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"The Practice Of Value Investing", by Li Lu

Li Lu of Himalaya Capital spoke in November 2019 to students at Peking University's Guanghua School of Management. His speech was titled "The Practice of Value Investing", and followed-up from the speech he gave five years earlier titled, "The Prospects for Value Investing in China".

I've never met Li Lu but through his writings, he's become one of my greatest teachers. Stuck at home in self-isolation, I thought I would translate a transcript of the speech so others can learn from him too.

I've tried to keep faithful to the original meaning while editing lightly to help the flow. Square brackets indicate where I've made an indirect translation or inferred an implied meaning. Big thanks to CG, JN and MC for their help. Otherwise, all errors are my own.

his book, "Modernity, Value Investing and China" ("现代化、价值投资与中国") and I've modified my translation accordingly. This version more clearly discusses his early investment in the cable company and thoughts on entropy. I've also translated the Q&A session which took place after he spoke - read it here.

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I. The Theory and Practice of Value Investing

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.

focused then primarily on the basic theories of value investing and whether they suited China. But value investing is a practical art and I didn't talk enough about its practice. 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.

There are only four basic concepts in value investing:

1. Stocks confer part-ownership of a business. They are not just pieces of paper to be traded.

2. 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.

3. Mr. Market: The market is there to serve you, not to guide you.

4. Circle of Competence: Investors must build their own circle of competence through long-term study and then stick within it when investing.

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. However, according to empirical research, only about 5% of market participants practice value investing. Why then do so many people understand value investing but so few practice it? Today I will therefore discuss why value investing is easier said than done, and where its difficulties lie. Also, why do people so easily revert to other investment styles when they encounter difficulties in their practice?

Let's analyse 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

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. Because value is uncertain, it should be purchased at the lowest possible price. I trust everyone agrees with this. The main difficulties in practising value investing must therefore come from the other two concepts: Mr. Market and the circle of competence.

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 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 realise 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 highfalutin', highly accomplished and often in positions of seniority. In other

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.

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. The second is to define what is a 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

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.

2. The Stock Market: A combination of Investment and Speculation

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 colonisation, there appeared a few proto-companies. From where did the concept of a company come? Because founding colonies and

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. 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.

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 – 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. 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 wealth this created enabled people to increase their consumption, closing the loop of the economy's virtuous cycle.

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: continuous, compound economic growth. This has continued for three to four hundred years, lifting human civilisation to an unprecedented level. Compound growth is an astonishing concept whose power most people don't understand. 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. That is the power of compounding! (For statistics on the American stock

Prospects for Value Investing in China").

These kinds of returns will attract more and more people to the stock market, in turn attracting more and more companies to list. This is the wondrous way in which the stock market works to mobilise 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, while speculators forecast other market participants' short-term behaviour.

What is the difference between these two groups? Is there any difference in their results?

If you invest in a company in a sustainably growing economy, your company's profits and your investment return will also grow sustainably. If you speculate on other people's short-term trading behaviour, 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 investing and speculating. I'm not

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 behaviour 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. The only difference is the impact you will have on society. Investors will help all parts of society enter modernity's virtuous cycle – the stage in which it enjoys continuous compound growth. If you are interested and would like to learn more about this, you can refer to my monograph, "Discussions on Modernisation".

a casino. From a social welfare point of view, we do not want this casino to be too big. However, without it, the market would not exist. 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

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. While the "K-line" has become passé and been supplanted by AI (artificial intelligence), both are fundamentally the same thing. When speculators pitch these theories, they always leave most people feeling perplexed.

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 them because they have something to gain. And what 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

exploitation tax". 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. 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

your best to avoid paying the "information exploitation tax" to a speculator. 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 legalised 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

only people who can scale up and have long-term track records.

Let me in passing just comment as to why index investing is acceptable. Index investing is basically the summation of investing and speculation. Since the net result of speculation is zero, the remainder must be the results of investing. 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.

3. The Circle of Competence

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. When we invest, we use fundamental analysis to forecast a company's future

company earns money; how much it will earn in the future; what kind of competition it faces; and its competitive positioning. 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 analyse 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? 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.

different for every person because everyone's competencies are different. To illustrate, I'll share my own experience.

I stumbled into this profession. It was 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

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. I don't know why but during that lecture, I suddenly felt like this was something I could do too. I didn't think I could do other things but this would be alright because it was studying numbers. 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

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 analyse a balance sheet. I started reading Value Line which presented ten years of summary financial information for thousands of companies. Value Line organised 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. Then I

assets on their books were real and if they were still doing business (even if I didn't know what that business was). 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 realised 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. 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

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 licences. 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 realised that my company had paid a lot for these licences. 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

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 licences 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

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. I was at sixes and sevens because I didn't think there was any margin of safety left, and so I sold. 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 realised that people's mentality changes after they invest in something. 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 realised 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

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. 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. 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. After all, it was my company that hired them. This is how I realised that after making an investment in a stock, people's psychology changes and they become interested in its every aspect.

There was another company at the time which taught me something revealing. This company owned a

were two gas stations near where I lived, one on each side of the same intersection. However, I realised that one gas station had many more customers, and that cars would come to it regardless of which direction they were heading. 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 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

From then on, I realised 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.

universal insight, it is that if you want to build your circle of competence, you must invest in things you truly understand. 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 completely 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. 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

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. 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 favour. But objectively, that's not the way the world works. Intellectual honesty is therefore vital. When you have the right approach and are doing the right things, you will see that your knowledge accumulates in the same way the economy grows. It's a process of compounding. All your past experiences will corroborate and reinforce each

Another important point is to let your passions and opportunities guide your research. Don't let yourself be led by what others are buying. Their stocks and opportunities are their business and of no bearing on you. You only need to take care of your business well. If something interesting comes up, go and look into it. If you take an interest in something, do some research into it. These passions will carry you forward and let you accumulate knowledge step by step. Don't worry and don't rush it.

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. If something is beyond your understanding, don't spend time on

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.

4. The Value Investor's Temperament

The next question is, what kind of person suits being 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.

First, this person must be relatively independent. He should judge himself by his 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

Independence is especially important for investors because they will face temptation every minute of the day. Comparisons also create jealousy.

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 analysing 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

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 approaching 40-50 years for the purpose of finding investment ideas. And how many has he found in this time? 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. And this particular investment

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? 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 cannot be developed, like extreme independence, patience and decisiveness. After reading Barron's for thirty years without

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. You absolutely do not need such a high IQ or to be so clever. Nor did 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 rationalise what they do. The more educated they are, the more convincing it sounds. But in reality, the worse it

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. 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. And you get to keep trying for as long as you want until you retire. 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. Etc. etc. 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

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.

5. How can an ordinary person protect and grow their wealth?

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

Second, if the stock market roughly reflects the overall economy, then index investing can also be useful. If the economy itself is 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

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. After that, you must look to see if their chosen circle of competence is in an intensely

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

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

6. Value Investing and Life

To close, I will try to summarise value investing. Is value investing a kind of faith? I think it might be because it manifests itself in a set of beliefs. 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

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 centres 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

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.

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. Later, I realised I had stumbled upon something wondrous. This profession is an incredible thing. It lets you spend every minute studying new things. 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

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

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. 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!

NEXT

John M. Barry: 'The Great Influenza'

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