meant they had to be cheap. I didn't know much about business at the time but it didn't take more than primary school arithmetic to analyze a balance sheet. I started reading Value Line which presented ten years of summary financial information for thousands of companies. Value Line organized these companies into different categories, one of which highlighted the cheapest stocks according to their PB and PE ratios. I focused on balance sheets because I still didn't understand these companies or their PE ratios. I looked at net assets and their value relative to the stock price. I didn't even understand what business the first few stocks I looked at were in but I did know they weren't losing money. Some had cash on their balance sheets, some owned property and some held stock in other companies. All had net assets worth significantly more than their market price, with some worth multiples more.

Perhaps because I hadn't worked at that point, nor had I met those highfalutin' folks on Wall Street, *I believed in Mr. Market*. Could it be because I didn't go to work anywhere anyway and I haven't seen it before. Then I made a point to visit a few companies located near New York to see if they were real or not, if the assets on their books were real and if they were still doing business (even if I didn't know what that business was). What's going on in this city? Is it the only company? Is it true that there is such a company? Is it true? This is how I came to start investing in a few companies whose
net assets were valued at about twice their market price. Because their value was high enough and their price low enough, I could muster the courage to buy.

Later, I realized something else: after I had made my investments, I became even more interested in the companies. It was completely the opposite of what typical theories will tell you. It's too deep. After I buy it, I will absolutely treat the company like it's really mine, so I'm absolutely perfect for his first one. Before it had just been an almost academic exercise; I had been an armchair general. I never felt a close connection with these companies and so never studied them in depth. But after I bought the stock, I felt like these companies belonged to me. I devoutly believed in Buffett's principles of value investing, especially the first which says that stocks confer part-ownership of a business. Buying the stock therefore made these *my* companies. And whenever I could, I would head over for a look to try and learn what these companies did because I still hadn't figured it out.

For example, one of the earliest companies in which I invested was headquartered in Pennsylvania. It had sold its primary Cable TV assets to the then largest Cable TV company, TCI (Tele-Communications Inc.) in exchange for TCI stock. My company's remaining assets included a telecommunications company which owned many licenses. Although its income was low, the income my company received from its subsidiaries was totally out of proportion with the market value of its stock. During my research, I realized that my company had paid a lot for these licenses. It had also done so some time ago, such that their true value likely exceeded their reported book value. I didn't know how much they should be worth but I did know that the value of my company's stake in TCI was alone worth three times my company's market cap. Going by my company's PB ratio, I thought it should be worth at least twice as much and even then, it would still only be worth half as much as the value of its stake in TCI. Not long after I made my investment, TCI's stock began to rise because it had acquired many other Cable TV operators. I became very

interested in Cable TV companies because I thought TCI also belonged to me. These companies basically operate a local monopoly; if a company has a license for a territory, other companies cannot enter. Subscribers paid their bills one month in advance, making income easy to forecast and allowing these companies to take on leverage. Moreover, costs were very low. Mathematically, this was a very simple business. TCI was a large-scale listed company and could use its stock to buy unlisted Cable operators for a low price. Its EPS would increase every time it made an acquisition, and its stock would go higher. This was just mathematics and was relatively easy to understand. TCI was the predecessor to today's AT&T Cable and has since become America's largest and most successful Cable TV operator. But at that time 20 some years ago, it had just started to become apparent how different it was from its peers. In line with TCI's rising stock price, my company's stock price also started to rise. What's interesting is that a novel product called the mobile phone appeared which suddenly made my company's telecommunications licenses very valuable because they could be used to build a national mobile wireless network. My company hired the President of the then largest telecommunications company to become its CEO, turning it from a relatively unknown entity into an overnight sensation. *This is when I got lucky*. All of a sudden, my company's stock became very valuable, not only surpassing the value of its stake in TCI but skyrocketing several times higher after that. The stock went up 6 or 7 times and I didn't think there was any margin of safety left, so I so I sold.
I didn't have the margin of safety. After I sold out, my elder sister, continued to talk about it. Naturally, the stock continued to climb after that but at the time, I hadn't figured out what the wireless internet business was about in fact, I still haven't even today.

This experience taught me a lesson: if there is enough margin of safety, I will dare to buy. Additionally, I also realized that *people's mentality changes after they invest* in something. It really changed. It was this stock, it was this, it was this ownership. When value investors say that stocks confer part-ownership in a business, it is also a *psychological* concept.

I only understood this after I had made my own investments. Theory doesn't do the feeling justice. As soon as I had bought shares; as soon as I had become an owner, I realized I cared about everything. I remember one weekend I visited my company but the security guard wouldn't let me in. So in the end, I spent an hour talking to him with great interest. How was he hired? What was he paid? etc. etc. I truly saw myself as an owner. I was very interested, and it greatly helped my understanding of the company. Thanks to my company, I started researching Cable TV companies and found them very interesting too. Later, it was the same when I researched telecommunications companies. As a result, I started researching similar companies one by one and it greatly increased my understanding of the whole industry. I made my investment because there was a margin of safety but I later developed a real interest in the business itself. Is it telling me the value of this company? Isn't it an indication of the work? The experience taught me that my company's value wasn't just on its balance sheet; in fact, its main value was in its earnings power. Yeah, so I started to be interested in this company. I didn't understand large companies so I found a few small ones, the best of which were located close to where I was living in New York at the time so that I could visit them. Talking with anyone was fine, including the security guard at the entrance.

There was another company at the time which taught me something revealing. This company owned a lot of gas stations, and so I became interested in gas stations. There were two gas stations near where I lived, one on each side of the same intersection. However, I realized that one gas station had many more customers, and that cars would come to it regardless of which direction they were heading. It's the same, right? It's the same standard. I think it's weird. Both gas stations had the same price and their gas was the same as it was made to the same standard. I felt this was very strange and since it was my company's gas station anyway, I went to have a look. The gas station which attracted all the customers was run by a family of Indian immigrants, who all lived there too. As soon as a customer arrived, they would come out to offer him a glass of water. Whether you wanted it or not, they would always offer it to you first, free of charge, and then strike up a conversation. If the kids were home from school, they would come out and help you tidy up your car. The other gas station was run by a typical American. He wasn't a bad guy but the gas station didn't belong to him. He was just an employee hired by the real owner, so he wouldn't come out from the store and nor would he pay much attention to what was happening outside. Thanks to this one difference, I calculated that in a given period, one gas station attracted almost four times as much traffic as the other. I just sat there for a few hours. It's just a bit of a difference, and it's clear that this management is also very important. From then on, I realized it was important to know whether a company's manager had an owner's mindset.

Through this, I began to gradually understand how a company could earn money and why it could earn more than others. The example of the two gas stations is a perfect illustration because they sold the same product and were otherwise identical. However, one's service was slightly superior to the other's and so it received four times as much traffic. What motivated that Indian fellow? He was an immigrant, like me. He needed money and if he couldn't bring in business, he would have financial difficulties. The other manager could be indifferent because he could just take his salary while pretending to do his job.

