

# The Prospect of Value Investing in China

Li Lu's Lecture on Value Investing at Peking University

Oct. 23, 2015

*This is an English translation of the Chinese transcript for a lecture by Li Lu gave at the Peking University Guanghua School of Management's Value Investing course on October 23, 2015.*

First of all, I would like to thank Guanghua School of Management and Professor JIANG, Guohua, for the opportunity to jointly create this course on value investing. I consider the timing for offering such a course on value investing opportune and significant. As far as I know, this is the only course of its kind offered in China. The only other course of its kind is taught at Columbia University. It was first created in the 1920s by Professor Benjamin Graham, Warren Buffet's mentor, at Columbia Business School. Himalaya Capital is very honored to be the sponsor of this course.

I would like to spend today's lecture focusing on the following four topics:

First, I want to touch upon some basic characteristics and fundamental ethical principles of this profession, as I assume that most of you here will eventually join the financial service and asset management profession after graduating.

Second, as asset management professionals, we need to know in the long run which financial assets can achieve sustained, effective, safe and reliable growth in wealth.

Third, through what effective means, in addition to your own efforts, can we prepare you to become outstanding investors so that you can provide value-added services to your clients, protect their assets, and grow their wealth continuously? We will explore the right way and main path for investment.

Fourth, we will discuss whether investment approaches (theories) which have proven effective in mature and developed nations are applicable to China, as many may consider China unique, rendering them irrelevant and inapplicable.

I have pondered these questions for several decades. Today I would like to share my thoughts and observations with you.

## **1. What are the unique characteristics of the asset management industry, and what is the bottom line of ethical conducts in this profession?**

Given that asset management is a service industry, what distinguishes it from others? What are some of its common and distinct characteristics? I think that it has two:

First, most of the time, users in this industry don't know anything about its products, and how to discern their quality. This sets the investment industry apart from almost all others. A car owner, restaurant goer, hotel guest can pretty much tell how good the product and/or service is once he experiences it. However, this is not so in the asset management industry. Most of the time, consumers have no way of judging whether a product is good or bad, and cannot determine whether a service is superior or inferior.

Not only consumers and investors, but also the professionals, including some of the top players, find it difficult to discern the quality of a product or service offered by other players. This is why the financial service industry, and asset management in particular, is completely different from other service industries. If you hand me the track record of a fund manager, which only contains performance data for 1 or 2 years, I cannot tell you whether the manager is good or not. Even if you give me a track record for the past 5 or 10 years, I still cannot make a determination. I must know what's in his portfolio, and I can only make my judgment after observing him over a very long period of time. Since people can't distinguish good products and services from bad ones in this industry, most investment theories are subject to the axiom "where you sit determines how you think and what you say."

The second prominent feature is that overall average compensation for this industry is much higher than any other, and is often delinked from the contribution to the growth of client wealth. The services provided to clients are, in fact, very limited. The product offerings often provide a very high return to investment professionals but not their clients. The pricing structure basically reflects the interests of professionals, and not so much those of the client. Generally speaking, industries prefer raising their quality of service level and making it transparent to customers in order to charge a premium. This is not the case in the asset management industry. This industry implements a uniform fee structure mostly in proportion to the net asset value (NAV). In other words, you will always be paid regardless of whether or not you actually make money for your clients. This is especially the case in private equity, in which the fees are even higher to the point of being ridiculous! You collect fees no matter if you make or lose money for your client. It is possible for a client to invest in a passive index fund. Furthermore, you can still get paid a lot of money even if your performance lags far behind that of the index. This is very unreasonable.

I believe you all want to join this profession for both the intellectual challenge and high compensation it offers. The compensation for this profession is indeed very high. However, I have to question whether professionals in this industry deserve it.

Together, these two distinctive characteristics lead to some obvious malpractice within the industry. The quality of professionals in this industry varies greatly, as there are many unqualified players passing themselves off as professionals. The industry lacks clear standards. It is filled with half-truths and even fallacies which mislead users. Many professionals themselves cannot distinguish truth from fallacy.

Given the unique characteristics of this profession, some basic ethical principles must be requisite for all professionals.

***First, make it your ethical obligation to seek truth and wisdom, and consciously refrain from allowing where you sit to determine how you think.***

Once you start working in the industry, you will discover almost all theories are closely connected to where you sit and what you say. If you do not undertake careful consideration, you will quickly substitute your own interests for those of the client. This is human nature and inevitable. This industry is complicated, and filled with many paradoxical views and half-truths. It is not a precise science, and there is great latitude for judgment and discretion. That's why I would like to urge young people who aspire to join this profession to develop this sense of ethical obligation. You should continue to acquire knowledge, search for truth and seek wisdom. You should be a sensible professional, and not disseminate theories promoting your own interests at the expense of your client. Don't be swayed by the specious theories of others. I cannot overemphasize the importance of this principle.