This was the difference.

I therefore began to take great interest in how a company is run, its competitive advantages, and the sustainability of these competitive advantages. Later, amongst those small companies I could understand, I found one or two which had a real competitive advantage and so could earn a good return. And later still, I applied this understanding big companies, thereby growing my circle of competence again. I raise these examples to explain that if my experience offers any universal insight, it is that if you want to build your circle of competence, *you must invest in things you truly understand.*

My company also started to understand and became interested in it, so I gave this example to tell you something. I just thought about it. The margin of safety is very important.

You only need to understand that which is related to your margin of safety; the rest isn't important. This is the first point. The second point is that when you start looking at business with an owner's mindset, your perspective will be *very* different.

The ideal is to be able to look at something as if you owned it without having to actually go and buy it. Unfortunately, this is very hard psychologically without using a few tricks.

Why do we treasure our own things even if they aren't the best? It's just human nature once something becomes ours. Therefore, once you start seeing yourself as an owner, you will instantly be full of the energy needed to go and study the business. And it's like this in the hearts of most people, so will be in yours when you turn yourself into an owner.

When I ask my analysts to look at a company, the first thing I tell them is to assume they have a long-lost uncle who died suddenly, leaving the entire company to them.

What must they do next? This is the mindset they need to embrace in their research.

Of course, it's never going to be the same as actually owning a company. When I first started investing, my own net assets were negative because all my money was borrowed.

This was a powerful motivation. It's the same now though; when we talk to anyone, we always do so with the mindset of someone who owns 100% of the business. When we visit a company, we talk with everyone. If we bump into a security guard, we stop for a chat. How's work going? What was the hiring process like? What are our company's HR policies like? We care about all these questions. The third point is that knowledge accumulates gradually but only if you maintain intellectual honesty. This is important because it is hard for humans to be completely objective and rational. It is very important because it is very difficult for us to make an objective sale and it is very difficult for us to make a reasonable decision. We are emotional creatures and so are likely to be biased towards things in which we believe or in which we have self-interest. We always predict that events will work in our favor. But objectively, that's not the way the world works, but it always feels that there is such a possibility to do this, to do this, this very important thing. Intellectual honesty is therefore vital.

When you have the right approach and are doing the right things, you will find the degree of accumulation of your knowledge growing in the same way the economy grows. The growth is the same. If I don't do this one, then that one. It's a process of compounding. All your past experiences will corroborate and reinforce each other so that you gradually develop a firm grasp of some topics. It's really useful.

The next one thing is very important to me, it's that you must let your passions and opportunities guide your research. Don't let yourself be led by what others are buying. Be sure to use your own interest, your own opportunities, other people's stocks, and other people's opportunities are other people's business, nothing to do with you. Just do your own business. If you find this, this, this opportunity, then you go to study these things, if you are interested in something *study it with interest*. Then these opportunities, these interests themselves, will bring you uninterruptedly moving forward, uninterrupted, point by point. It's like their support, don't worry about it. So the final result is that everyone's circle of competence is different. Everyone is like us. It's this value investor who can't tell that it's not the same, and it doesn't need or need to pay more with other people. The end result is that no two people's circle of competence will be the same. Every value investor's portfolio will be different and that's OK. You don't need to communicate too often with other people. You don't need to invest in too many things.

Because you need to understand everything in which you invest, you can expect it to take a long time. It will be the same for every stock and every company. The circle of competence you ultimately build will be small, as will the number of companies whose future you can predict with a high degree of certainty. Your circle of competence will inevitably be small. Making money doesn't depend on how much you know; it depends on whether what you know is right or wrong. If what you know is right, then at the least, you won't lose money.

The next question is, what kind of person can be a value investor? Do value investors share any common traits or a special temperament? Warren and Charlie have always said, what makes a value investor successful isn't IQ nor his experience; it's his *temperament*. What does this mean? I will now share my understanding. From my many years of experience, I agree with them. There are some people who are not suited to being value investors; and there are some who are just naturals. What kind of person is more suitable for this kind of investing?

First, this person must be relatively independent. *They should judge themself by their own yardstick, and not others'*. For example, there are some people whose sense of happiness is derived from what others think of them. If the handbag they buy isn't admired by others, it loses any meaning. Other people are different. As long as they like the handbag themselves, they'll be happy. Independent people aren't influenced by others. This is an innate characteristic. Independence is especially important for investors because they will face temptation every minute of the day. Comparisons also create *jealousy*. So this one thing I think is the very important and a very important reason for being an investor, because you always face temptation - there are all kinds of temptations at the moment. It's okay.
Remember comparisons create jealousy. This is an innate characteristic.

Second, this person should be relatively *objective and unemotional*. Of course, we are all emotional beings and so cannot completely escape our emotions. However, some people make the search for objectivity and rationality into a value and a moral pursuit. These people are better suited to value investing. Investing is about objectively analyzing all sorts of problems and assessing events far out into the future. This is inherently very hard. If we look from the perspective of a company's income statement and not its balance sheet, then competition is the most important thing to consider. Profitable companies will attract competitors who will try to snatch market share and profits. It is therefore hard to forecast whether a company which is doing well today can maintain its profitability ten years from now. Even if management can't necessarily answer this clearly, those above the fray usually can. It is therefore vital for you to maintain an extremely objective stance and be willing to learn continuously. The attitude of regular objectivity and rationality can become very important if you can continue to learn. This is also very important.

The next attribute is relatively special. You must be both *extremely patient* and *extremely decisive*, even though they are in contradiction. When there are no opportunities, you might *go for years without taking any action*. But as soon as an opportunity arrives, you must be able to become extremely decisive and act without hesitation.

I have been Charlie Munger's investment partner for sixteen or seventeen years now.
We meet for dinner at least once a week and I've developed a deep understanding of him.
Let me tell you a story about his investments. Charlie subscribes to Barron's, a weekly magazine about the stock market published by the Wall Street Journal. He's read this magazine for 40-50 years for the purpose of finding investment ideas. And how many has he found in this time? Can you guess? How many opportunities in 40 to 50 years?
Just one! there has only been one and he only found it after reading the magazine for more than thirty years. And he hasn't found another in the ten years since. This hasn't stopped him from continuing to read the magazine every week though. He is extremely patient and can go for a long time without doing anything at all.

But when he finds an opportunity, he will go all in.

So this is a special kind of brand, so you have to have extreme patience to take it seriously when opportunities don't come. When the time comes you must have strong and decisive kinetic ability. So this is what's required of an exceptional investor: he must have extreme patience and stay focused even when there are no opportunities. When an opportunity does come, he must then have the ability to move swiftly and decisively.

Fourth, how could Charlie persist in this for 40 or 50 years? It's because he is *intensely interested in business*. Warren and Charlie always talk about having *money sense* – that is, an intense interest in business and a natural predisposition to mulling over questions like: How does this business earn money?

What is the competitive state?
What will the world be like in the future?
Why does it earn money?
What will competition be like in the future?
Can it still make money in the future?

These people always want to get to the bottom of these questions, and their passion is their main motivation. These attributes aren't especially common but when they are found together, they can make for an exceptional investor. Some of them are innate and some can be cultivated. For example, you can develop an interest in business over time. However, some attributes cannot be developed, like extreme independence, patience and decisiveness. After reading Barron's for thirty years without reward, the average person would have given up. Moreover, if they found an idea, they would expect another in short order. Not Charlie though. We're very close and I can tell you that he really is like this.

It's not easy to be independent because most people will be judged by society or mind what others think of them. However, these people will struggle to succeed as value investors. In contrast, your IQ and education are not that important. If they were, then Newton would have been a stock market genius. However, Newton invested his life's savings into the South Sea Company at the top of the bubble, almost leaving his family destitute. It's no use therefore, even if you think you're smarter than Newton. Mozart is the same. You absolutely do not need such a high IQ or to be so clever. Nor do you need any kind of outstanding education or experience. I've seen too many smart people with good educations and outstanding experience fail as investors. More often than not, they will give in to speculation. Naturally, they all say they combine fundamental analysis with some understanding of the market. At any rate, they can use all sorts of theories to rationalize what they do. The more educated they are, the more convincing it sounds. But in reality, the worse it really is. You don't need professional training or an MBA; but you must have an intense interest in business. If you aren't interested in business, an MBA won't help.

I have a friend who is an extremely good investor who says that investing is like playing golf. I agree. You must maintain your equilibrium. If your heart isn't still, you won't swing well. There is also no relation between the last hole and the next hole because each is independent of the other. If you hit a birdie in one hole, it does not mean you will do well in the next. Meditation is also very good to help you be clear about your own understanding of this blind spot. The risks and reward of every hole should be considered on its own merits. How well you do on each will not in itself determine how well you do overall.

Similarly, the record you leave in this life will be your legacy. The longer you live, the harder it is to do well. Golf can therefore help you develop this mindset for investing. Meditation is also of benefit as it can help you identify your blind spots. Bridge can help you train your patience too. There are some things which can help you cultivate these attributes, especially those I described which are not innate. However, like golf, these are things which you will lose if you don't train or put them into practice. Once you leave the world of business, you will gradually lose your acumen.

If someone says they don't possess this temperament, what should they do? My advice is not to force yourself to do something for which you're not suited. You can find someone with the right temperament to help you. Everyone should always focus on their strengths and their passions as this is the only way you will be happy and find the motivation. You must do what's right for yourself and not for others.

Next, we will discuss how an ordinary investor who perhaps doesn't want to become a professional investor or doesn't have the opportunity can protect his wealth and gradually increase it. First, don't forget that your alternative is always cash. A decision to invest in cash can be the result of fundamental analysis. When you haven't found any investments which satisfy your opportunity cost, cash is a good choice. At the least, it's better than throwing your money around speculating. Realize this, if the economy itself is growing growing at 2-3% in real terms, then it should be growing at 4-5% in nominal terms once we allow for inflation. The average profit of large companies should grow faster still thanks to their scale, perhaps at 6-7%. And as we said earlier, if you grow at this rate for more than 200 years, your return will be greater than a million times. Even in your own lifetime of 30 to 40 years, this return will deliver a very satisfactory result. So there is no need to listen to anyone who promises you a return greater than 10% every year or to double your money, because they are mostly speculators. Investment must be reliable. What kind of things are reliable? Things that are sustainable. If something isn't sustainable, don't listen to it. Index investing is therefore a good choice when the index reflects the economy's overall performance. Of course, it's even better if you can find an exceptional investor. However, this is not easy, especially in China today. We'd really like to establish a value investing community in China like "Graham and Doddsville". There would be some core members and everyone would volunteer to share a record of their returns and how they earned them. This way, we could see their long-term results. There are lots of investors these days who more often than not call their funds "products". I struggle to understand this as it feels like they're coming out of a factory. Managers will run dozens of products at a time. It seems almost like if you don't have one or two hundred products under your management, you cannot call yourself a successful investor.

And in the end, there is no way to determine these investors' real results. For the last 23 years, I have managed a single fund in which basically all my money is invested. This way, you can easily judge my results. If you can find an investor worth trusting who does things the right way, then this can be a very good choice. Ordinarily, the first thing you must when choosing an investor is confirm whether they are a speculator or not. Then they must possess an investor's temperament. Next, they must possess a deep understanding of their profession and a relatively long track record of investment returns. If it's not, then it's less likely they can achieve good results. You can then look to see if their fee structure is reasonable and fair, and if their interest in any way conflicts with yours. Finally, this person shouldn't be too old so that there is ample time for them to compound your wealth.
If you can find someone who meets these criteria, consider yourself lucky. The biggest taboo for personal investors is to be like Newton and be seduced by the market: to buy at the market's hottest peak and to sell at its most depressed.

If you don't participate in speculation and stick strictly to investing in what you understand, then you won't lose money. Some people insist on investing for themselves but since your time is limited, your portfolios must be *concentrated* in the few ideas you really understand. This level of concentration is very important as it reflects the inevitable concentration of your time, energy and experience on a small field of possible investments. Through hard work over a long period of time, a personal investor can reach this level. The worst thing you can do is to pay the "information exploitation tax". If the fee structure on an investment fund isn't fair, don't even consider it. Anything that works only in the manager's favor will certainly have issues. If you believe in these few basic principles, you can protect your wealth and grow it gradually. With compound interest and the right approach, then even at a modest rate, your wealth will grow steadily and in time become quite sizeable.

Most people don't believe in the power of compounding though because it is not something we see in everyday life. For example, our own wisdom and experience have the highest chance of compounding. But due to the way most people study, their knowledge will age and never accumulate. Therefore, they won't see even the most basic compounding. The average person will almost never see this kind of compounding. They don't think about it either because it's so hard to conceive. But if you're interested in investing, you must already understand the power of compound interest, Einstein's so-called 'Eighth Wonder of the World'. The more you understand the power of compound interest, the more you will understand how hard it is to obtain. So when you find an opportunity offering compound interest – even at a rate of six, seven, eight or nine percent – you will seize it because you know this could be the most important opportunity of your life. If you live for a long enough time for the benefit, it is the most important opportunity for your best life.
This is my advice for the average person. To close, I will try to summarize value investing.