***Second, develop a sense of fiduciary duty.***

What is fiduciary duty? Every penny entrusted to you by your client should be treated as though it were the money your parents had worked hard to earn and saved thriftily over their lifetime. Even if it is a small amount, it is the fruit of a family's lifetime of hard work and frugality. When you can treat every penny of your client's money as the life savings of your parents, you will begin to understand the meaning of fiduciary duty.

I tend to think that fiduciary duty is something innate, part of someone's DNA. I know some who have it and some don't. Those born without cannot acquire it later by any means or through any effort. The best candidates for entering this professional are those who have it. You can always test yourself and see if you have it or not. If you don't, I would advise you not to join this professional. Otherwise, you do more harm than good by destroying the wealth of many families. If you are to entrust your money to someone, you need to find out whether he has this DNA or not. To a certain extent, the economic crisis of 2008 and 2009 was the result of the long-term 'successful' conduct of those who had breached their fiduciary duty, which proved devastating to society as a whole.

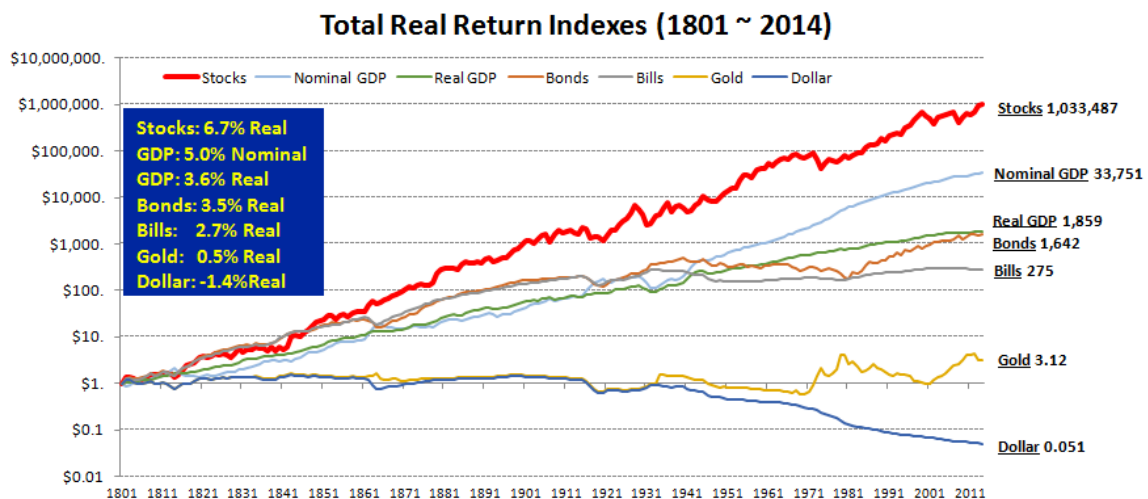
These are the two most fundamental ethical principles for guiding aspiring professionals. As many of you here will become professionals in this industry, and as the ultimate purpose of this class is to prepare future leaders in China's asset management industry, I hope that you

take to heart the following two unbreakable ethical principles when you join this industry one day.

**2. As asset management professionals, we need to know in the long run what financial assets can produce sustained, effective, safe and reliable growth in value.**

The second topic is, in the long run, what financial assets can produce real, long-term reliable return on wealth. We just witnessed a collapse in the stock markets, and many people think cash is the most reliable asset. Some even think gold is very reliable as well. Is there any way for us to measure the historical long-term performance of these assets? How long is 'long-term'? I believe the longer the better, as long as we can find the data. The best data cover a long and continuous period of time, since only such data is really convincing. The Western world is the cradle of today's modern economy, and its markets matured the earliest. Furthermore, the Western economy is the largest and has the largest amount of market data available. It therefore provides the greatest explanatory power. I use US data here because it can be traced back 200 years. Let's see how the US has performed on various financial assets.

In the past several decades, Professor Siegel of the Wharton School of Business, University Pennsylvania has worked diligently to compile solid data for returns on several major classes of financial assets in the US during the past couple of hundred years. These data can be traced reliably back to 1802. Following I will examine his chart (refer to Chart 1) to understand the performance of various asset classes over the last 200 years.



Source: Siegel, Jeremy, *Future for Investors* (2005), Bureau of Economic Analysis, *Measuring Worth*

Chart 1: 1801 ~ 2014 Total Real Return Indexes by Asset Classes in US

The first asset class is cash. The recent ups and downs in the (Chinese) stock market caused a lot of (Chinese) people to appreciate the importance of cash. Many may think cash is the best way to preserve value. Let's see how well it has performed. If you had 1 US dollar in 1802, how much would it be worth today? What would be its purchasing power? The answer is 5 cents! In other words, it would lose 95% of its value or purchasing power over 200 years. The reason is plain to all: inflation! Let's look at the other asset classes next.

Traditional Chinese people believe gold, silver and precious metals are also very a good investment to preserve value. The developed Western nations embraced the gold standard as their monetary system for quite some time. Gold prices indeed increased. However, gold prices witnessed a continuous fall in the 20th century. How has gold, the most important symbol of precious metals, performed in the past 200 years? How much is the amount of gold bought with 1 US dollar 200 years ago worth today? What is its purchasing power? The result is 3.12 US dollars. Yes, it clearly retained its value. But a 3 or fourfold appreciation in 200 years may be quite unexpected as its value has increased very little.