Is value investing a kind of faith?
You aren't willing to exploit others.
You won't participate in zero-sum games.
You will only pursue your fortune in a way that also benefits society.
You won't be someone who counts on gambling to make money.
The next time you see speculators, you won't need to wish them good luck because you know good luck can't last forever. Instead, you'll simply wish them to have fun! When people go to play at the casino, they are trying to buy happiness. But it's a waste of money because you can't buy happiness. It even seems like a waste to go to the casino because so many people come back feeling down and out. In the worst case, you might even become addicted and lose it all. If you say you're only going for some fun, that's OK. But if your values are different from those of a gambler, you will keep your distance from gambling when in the stock market. You will not invest in things you don't understand. And remember that understanding something means being able to make accurate forecasts over a long period of time with a high degree of confidence. If you can't satisfy this condition, you won't do it. So yes, from this perspective, value investing is a set of beliefs. So yes, you can call it a faith. And if it is a faith, then you must seek proof. In the process,

you will experience the test of despair. Your feelings will rise and fall from top to bottom, at least at the beginning. But gradually, these values will become a part of your being. The emotional tumult will gradually be replaced by a feeling of stoicism. Thanks to your intense interest in business, you will gradually build your own circle of competence. Then within your circle of competence, you will move with skill and grace. You will achieve a single minded focus on your work and rise above the noise.

I've seen that the most successful investors all tend to leave the financial centres behind. In fact, their results tend to be better the further they live from these places. Omaha, for example. Having less interaction with people from financial centers like Beijing, Shanghai, New York and Hong Kong might actually help you. All those highfalutin' trading theories are just noise. Why is it called noise? Because it ultimately produces next to nothing. If you remember anything from what we've discussed today, it should be the idea of a zero-sum game. The net result of all speculation is zero. Although it's not often raised, this fact is a simple mathematical concept. If you remember this the next time you come across one of those highfalutin' theories, you will be able to see those folks as Mr. Market. You'll see that Graham's description of Mr. Market was very apt. The final result of speculation is 0. You just have to remember this one next time you run into someone talking regarding it as a Mr. Market talking.

My journey as a student of value investing has been especially meaningful to me on a personal level. In seeking a livelihood, I gate-crashed this profession by good fortune and without any forethought. Frequent incidents of this kind can really make you learn new things. Later, I realized I had stumbled upon something wondrous. This profession is an incredible thing. It lets you spend every minute studying new things. Realizing one's own ability. The value of your knowledge and self is growing in the way of encouragement. It won't just be your assets that grow through compounding; you will also feel your knowledge, practical experience and judgement compounding at the same time. It is especially meaningful to see in the investment industry the phenomena of compound interest working twice, and in a way which isn't often seen in real life. When I was young, I always wondered about the meaning of life. Later, I gradually came to realize that *the meaning of life is the pursuit of true knowledge.*

True knowledge can change your life and your fate; it can even change the world. Moreover, mankind is completely different from what else we can observe in the material world. The world we can see is one in which entropy increases. Energy flows from high places to low places; big things devour small things. If a large celestial body hits a smaller one, it will crush it. The entire planet and our universe are to a certain extent heading towards annihilation. But the world of man is not the same. Mankind can turn the world into one in which entropy decreases. *We can reverse entropy's course.* Through study, man can go from ignorance to erudition; through self-cultivation, man can become a virtuous person who contributes to society. Man can create things which were previously unimaginable. Since man's arrival, the earth has changed. Today, we can even leave this planet for the stars; it is entirely possible that we go on to change the universe.

As I mentioned earlier, the first investment I made was related to the wireless telephone. At the time, I hadn't really figured out what that was. Twenty-six years later, who can bear to part with their mobile phone? Mobile phones, the internet and all these things were game changers born of knowledge. The internet is based on TCP/IP which is a protocol. At their heart, computers are permutations and combinations of 0s and 1s combined with a diode which uses silicon and electricity to tell those 0s and 1s apart. The world has changed and its investment in this school is particularly good for me. My personal experience is true. This is how knowledge can create changes which turn our world upside down. Speaking for myself, the experience of investing has allowed me to truly experience mankind's ability to reduce entropy. Investing especially if it is the true path of value investing is a person's journey to reduce entropy. Along the way, you can help create new things and you can do so in a win-win way. You won't just be helping yourself you'll be helping those around you. The insights in which you believe can separate mankind's world from the material world inhabited by other living things. I think this is a wondrous thing and I want to share this feeling with you all. I hope that we can all go far on the road of value investing. Thank you everybody!

[Now starts the Q&A section]

Q: I've been a sell-side analyst for more than ten years now. What challenges do you think there are for me to become a value investor? How do I get in? Can you teach an old dog new tricks?

Switching from the sell-side to the buy-side requires a change in mindset. I have a business owner's mindset because after I bought my first stock, I thought the company belonged to me. This is human nature: we think the things which belong to us are special. It's similar on the sell-side. If you're incentivized to pitch a certain stock, you're always going to be inclined to put lipstick on a pig – perhaps even to describe it as a unicorn. Of course, you might be responsible for pitching a company that is fundamentally sound in the first place, like Moutai. But you will still have the mindset of wanting to pitch it and make the sale. As they say, "He who pays the piper calls the tune" – and this is very hard to change. Because if you didn't act this way, you wouldn't fit in and [wouldn't be able to progress your career]. The problem is that many folks who transition from the sell-side to the buy side can't shake off their old mindset they can't stop selling. I've seen this many times with friends who worked in investment banks but who never really succeeded as investors. People are like this. As Richard Feynman said, *"you must not fool yourself – and you are the easiest person to fool"*. When you are able to sell something especially well to other people, it's usually because you've persuaded yourself too. It's all about you, so don't lie to yourself This is why I see the most important thing is to stay objective and rational. How do you stay objective and rational then? You must change your mindset. I therefore think the best thing for you would be to spend some time making investments on your own account. Feel the difference in psychology [between pitching and owning]. After a while, you will really feel that these companies belong to you. Your frame of reference will begin to change dramatically. The way you gather information will change. It's like your antennae changes direction. This is why I think the first step must be to change your mindset. The best thing for you to do before becoming a professional value investor is to make some investments on your own account. But you must do so as a value investor and not as a sell-side analyst. A sell-side's analyst approach is to talk up whatever it is they want to pitch. Because if you don't, you won't succeed on the sell-side. When you meet an insurance salesman, they'll always want to recruit you as a 'down-line distributor' (i.e. a subordinate in a multi-level marketing scheme). Why do they see everyone as a potential recruit? Because this is the only way for them to succeed! Therefore, the most important first step for you is to change your mindset. When you feel like you have, you will be on the road to leaving behind the shackles imposed on you by working on the sell-side. Your knowledge of business and companies will still be useful, however, and something on which you can build. When you use your owner's antennae to re-organize all this information, you will find you've tuned into a different channel. You will still posses your original knowledge base but the way you organize it will change in a subtle and important way. It is very difficult to complete this step. I have seen too many examples in the past, especially in investment banks. Unless you go through this process, it will be very hard to transition directly to the buy-side. Studying mistakes can help us understand success. Have you seen any determined young people fail in the end as value investors because they were unable to stick with it? Even if they possessed the temperament you described earlier? If so, why do you think they failed? I've seen many different people fail for many different reasons, the most important of which is passion. The main reason is that interest is the most important reason. Interest is that one person can finally do a thing well in time. For someone to stick with something and get good at it, they must be interested and passionate. The easiest way to succeed is to be passionate about something and good at it. And some people may have this temperament and special adaptation of this value investment. Say for example you have someone with a value investor's temperament but who is more passionate about other things. After studying value investing for a little while, they will turn their attention elsewhere. This is totally understandable and actually quite reasonable. In my opinion, the most important thing isn't to think about in which pursuit you can earn more money. Because if you do, you'll always be jumping around since there will always be people who earn more money than you. If you measure your life based on how much money you can earn, you will always be miserable. You must therefore follow your passions. If you are interested in value investing, you will go further the longer you stick with it. But you won't stick with it if you're not really interested. That's been the case in the majority of instances I've seen. Of course, the things you learn as a value investor can be useful elsewhere provided you have the right temperament. You will know it for yourself.

Q: How do I know if I really understand a company? Is there an objective benchmark to test my understanding?

We're in the business of forecasting. So determining whether you understand a company or not is simply a matter of assessing whether your forecasts were right or wrong. However, the answer won't immediately reveal itself. You'll have to wait many years to get it. If you are intellectually honest, you will insist on knowing the answer and so will naturally learn if you really understood or not. I hold my employees to a standard: if they really understand a company they're researching, then they must be able to say what will be the worst case for that company after ten years. The best case scenario will usually take care of itself. You must therefore understand what the worst possible case could be after ten years. If you can't do that, then you can't really say you understand the company. But if you can, your forecasts you should have a very high chance of proving correct. And you must go back after ten years to see if you were right. This is therefore a very hard question. How come? Because people possess many cognitive biases. Charlie Munger listed 25 of these cognitive biases in *Poor Charlie's Almanack* and there may be even more in reality. The reason they exist is because our minds are the product of natural selection, and their main function is for us to survive and procreate. However, our living conditions today are the result of cultural evolution. We live in a civilized society, many of whose rules do not fit with biological evolution. This civilized and progressive society is not so much the same as this biologically progressive society, so we are in it. As a result, many of our innate cognitive biases serve us poorly, making it hard for us to be objective and rational in our judgement. You might think you understand something but you don't understand your innate blind spots, nor the way they mislead you into a view which ultimately proves wrong. In other words, you didn't actually understand. So when you think you understand something, you must first understand what you don't know because our knowledge is limited.

The most important concept in the circle of competence is its *boundary*. It is a bounded circle. If you do not know where its boundaries lie and believe you know everything, then you certainly do not. You also need to understand that when you know something is right, you must also know when it will go wrong. Munger has a standard which I think is immensely useful. He says that *if you want to hold an opinion, then you must be able to refute it better than the smartest person you can find who disagrees with you*. I can refute this point of view. It is only in this situation that I deserve to have this point of view. This is a true standard. According to this standard, you can judge whether you understand or don't understand. You can use the other way around and think about whether I can find out whether I can finally recognize it. It's just that you have to know this ability of yours is indeed in a circle, or you don't know what you know. Where is the boundary of this circle of this competence? You are really unclear now, you can't understand all of them, but it will be very clear once you have a specific question. There are some colleagues from our company here today and each one of them has gone through my questioning. My questions will push you to your limits and if they don't, then there's no way you really understand something. This depends on intellectual honesty and requires continuous training. It is very hard to do immediately. Without this way of thinking, it is very hard to develop a true understanding of something. But if you can develop the habit, it will stand you in good stead for the rest of your life.

Q: You just spoke about how to achieve real understanding. You also spoke earlier about how value investing is a learning process. Could you please talk a bit about which learning methods can help us compound our knowledge?

Knowledge must fulfil several basic conditions to be considered useful. First, it must be able to be verified. It must be supported by logic and the facts you can see for yourself. Moreover, it should confer a high degree of explanatory power. At the same time, it should be helpful for making predictions. When we look at real life, it is scientific knowledge which best meets these standards. However, many of the phenomena we encounter in real life have no foundation in scientific theory because they relate to people. And in the case of people, we must think in terms of a distribution of probabilities. When you study mathematics, statistics is far more important than calculus, so you must study it well. This is because *virtually all problems in the real world are statistical problems*. So, how should we go about studying real world problems? You still need to use scientific methods but you must understand that all you will get are vague results. Of course, it's better to be vaguely right than precisely wrong. And yet scientific methods remain the most effective means with which to compound your knowledge. Let your own interest be your guide when you have a strong passion for something. When you become really interested in something, you can accumulate knowledge about it faster, more effectively and better than anyone else. At the end of the day, you will be using this knowledge in a competitive environment. Your judgement must be better than someone else's. When you're really interested in something, you will keep pursuing it even when others have given up. In the end, the only reliable approach I've seen is to accumulate your knowledge piece by piece by letting your passions be your guide, using a scientific approach and maintaining intellectual honesty.

Q: It seems there are two models for success in our circle. The first looks at the big picture and puts their trust in exceptional companies run by honest managers. They then step back completely and let management do the work for them. The second hopes to understand the company even better than management itself, with nothing too big or small. What do you think of these two styles?

These styles are actually both a part of acquiring knowledge. The quality of management is a big variable for companies. When a company is in its early stages or growing rapidly, its founder and senior managers have an enormous impact on value creation. This is especially true when we look over a long time horizon; the longer the time horizon, the more important this becomes. However, many companies are driven more by the competitive dynamics of their industry, not any single person's determination. No matter how good someone is, they will not be able to produce exceptional results in a terrible environment. However, even a person of modest abilities can produce exceptional results in the right settings. The specific situation of each enterprise is different. For example, there are some exceptional [Chinese] state-owned enterprises whose senior managers have no experience doing business. And yet this in no way impacts their ability to produce good results. Each industry's conditions are different and must be analyzed on their own merits. However, the standard we use should be the same: your knowledge should allow you to make reasonably accurate forecasts with a high degree of certainty about what conditions will be like many years in the future. No matter how you go about doing it or from what angle you look, you must cover each and every aspect. If you want to understand a company, you must understand its management and the basic drivers of its industry. This is one of the reasons why value investing is so hard: there are many, many things you must understand. This is therefore why we must have a margin of safety. I haven't talked much today about this concept but the reason we have a margin of safety is because our forecasts are limited, as is our knowledge. If you have a sufficient margin of safety and enough protection in the price then you can still make a lot of money even when you don't fully understand something. Why did I raise the example I did during my lecture of the cable company? Even though I knew next to nothing about its business using my standards today, I got very lucky and made many times my money. But I only invested because I had a margin of safety. And after I invested, I went on to learn many more things. The margin of safety is therefore especially important. When the future isn't clear, you must choose those opportunities which are especially cheap. And when you are choosing amongst multiple opportunities, the bottom line is that they should be cheap.

Q: Can you please tell us what are the most important sources of a company's moat? Is it a brand, the management team or its business model? What types of moat do you value most?