Now let's look at treasury bills and bonds. Interest rate for short-term treasury bills, on par with risk-free interest rates, has never been too high, slightly higher than the inflation rate. Treasury bills have achieved a return of 275 times their original value in 200 years, while bonds enjoy a higher return at 1600 times their original value.

Next, let's take a look at stocks. This is another major class of assets. Many may think stocks are a much riskier investment than the other classes of assets and, therefore, less likely to retain their value. This is especially the case after the rollercoaster ride of the Chinese stock market in the past 3 months. After experiencing a both huge bull market and a huge bear market in a short period of 8 months, many people have a considerably better understanding of the risks involved in the stock market. So, how did stocks perform over the past 200 years? If we had invested 1 US dollar in the stock market in 1802, what would be the value of our investment today?

Here is the result: 1 US dollar in stocks, after discounting for inflation, experienced an appreciation of 1 million times the original value over the past 200 years! Its value today would be 1.03MN US dollars. Even the remainder of this number is bigger than the return on every other class of assets. What are the reasons behind such an astonishing performance? The answer lies in the power of compounding. The average annualized rate of return for stocks, discounting inflation, is only 6.7%. No wonder Einstein called compound interest the eighth wonder of the world.

Some questions are posed by the data: why is it that cash, the safest investment by common wisdom, lost 95% of its value in 200 years, whereas stocks, the riskiest investment by popular consensus, appreciated to nearly 1 million times its original value (after discounting for

inflation)? What caused the huge disparity between the returns on these two classes of assets in the past 200 years?

There are two reasons for this phenomenon.

The first is inflation. In the past 200 years, inflation has had an annualized rate of 1.4%. If inflation has been growing at 1.4% annually, then purchasing power has been decreasing at the same rate. After 200 years of depreciation at 1.4%, 1 US dollar will be worth 5 cents, losing 95% of its value. This is purely a math problem, and easy to understand.

The other reason is GDP growth. In the last 200 years, GDP has grown to 33,000 times its original size at an annual rate of slightly higher than 3%. If we understand economic growth, then we can comprehend other phenomena. Stocks represent the large scale companies in the economy. By and large, GDP growth can be measured by the growth in revenue for these companies as reported in their financial statements. Generally speaking, companies incur costs, but these costs are relatively fixed and don't grow as fast as revenue. Therefore, net profit will grow faster than revenue growth. When the nominal growth rates for revenue are 4% to 5% net profit will grow roughly at 6% to 7%. The cashflow generated by companies will grow at the same rate. As we can see, the actual data support our theory. The core value of stock lies in the growth of its earnings discounted to present value. In the past 200 years, the average price/earning ratio (PE ratio) has been around 15. If we flip the PE ratio, we get the cash return per share (EPS), about 6.7%, which reflects the market valuation of a company based on its profit margin. Therefore the price of stocks will grow at 6% ~ 7% annually, and ultimately increase 1 millionfold after 200 years. It is easy to understand the phenomenon when we look at the math. The stock index, which aggregates all stocks in the market, grows at 6 to 7% when GDP demonstrates long and sustained growth at 3 to 4%.

In this initial analysis, we may conclude that inflation and GDP growth are the two most fundamental reasons for the difference in performance between cash and stocks.

Next, we address a more important question: how could the US economy experience 200 years of sustained and compounded GDP growth while inflation continued to exist at the same time over a long period? Furthermore, how could the economy grow almost every year? It experienced downturns in some years and above-trend growth in others. However, when we examine the past 200 years, we see a continuous upward trajectory. If we take a year as the unit of measurement, GDP grew almost every year. This is real, long-term, cumulative and compounding growth. How can we explain this phenomenon? In China's past 3000 to 5000 years of recorded history, such a phenomenon has never occurred. This is in fact a modern phenomenon not present in China three decades ago.

This being the case, is it possible to quantify the basic pattern of GDP growth, and determine what this growth looks like for the past several thousand years of human history? Can we find some periods in which sustained growth did not occur?

To answer these questions, we need to understand what the changes in overall GDP, consumption, and production in human history, which took place after the appearance of civilization, look like. If we take a longer span of time, and look back further to the era of hunters and gatherers, the agrarian age, and the age of agricultural civilization, what would GDP growth for the entire human race be? It is an intriguing question. I happen to have a chart that may answer our questions (refer to Chart 2). It was created by Professor Ian Morris (a renaissance man) of Stanford University who, over the past ten years, led a research team which measured energy capture and expenditure over 16,000 years using modern technologies. Technological advances in various disciplines in the past 20 to 30 years made this project possible. Throughout most of human history basic economic activities revolved mainly around the capture and expenditure of energy, and the measure of energy is closely correlated with the concept of GDP we are discussing today.