This all depends on your investment horizon. The longer your investment horizon, the more important *industry dynamics* become for protecting your moat. The shorter your investment horizon, the more important *people* become. The source of each industry and each company's competitive advantage will be different as will the degree to which they can protect their moat. We hold ourselves to the same standards and use the same analytical methods when looking at each industry. However, after spending much time on our research, we ultimately reached the conclusion that most companies are *too hard* and predictions about them cannot be made. The changes in many companies themselves do not make for sustainable competitiveness. Take the simplest example, restaurants. At any time, there will always be a group of restaurants in Beijing with the best business. And some cuisine will always be the most popular. However, you will see that after not too long, these will change. Because even though they're doing well now, it's hard to guarantee that they will still be in the future. You can spend a lot of time on industries like this and ultimately realize the same thing: they are too hard to predict. So speaking for myself, I put all of my efforts into looking at industries about which predictions can be made. Within these industries, I then look for exceptional companies – and not just exceptional because of their industry but on their own merits. Which companies are in these companies? I define exceptional as having returns on capital well in excess of their competitors. This peer in the industry is far higher than his competitors. Within these companies I then look for things which really interest me, which I think I have the ability to research or which are already within my circle of competence. The companies which make it through this selection process are the ones I will then go and spend time on. There are about 100,000 listed companies around the world but you shouldn't ever try to study more than five to ten at a time. Your most important work is therefore to *find a way to cut this number down*. There are many things you can ignore and many which are outside your circle of competence. The most important thing you can do then is to ensure that when an opportunity comes up which is within your circle of competence and fits, you don't miss it! But if an opportunity doesn't fit, you can completely ignore it. Go back to what I said at the start. You must understand yourself relatively well and then you can be picky in your choices. Once you understand a company, you can just sit and wait until an opportunity comes when the price gives you sufficient margin of safety. At that point, you won't lose money even if you're wrong. This is when you can go all-in. This is why you should focus your research on things that you can understand well and understand clearly. And since you will only be choosing a few companies, you might as well choose the very best ones. Of course, you can also choose the smallest companies or those whose price is already cheap. If you understand them well and there is sufficient margin of safety, you will not lose money. In short, you want to *invest in certainty and avoid uncertainty*. When price can give you certainty, then price becomes the most important consideration. When your own knowledge, ability and judgement can give you certainty especially when you have been researching truly exceptional companies then you don't need to constantly change your watchlist every few years. You can just keep going and let the companies own compounding do the work for you. Especially excellent corporate creativity does not need to be obtained continuously in the United States for a few years, and it can be sustained for a long, long time.

Q: Thanks to your speech, we now know a bit more about the special traits a value investor needs – particularly in terms of temperament. Amongst the entrepreneurs on whom you focus, what kind of special traits do they possess?

I've been a generalist for some 26 or 27 years. I've seen both successful and unsuccessful entrepreneurs. I've realized that market economies have a very special property they can unleash a person's true potential. Many successful entrepreneurs actually have all sorts of "issues" in their ordinary lives. Before they were discovered by the market economy, you might not have wanted to associate with them. And if they had been in another industry, the odds are they would have failed. However, a market economy can allow any special or uncommon person any outsider to ultimately succeed within their niche. I've therefore never believed that someone who fits the conventional mold can become an exceptional entrepreneur in a market economy. The market economy enables people to set up businesses which reflect their unique traits, and then to go on to great success. For this reason, my conclusion is that there is no uniform standard for identifying what kind of person will go on to succeed. At the level of the individual company though, it's not just about analyzing people. You can analyze why a person chose to build the company the way he did, and why that enabled its success. For example, Jack Ma (founder of Alibaba) might not have managed detailed operational matters. But he knew very well how to manage people and use them. The kinds of people he used would then be very focused on the details – like (Alibaba's CEO) Daniel Zhang. Every person will therefore find the company which bests fits him. And when you are evaluating that company, you must not jump to the conclusion that because someone is like such and such, then the business will succeed. I've seen many people who tick all the boxes but whose businesses are very average. I'm sure you've all had the same experience. If you think about the people you know, I'm sure there will be some who are particularly talented and look like they have a lot of potential. But in the end, they don't do particularly well. When it comes to judging an enterprise that is particularly suitable for you, it is not easy to judge why this person is the cause. What kind of company will be successful and unsuccessful? I have also encountered a lot of these companies, which seem to respond to any conditions. I therefore think that every company must be assessed on its own merits, with proper analysis done on its own unique circumstances.

Q: As a student hoping to enter the investment industry after I graduate, is it best to work for an institutional investor as my first step? Do I need to apprentice myself to a teacher?

When I was studying at Columbia University, I also attended a value investing class like this. At the time, Columbia was the only university to offer this type of course and Buffett would come once a year to speak. Someone would always ask him this question and he would always say, the best way to learn is to go and work for the person you admire the most. This way you will learn especially quick. After his answer, I decided to create my own company. Just kidding! The real reason I founded my own company was because I couldn't find any other work. No two people are the same. Some people will learn faster under someone else's tutelage. However, there really aren't many people who practice value investing and so there aren't many value investing firms either. Moreover, these firms don't usually need to hire too many people. Take Buffett's company for example. It has more than 100 subsidiaries and employs more than half a million people but his head office only has about 25 people. Until seven or eight years ago, there were only two investors managing some $500bn in capital: Buffett himself and Munger. It's therefore hard to go and work for him. My company is the same and only has ten or so staff. So while it might be good to go and work for a value investor, the opportunity to do so is exceedingly rare especially since the most exceptional investors seldom need to hire anyone. This is a paradox. This is the reason why we started this class and also hope to found a community of Chinese value investors. We want a 'whitelist' of investors who have a long track record of independent results managing a single fund to a single style not like those investors who launch a hundred or more 'investment products'. We need to find these kinds of people. hen everyone will be able to see that these kind of results are indeed real and possible. If I had never seen Buffett in the flesh, I would never have joined this profession. Naturally, I also wanted to work for Buffett. But he wasn't hiring. Now, we also don't hire people. I therefore think the best way to learn is self-study; that and having some contact with more experienced investors can go a long, long way. I generally don't speak in public, with the only exception to return to my alma mater, Columbia, to talk with the students of that same value investing class. Before this class was launched at Peking University, I had never given a lecture in China before; even today, this is only my second time speaking in China. Why don't I speak more often? It has to do with investing and my own personal biases. Going back to the question on the difference between the sell- and the buy-side, it is our natural human instinct to sell. Everyone always wants to dress things up to seem better than reality, otherwise why would we spend so much on our clothes? Similarly, we always want to present ourselves as having superior knowledge and judgement. Humans have a bias towards self-aggrandizement which is very hard to change. And we intensify this each time we speak publicly, especially if it is about some specific stocks. It's important to maintain a healthy skepticism because no one can ever be 100% certain. If you get to 80% or 90%, that's already pretty good. But when you go out and speak in public as if you had 100% certainty, you fool yourself into thinking you have 200% or even 300% certainty. You lose even the slightest doubt in yourself. And the more you speak, the worse it becomes. This is why I generally don't like to speak in public. There's only one exception and that's when I can speak with students and that's only because this is such a rare opportunity. I don't talk about specific companies but can share my experiences. So in summary, your first choice should be to go work for someone you admire. The second choice is to study by yourself and in the process to also reach out to people you look up to. You must stay in touch with them. Classes like this are a good example there are people here today who have flown in from all over the country perhaps even some who have flown in from the US. It's actually very helpful and I would certainly do it too if I were in your position. What we've discussed today should be especially useful in practice because after all, value investing is a practical art. Furthermore, value investing is a *solitary pursuit* in which you must be responsible for the decisions. If you add more people to the discussion, it will become a committee and you will lose your objectivity. Group dynamics will take over and impair your judgement. Our innate biases are an astonishing impediment to investing. Our minds have not evolved in a way which suits investing so you must train yourself. If you can work with a great investor, treasure the opportunity and seize it! But if you don't, you can still make your own opportunities. At the end of the day though, self-study is the most important thing. You must experience these things for yourself.