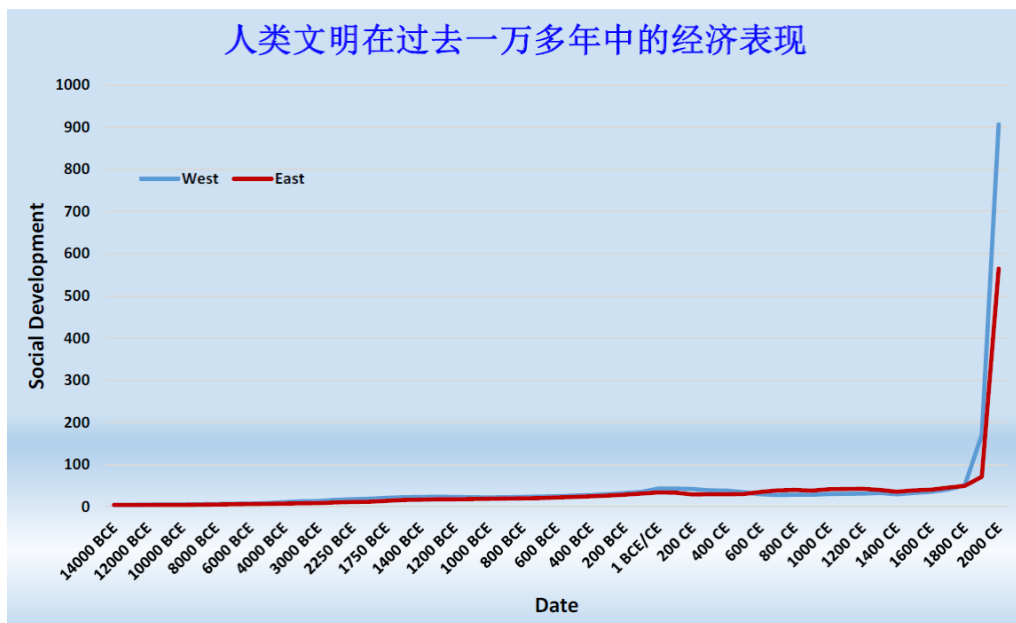


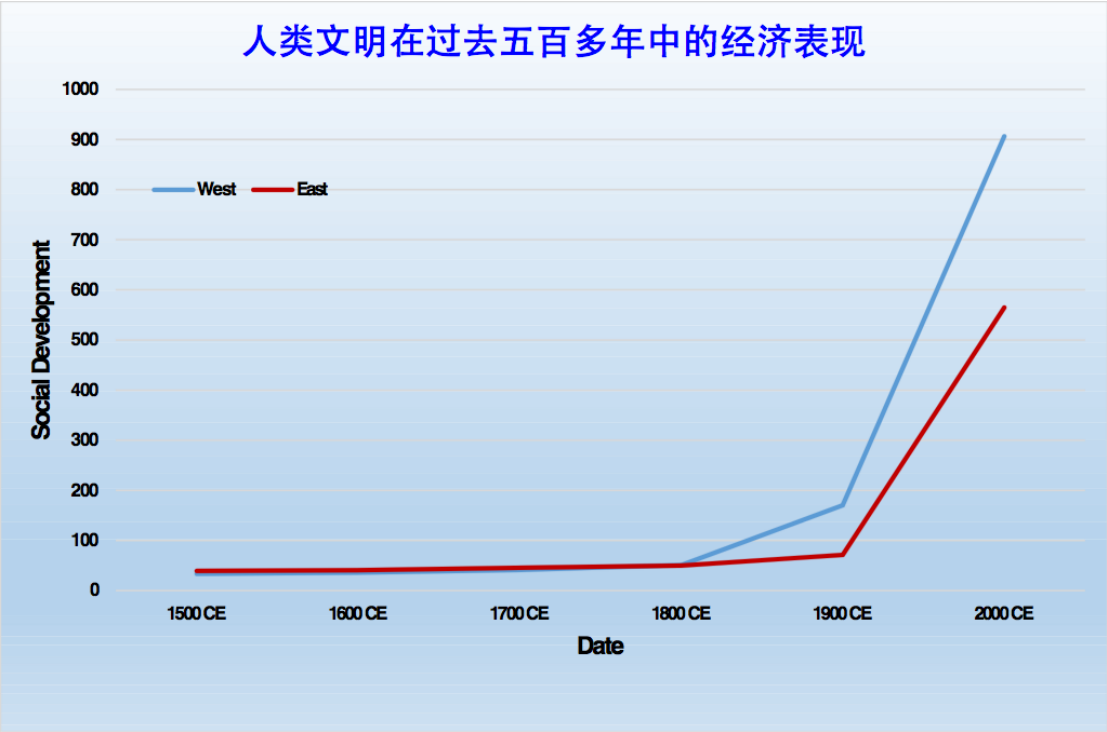
Chart 2: Economic Performance of Human Civilization in the past 16,000 years

Source: Ian Morris, *Social Development* (2010)