Q: I'd really like to go and buy stock in a cheap company to study it and learn more. But before I do, I'd just like to ask: what kind of margin of safety can research into a company's balance sheet provide?

I can tell you are keen to buy a stock, or keen to research one and buy some more. Don't get the order wrong though: do your research first and then buy. I think your question relates to companies with a low price to book ratio, right? In today's market, there aren't many stocks like that except in Asian markets, that is. I assume you can invest globally. There are about 100,000 stocks around the world which are traded daily. In Asia, there are still many companies you can look into. For example, the company may be profitable now and for many years into the future. You can verify the value of its assets, be the stocks, financial securities or real estate. You can then subtract liabilities to derive a net asset value. If we say the NAV is 100, there are companies which transact at about 50. Although this kind of opportunity is more rare now than when I started, they still exist! It's strange but the market always has nooks and crannies where you can find opportunities like this. If I was going to start again and didn't know anything at all, I might well start here again. I can grasp the concept. I can see what I'm doing and even feel it. Even if I don't understand anything else about the company, I won't lose money this way. However, in today's market and with the scale of money we manage, I can't look into this kind of company anymore. So I'm not really an expert and I'm sorry to say that I cannot give you a satisfactory answer. I know this kind of opportunity exists in other markets but I really don't know about China, apologies.

Q: Can you please describe the experiences and traits which shaped Munger's investment philosophy? As far as you understand, how was Munger's investment philosophy formed?

First, many of Munger's concepts were already deeply ingrained before he began investing. For example, he was already very interested in understanding how the world works especially at a practical level. He wanted to figure what works in this world and what doesn't, and meticulously avoid the things that don't. This had nothing to do with investing; it was just an interest he had pursued from childhood. On reflection, I was the same. Before I heard Buffett speak for the first time, I already had some preconceptions in my mind. For example, I already had a visceral dislike of speculation. So after I heard Buffett speak – even though I would meet a lot of them later – I never had any interest in those Wall Street schools of investment thought, the men of the hour or all those successful people. (Buffett has said that value investing is like a vaccine which either takes or it doesn't.) Buffett has never seen anyone – and neither have I – who began speculating, had an epiphany one day and then became a value investor. In any case, I haven't seen a single example of this. The concepts which made Munger successful therefore took shape long before he began investing. These concepts then went on to influence Buffett. Because Munger was interested in whatever worked, he naturally became interested in exceptional companies. Because these companies had figured out what worked, their ability to make money was far better than those otherwise cheap companies. Buffett worked for Benjamin Graham for two or more years early in his career and was profoundly influenced by Graham's way of looking at things. Because Graham's theories were mostly formed during the Great Depression after he had failed spectacularly in the years leading up to 1929 doing some investing and some speculating. After 1929, he drew lessons from this painful experience and began to systematize a new methodology, after which he began to perform better. Graham primarily practiced in the period from 1929 to the 1950s. After the market crashed in 1929, it took seventeen years until it recovered in the early 1950s. Graham's career therefore spanned the most disappointing period of the American stock market. The stock market was in constant decline, not dissimilar from China's A-share market. He obtained excellent results in this period but even he couldn't scale his strategy. You can't scale a strategy investing in what Buffett calls 'cigar butts'. Graham's ideas made him very successful at the time and so he obviously had a large influence on Buffett. But when Buffett began investing himself in the mid- to late-1950s, America had already emerged from the era of the Great Depression. The economy was on the rise and those exceptional companies were just beginning to come into their own. For this reason, Munger's influence on Buffett at that time was especially important. Munger had reservations about Graham's theories from the very beginning. He wanted to figure out how the world works; what succeeds and what doesn't. He then wanted to repeat what worked and avoid what didn't.

He never emphasized that these companies had to be bought at a discount because their excellence was in itself a discount as it would allow them to continuously surpass expectations. And he doesn't emphasize that he has to be very responsible because this is a rather deliberate question. As Buffett matured, he therefore left behind the influence of the Great Depression and its method of survival. However, he never relaxed his requirements on valuation and margin of safety. From what I've observed of Buffett, these concepts are deeply ingrained. I think I'm also like this, which probably has some connection to my personal history. No one's style is the same.

Q: You said earlier that index investing can be a suitable choice for the average investor so long as the index reflects the overall economy. Assuming passive index investment funds continue to occupy a larger and larger share of the market, what consequences do you think this will have?

This is a very interesting question, although perhaps less relevant in China because index funds do not yet comprise a large part of the market. The situation is different in the US. In China, because we haven't yet fully implemented an effective system of corporate disclosure, nor do we have a strong policy for de-listing companies, our indices do not fully or fairly represent the underlying economy. I think that the regulators will address this in the coming years. We have transformed from a manufacturing- and export-led economy into a consumption-led economy. In this new era, the means of financing may move from indirect finance to direct finance. The role of the stock market will grow in importance, and this will require attracting more and more people to participate in it. But if we want more people to participate, we will have to better control the market's gambling and excesses, and increase the part of it which focuses on investment. The best, fastest and biggest way to do the latter is through index investing, which means making indices better reflect the underlying economy. One possibility would be to develop a good ETF to do so. But there are many man-made factors involved which make this not the easiest course of action. The best approach is to therefore use a market-based solution and enhance regulation so that the existing indices become more representative. This is China's challenge. America's challenge is that indices comprise a higher and higher percentage of the market. When they reach a certain point, will indices begin to have their own positive and negative feedback loops affecting prices? The market needs investors because they are the ones who *discover prices*. If a market lacks a price-discovery mechanism, it will distort all financing. Inside, we need the investor to be an investor who can really set the price for this security. The *biggest problem with passive investing is that it is price agnostic*. What proportion of investors does a market need to be effective? This is the challenge currently faced by mature markets. However, if this trend continues, there is a possibility that investors are crowded out and the market loses its ability to discover prices. A lot of people are talking about this but I'm personally not too worried. Before the advent of index funds, the market always had a large element of speculation. Value investors were always in the minority. I look at value investors and fundamental investors separately here. We have always had a lot of investors and speculators. The former are a sub-set of the latter but are pickier and demand a greater margin of safety. But otherwise, their thinking is similar. My suspicion is that these people have always been in the minority in the market. There was a Professor at the Columbia University School of Law called Louis Lowenstein who made a relatively systematic estimate of how many value investors there were in the market. He estimated at the time that there were about 5%, which wasn't scientific but I haven't seen anyone else yet expand on his work. But whether it was 5% or 7% or 4% or 10%, the proportion was not particularly high. So before the advent of index investing, these people had long been the most powerful force in the market. But while there had never been any large-scale disasters, bubbles remained an ever-present phenomenon. 2008-2009 was of course an extreme situation. But overall, I don't think this will be a big issue for many years to come. However, this problem does not exist in China. China's problem is that today's stock indices do not fairly represent the underlying economy. Furthermore, there is no alternative ETF. Whoever can create an ETF which better represents the underlying economy will make a huge contribution to common investors. The regulators must do more work on this.