From this chart, we can see the economic development of the entire civilized world in the past 16,000 years. It also presents the comparison of Western and Eastern civilizations. The blue line represents Western society from its earliest existence in Mesopotamia to ancient Greece, Rome, and later on Western Europe and America. The red line represents Eastern

civilization, from its earliest inception in the Indus Valley civilization (Harapan Civilization) to the Yellow River Valley and later the Yangtze River Valley in China, South Korea and Japan. The horizontal axis represents the progression of time from 16,000 years ago on the left to modern time on the right. Without applying any mathematical process, the two lines are rather smooth, flat and almost identical. After a mathematical process is applied, we can see a very minor discrepancy between them. During the age of agricultural civilization, human society witnessed some level of development, but at an extremely slow rate. The development curve resembles a wave. It fluctuates, but there is an invisible ceiling it cannot break through. We observe 3 or 4 attempts to break through the ceiling, each of which is followed by a back fall. The curve then crawls within a narrow band. However, in the past 300 years, we see a completely different trajectory. There is a sudden upward spike in movement resembling the shape of a hockey stick, which is analogous to 1 US dollar growing to a value of 1 M.

If we zoom in on the chart, take a section of 200, 300 years, and then zoom out, the new curves (Chart 3) look very similar to the ones in Chart 1. In other words, the charts for GDP growth and stock performance are very similar for the past two hundred years. If we condense the chart further we find the line becomes essentially vertical. This can be explained mathematically by the magical powers of compounding, and indicates that the economic pattern of sustained, long-term compounding growth is a modern phenomenon, which had never previously occurred in the recorded human history of the past 16,000 years.





### Chart 3: Economic Performance of Human Civilization in the past 500 years

Source: Ian Morris "*Social Development*" (2010)

For the most part, GDP has been flat in the rather long history of human development. This was particularly so for China. In the past 500 years, we can clearly observe this trend. We see a sudden uptick in the blue line (the West) at the separation point (around 1800 CE). This is almost 100 years earlier than the point at which the red line (the East) starts to rise. In first 100 years (1800 CE -1900 CE), the emergence of the East was mostly represented by development in Japan.

In order to understand stock performance in the past 200 years, and the next 20 years, we must be able to understand and explain the basic trajectory of human civilization. Otherwise, it will be hard for us to remain rational when a stock market crash occurs. We will think the world is coming to an end whenever we encounter a crisis similar to that of 2008 and 2009. Predicting the future lies at the heart of investing. As Yogi Berra once famously said "it's tough to make predictions, especially about the future." Why did the economy of the human civilization perform the way it did in the past 200 years? It is difficult to make predictions concerning the future if you can't answer this question, one I have spent almost 30 years pondering. I compiled my thoughts, observations and insights in writing a long thesis entitled *A Discussion on Modernization By Li Lu*. If this question interests you, you may want to read it. You can find it online at [http://www.himcap.com/articles/a\\_discussion\\_on\\_modernization.html](http://www.himcap.com/articles/a_discussion_on_modernization.html).

In this thesis I divide human civilization into 3 eras. The first era is the earliest age, that of the hunter and gatherer. This period began 15,000 years ago when homo sapiens began to roam the earth. I call it Civilization 1.0. During this era, humans were quite similar to the other animals of the time. A profound change occurred around 9000 BCE, when agriculture and animal husbandry were developed in Mesopotamia (modern day Iraq). Similar change arrived in China's Yellow River Valley around 6000 to 5000 BCE. These advances allowed human civilization to make a second great leap forward. By this time, GDP growth was much stronger than during the earlier era of the hunter-gatherer. I call this era Civilization 2.0, i.e. the Agricultural (and animal husbandry) Civilization. This era continued for several thousand years. The growth and development of human society was relatively flat until about the 1750s. Hereafter, GDP suddenly demonstrates steady annual growth, a trend which continues to the present day. We take this for granted and think it is no big deal. However, we consider a drop in China's growth from 10% to 7% to be a major event. Though steady annual GDP growth is a very modern phenomenon, it is deeply rooted in our collective psyche. To understand this era,

we need to understand the phenomenon of modernization. I refer to it tentatively as Civilization 3.0 .

Dividing history into 3 distinct eras allows us to clearly understand the nature of Civilization 3.0. The most distinguishing feature of Civilization 3.0 is the sustained, cumulative, and long-term compound growth and development of the entire economy, with which comes the investable value of modern financial products. All discussions concerning investment are meaningless unless the precondition of sustained compound growth has been fulfilled. Only then we can talk about asset allocation, stocks and cash, etc. Therefore, if we are to understand investment and the growing of wealth, we have to understand the origins of wealth creation rooted in 200 plus years of sustained, cumulative GDP growth. During Civilization 3.0 modern science and technology, as well as the free market economy, emerged in the world due to various causes. These two forces combined to create Civilization 3.0 as we know it today.

In my thesis, I offer a detailed description of human civilization's evolution in the past 10,000 plus years. I explain the concept of a free market economy using two formulas:  $1+1>2$  and  $1+1>4$ . In the modern era, the evolution of civilization was fundamentally changed by the arrival of free trade. In the economic context, Adam Smith and David Ricardo proposed that free trade produced a synergetic effect, i.e.  $1+1>2$ . With the division of labor, 2 individuals or economies can engage in free trade, and thereby create more value than they could on their own. The more people participate in free trade, the more value is created and added. This type of exchange existed during the era of Agriculture Civilization. However, modern science and technology acted as an accelerant which hastened the process of value creation, as ideas, rather than mere goods, commodities and services, began to be exchanged. Knowledge yields greater value in the free marketplace of ideas. It creates what I refer to as a  $1+1>4$  situation. When two parties exchange ideas, they obtain the ideas of the other while retaining their own. This may spark entirely new ideas. Exchange of knowledge requires no trade-offs, unlike trading rice for milk (in a barter system). When knowledge is combined it generates compounding and synergetic growth. Only when each exchange results in significant bursts of growth can a society rapidly create enormous wealth.

When exchanges between entities continue, and with the effect of wealth multiplying by the billions, a modern free market economy is born. This is what I mean by Civilization 3.0. It is only in this context of exchange that the overall economy can enjoy continued and sustained growth. This is an economic system that enables the unleashing of human potential. In the history of creation of human institutions, this is probably the greatest creation of all. Once this institution (free market economy combined with modern science and technology) is created, the unique phenomenon of sustained economic development appears. That is to say, sustained economic development mainly manifests itself in sustained GDP growth.

Inflation is, to be precise, a currency phenomenon. When the money supply is greater than the aggregate goods and services (total output) of an economy, prices will go up. Why is this the case? When an economy is expanding, it will require more investment. In the modern economy the banking system provides capital for investment (through bank loans). Banks receive deposits then pay the depositors interest. Generally speaking, as interest rates must be higher than zero, loan interest rates must also be positive. In order to have money to grow the economy, you must first increase money supply. If you want to achieve growth in the real economy, you must invest first. Your investment then becomes raw materials, semi-finished products, finished products and inventory. In this process, you first put money into the economy. This amount of money exceeds the current total output. This time lag creates the attendant effect of inflation during GDP growth period. Inflation and sustained GDP growth allows us to mathematically explain why there is such a large disparity between the return on cash and stocks over the long run.

### 3. What is the right way and **main path** for investing? How does one become a great investor?

If what we observe holds true, it is better for the individual investor to invest in stocks and avoid cash. However, therein lies a bigger problem: the volatility of the stock market. If we need money in the short-term, we may lose money because of price fluctuation. It often takes very long time to achieve desired return. Let's look at the following chart:

Updated through June 2012		Real Returns
<b>Long-Term</b>	1802-2012	6.6%
<b>Major Sub-Period</b>	I 1802-1870	6.7%
	II 1871-1925	6.6%
	III 1926-2012	6.4%
<b>Post-War Period</b>	1946-2012	6.4%
	1946-1965	10.0%
	1966-1981	-0.4%
	1982-1999	13.6%
	2000-2012	-0.1%

#### Chart 4: Returns on Stocks in the US 1802- 2012

From chart 4, we can see the average return on stocks in the US in the past 200 years is around 6.6%. If one looks at intervals representing every 60 years, the number is about the same, and relatively stable. However, a different picture emerges when we examine shorter intervals. For example, in the interval between 1946 and 1965 average return was about 10%, above the long-term trend. But in the ensuing 15 years (1966-1981) stock prices declined rather than grew. Next, we examine the period between 1982 and 1999 and find during this period stock prices grew at a much higher rate, about 13.6%. The picture is reversed for the following 13 years, in which a downward trend was experienced. Prices continued to fall throughout this entire interval. It is no wonder John Maynard Keynes once said famously, "in the long run we are all dead." As an individual investor, your investment timeframe is limited. Most investors have about a dozen, or 20 years at the most, to invest, as we find in public records. If you happened to be stuck in the market around 1981, or 2001 and 2002, your return would be negative. So, as an investor, you only need to invest in the stock index if you want to achieve the same long-term performance as the stocks. However, as to a meaningful investment horizon specific for an individual, you may find that your returns are continuously negative over ten or more years. In other periods you may come to believe you are a genius. You barely lift a finger and reap a return of 14% year after year. If you cannot discern how you achieve your return, you will not be able to determine if it good fortune or your own ability.

If we assume our investment horizon is ten some years, then it will be hard for us to guarantee we can earn a substantial return. This is a definite problem! At the same time, the stock market is very volatile during different time intervals. Therefore, our next question is whether there is a better way than investing in the stock index. Is there an investment which outperforms the stock index, and provides more reliable protection for client wealth at different time intervals, as well as during years in which we need money? Is there a means of investment which will allow clients' assets to ride the wave of compounding economic growth for long-term, reliable, and outstanding returns? Do we have such an investment strategy, outside of shortcuts and devious measures, which is replicable and teachable, and will continuously provide such returns in the long run?