Q: Can you please share how value investing has shaped your thinking on health, family and life?

I've thought a lot about this question, and perhaps I'm not the best person to answer it. I've been divorced once and it wasn't my choice to do so. So in this respect, I'm far from being a lifelong winner. However, I've kept a good relationship with my ex-wife and today, I still manage her money. So I'm far from being an expert in this field and you mightn't get the best results if you follow me. I think investing is a very long-term pursuit in which short-term results are not useful at all. The reason Buffett has won everyone's admiration is because he has a track record approaching 60 years now. It's important to obtain a long-term track record and one of the prerequisites for doing so is keeping in good health. Between Buffett and Munger, one is 89 and the other is 96. Their passion has not diminished, and they still go to work every day. I therefore think having a long life is the first important element of success. And if you want a long life, one of the most important things is to do something that you like. While of course you must maintain a good lifestyle and habits, you must also find *serenity*. If you look at Buffett and Munger, *they just don't get anxious*. Because everything they do creates a win-win outcome, they just don't feel any pressure. For example, 50 years ago, they set their salaries at $100k each. And 50 years later, they are still paying themselves $100k each. Imagine how much they could earn if they set a 1% management fee on the $500bn they manage? Or how much they would have netted if they had charged a 20% performance fee? However, if they had charged these fees, they would have had constant pressure to perform. They would have pressure from redemptions. And they never could have done as they please. Buffett currently has more than $100bn in cash but has *no pressure to act*. He has arranged his life well so that he can live in Omaha. If you go there, he might come visit you. If not, he'll just keeping doing what he does. He eats the same thing every day. He "tap dances to work". And this is what has allowed him to accumulate such a long track record. Moreover, *everything* he does with other people is done in a *win-win way*. He wholeheartedly pays attention to other people. We've known each other for so many years, and I can say that he genuinely cares about other people. He genuinely goes out of his way to help them. He has no mal-intent. That's not to say he doesn't make judgements or that there aren't people he dislikes he just avoids awkward situations. This is to say that it's very important to have a good family life and an environment in which you are surrounded by love It's important to be well-intentioned with your colleagues and your friends, and no to have any ill will. It's very important. Then, you do everything you do in a multi-dimensional way to see you that we have never been quicker since we came. Whatever you do, you must do it in a win-win way. We've never taken a management fee and don't charge anything for the first six percent return. So if you earn an index-like return, you would never pay a dime to us. And on the money you earn over and above the index-like return, everyone hopes to make more money. On this, we borrowed Buffett's early approach and fee structure – *the Buffett formula*. This allows us to live in a very stable way. I have no pressure, and this is very important. I could even come here and speak with you today. Our colleagues are all warm and cordial with each other. We are all very open and transparent, and shun any rivalry. The relationships we have with other people are all mutually beneficial. We don't beat ourselves up. We only do things we truly understand, and refuse to do what we don't. In this way, we can act with no misgivings and avoid the markets ups and downs from affecting our emotions. You will only be able to accumulate a long track record if you can live this way. Having a calm mindset is therefore extremely important. It's critical to turn your life and your relationships into ones of mutual benefit based on love. It is important to give back and to help others; in fact, this can help everyone to feel better and appreciate what they have. Buffett's definition of happiness is, "*to have the people I want to love me actually love me*". I think this definition is pretty good. Using this kind of method to arrange your life will allow you to build mutually beneficial relationships with people over the long-term. In turn, this knowledge can allow the capital you manage to accumulate gradually, allowing the people who have entrusted it with you to have the means to help others. We only offer our services to university endowments funds, charity funds and family offices focused on charity. We are very picky with our clients and do not manage money simply to make the rich richer. This is how we feel like we are contributing to society. If you arrange your life in this way, you will be more at ease and less anxious. You will be able to walk through life unhurried and at your own pace. A lot of investors have told me that they want to invest like I do but their clients won't let them because they're always thinking about how much money they can make in the next hour or so. I personally think that you should not take these kinds of people as your clients. They then say that if they didn't have these clients, they wouldn't have any clients. And then how would they go about finding clients like mine? I didn't have any investors when I started, only the money I had borrowed. My net assets at the time were negative. Munger likes to ask, how do you go about finding a good wife? *The first step is to deserve a good wife, because a good wife is no fool.* Clients are the same. When our fund started, it was my own money for many years plus some from a few close friends who believed in me. Over time, as you accumulate more experience and build your track record, suitable people will naturally find you. And amongst them, you can choose the most suitable. You can do it this way very gradually with no need to rush and with no need to compare yourself to others. The most important thing is therefore to be able to let things come as they are. You must have faith in the power of compounding and the power of gradual progress. Compound interest is a gradual force: 7% compounding over 200 years will give you a return of 750,000 times; that's not bad at all. But this is the power of compounding. Whoever would have thought when China began its Reform and Opening 40 years ago that we would end up here today? Growth during this time has averaged about 9%, which doesn't sound too high. But in forty short years… and some people sitting here today weren't even born forty years ago! We can truly say that heaven and earth have been turned upside down during that time. You must therefore keep faith in the power of compounding. Don't get anxious; nor is there a need to struggle with others, or compare yourself to them. *People who suit each other will find each other*. Don't worry even if you can't. If you have patience, can take things with tranquility and do things gradually you will do even better instead. I made the comparison with golf because golf requires you to keep your emotions still. If you get anxious, you will immediately hit the ball wrong. The results come quickly when your emotions change. If you can keep your heart still, you will do things better and better the more you try. Live in moderation; train your body; seek mutually beneficial outcomes; don't beat yourself up; do what you love. These all sound like common knowledge but are hard to live by when you're young. People are anxious, especially when they're young. Why is that? Because they're always comparing themselves to others Which of your old classmates are doing better or worse? That's their lives; what business is it to you? Every person Every person must live their own life. And in fact, our lives are very short. Time feels like it passes slowly when you are young but when you get to my age, it flies past. A year can come and go in the blink of an eye. You must therefore endeavor to live your own life as this is the only way to be happy. In addition, living your own life is the only way to find real progress. Don't be worried if it takes time. As Mr. Duan Yongping likes to say, "slow and steady wins the race".