There are a variety of theories and practices in investing over the past decades. As far as I can observe, and based on statistics and data, there is only one philosophy and strategy, utilized by one group of investors, that can bring reliable, safe and outstanding returns to their clients over a long period of time: value investing. Utilizing long-term performance to test this claim, I find very few can sustain an outstanding performance record over the long haul, and those who can are almost all value investors.

The largest hedge funds in today's market mainly deal in bonds and have seen ten or more years of good returns. However, in the past dozen or so years, risk-free long-term bonds have seen their returns fall from 6%, 7%, and 8% to almost 0%. If you factor in that they are two to three times more leveraged, the return is about 10%. Five to six times more leverage results in a return of about 13%. It becomes harder to determine whether this kind of performance is the result of luck or ability even with a track record of more than 10 years. However, you can find value investors with good long-term performance throughout all time intervals. Contemporarily, we have Warren Buffett, with a track record of 57 years. There are others with 20 to 30 years of successful records. They all have one thing in common: value investing.

If I were you, I would want to be clear as to what value investing is, and understand how these investors could perform so well in hard times and do so continuously. I recall 20 some years ago when I sat in a lecture by Warren Buffett on investment. The audience was as small as today's. It was Warren's first lecture at Columbia University. I was there by happenstance and wanted to know what value investing was all about.

The earliest proponent of the value investing system was Benjamin Graham. He put this system in place about 80 or 90 years ago. When we talk about value investing today, we think of Warren Buffett, the leader and representative figure of value investing. But what does value investing entail? It is quite simple really. There are only 4 ideas which you must remember. Ben Graham, Buffett's mentor, developed the first 3 concepts. The last one is Buffett's unique contribution.

First: ***stock as fractional ownership in the company***. Stock is not only a tradable security but also a certificate representing fractional ownership in the company indeed. Investing in stock is investing in the underlying company. The company will grow as GDP grows. When the market economy expands, value will be created as a result. As a partial owner of the company, the value of our ownership will grow. If we invest as shareholders in the company, we support the growth of the company and will be rewarded accordingly when the value of the company increases. This is a sustainable way to invest, and what I meant by the right way; you reap what you sow. That's why this is the right and main path for investing. Unfortunately, few people understands stocks in this way.

Second: ***Mr. Market***. What is a market? On one hand a stock is a fractional ownership in a company and, on the other, a tradable security that can be sold freely. Where there is a market, there will be bidding. How should we understand this phenomenon? For value investors, the market exists to serve them and offers an opportunity to acquire ownership. Many years later they can cash in the ownership in times of need. Therefore, the market is but a service provider. It can never tell you what the true value of a stock is. It can only tell what the price is. You can't treat the market as your teacher, but only as a tool at your disposal. This is the second important concept. However, almost 95% of market participants have a diametrically opposed understanding.

Third: **Margin of safety**. The nature of investing is to predict the future. However, prediction is inherently not 100% accurate, but can only range from 0% to near 100%. Therefore we must leave a large margin for error in our judgment, referred to as the margin of safety. You should always allow for such a margin no matter how certain you are and make sure that your purchase price is much lower than the intrinsic value of the company. Since stock is fractional ownership in the company, as **the company is valuable and has intrinsic value, so does its stock**. And the market is there to serve you, therefore you can wait until the market price is much lower than its intrinsic value to buy the stock and sell it when the market price is much higher. In this way, even if you are wrong in your prediction, you won't lose too much money. If you are right in your predictions most of the time, and have 80% to 90% confidence, but are not quite 100% certain, you will suffer when the outcome with 10% or 20% probability comes to fruition. However, with a sufficient margin of safety your losses will be limited. If you are right, on the other hand, you will be rewarded much more handsomely than others. Therefore, seeking a huge margin of safety for every investment you make is a very important principle.

Fourth: **Circle of Competence**. This concept was added by Warren Buffett through his own 50 years of practice and experience. He believes that, with tireless long-term effort, investors can build their circle of competence, which will give them an unparalleled insight and understanding of selected industries and companies. The circle allows investors to make more accurate predictions concerning how companies will perform in the future. One's competitive strength lies well within this circle of competence.

The most important idea behind circle of competence is knowing the boundaries. No real competence can be limitless. When you advance an argument, you must be able to tell me which premises will disprove this argument. If you are able to do so, your argument is sound and valid. If you simply state the conclusion without providing premise(s), your argument will not stand up to scrutiny.

The concept of a circle of competence is critical because of 'Mr. Market.' The market exists to expose the human weaknesses of its participants. Your lack of understanding, as well as psychological or physiological frailties, will be laid bare in the market. Those who have worked in it can relate to this statement. A market is the sum of all participants and, if you don't know what you are doing, you will be beaten down sooner or later. This is why we hear market tales all the time about people making big money but actually losing money in the end. Mr. Market can discover the fallacies in your logic and identify all of your weaknesses. If you are operating outside of your circle of competence, or your circle has no boundary, Mr. Market will find you at some time, in some circumstance, and he will destroy you.

Only in this sense (investing outside of circle of competence) is there real risk in the market, which is not ups and downs in stock prices, but rather permanent loss of capital. Whether this risk exists for you depends on whether you have a circle of competence that is

small with clearly defined boundaries. Only within such a tight circle are you able to develop your ability to accurately predict the future with continuous and long-term effort.

The investment method developed by Professor Graham generally identifies companies without long-term value and growth. The concept of circle of competence is proposed by Buffett based on his own practice of investing in great companies. If you can truly accept and follow these four ideas, you can buy into companies within your own circle at sufficiently low prices and hold onto these investments over the long-term. Thus you can achieve good sustained and reliable returns through the organic growth of their intrinsic value, as well as stock price's regression to the intrinsic value.

These four ideas encapsulate all of the notions of value investing, as well as its fundamental tenets. The philosophy of value investing is not only simple to explain and easy to understand, but also the right way and main path of investing, as well as the only sustainable way. What's sustainable way? If what you get is what you deserved in others' eyes, your way is sustainable. On the contrary, if others will consider you a swindler when you disclose how you make money without any reservation, your way will certainly be unsustainable. This is what I mean by the right way and main path.

Value investing tells you that investing in stocks is in fact purchasing ownership in a company. Furthermore, investment helps bring the price of the company closer to its real intrinsic value. This is beneficial not only in helping the company grow this intrinsic value, but also allowing it to ride the wave of Civilization 3.0. You will partake in value created through the continuous growth of the company. At the same time, you can provide your clients with sustained, reliable and safe returns over the long-term. You will be rightfully rewarded for your efforts and others will believe you deserve it.

Once on the right way and main path you will not be swayed by fluctuations in the market, and will clearly be able to value a company's real worth. You will respect the future knowing that it is filled with uncertainties and build in a margin of safety to properly diversify risk. If your prediction is wrong, you will not lose a lot of money, and stand to gain substantially when you are right. This will allow your portfolio to continuously and steadily provide higher and safer returns than market index in the long run.

Let's suppose you have nothing in the game. To start off, you take 2% commission and another cut of 20% if you win. If you lose, you close down your present operation and simply open another the following year. If you tell people that this is the way you make money, will they think you deserve the money or jail? However, if you persist in using the 'Buffett Way', and allow for a large margin of safety on prices, diversify risks properly, help all parties win, and charge small fees, all will think you deserve to keep the gains you have achieved. Then you will be well on your way on the right way and true path of investing.

This is all there is to value investing, which sounds rather simplistic and logical. In the investment world, there are many followers of various investment theories, but true value

investors are hard to find. Therefore, one notable feature of investing is that most people don't know what you (investment professionals) are doing, and investing can ultimately be a killer of wealth. The recent stock market crash (bull to bear) is the best case in point.

On this wide open main path of investing you find very little traffic and wonder where everybody is. You need only look at the 'heterodox paths' of shortcuts with traffic backed up for miles. Investors take shortcuts because the right and main path takes too long. In theory, value investing is a sure way to reach your goal successfully, but the biggest problem is it takes too long. It may be the case that a company has fallen out of favor with Mr. Market and its price is therefore much lower than its intrinsic value when you buy it. Unfortunately, you don't know when Mr. Market will come to his senses. In addition, the growth of a company depends on the efforts of everyone from top executives to frontline staff, in addition to time, persistence and some luck. It is an arduous process.

The other difficulty lies in your ability to predict the future, as the ability to invest involves the ability to correctly make such predictions. Understanding a company or an industry means you can predict what state the company/industry will be in 5 or 10 years, by no means an easy task. However, before we make an investment decision, we need to know what situation the company will be in. What will happen if there is an economic downturn? Otherwise, how can we know if the value of the company is higher or lower than the price? We need to have an estimate of the company's future annual cash flow for the next 10 or 20 years to discount them to today's value (present value of future cash flow). It is difficult to know what shape your company will be in, even as the founder. You may say, 'of course I know,' and undoubtedly say this to your customers and investors. You may even tell your employees that the company aspires to the Fortune 500. In reality, you probably cannot predict the company's growth more than 10 years into the future, as few can due to innumerable uncertainties. This does not mean it is a completely lost cause. You can probably predict with high degree of confidence the worst case scenario for selected companies and industries over the next ten years. They may perform better than expected. However, this skill requires relentless effort and studies, along with many years of hard work.

When you are capable of making these judgments, you have begun building your circle of competence, which must be a very tight one at first, but will expand outward as time passes. This is why value investing is inherently a long haul. While it will definitely take you to your destination, most people are not willing to make the effort. You can spend a lot of time, yet still understand very little.

If you are a true value investor, you won't go on a TV money show to critique the stock prices of all companies, or tell others what the stock prices should be. You won't casually state 5000 point is too low, that a bull market is imminent, or that 4000 point is a bottoming out. You will know that such pronouncements are outside of your circle of competence. No matter how big the circle you draw, those statements won't fit into it, and those who set the boundaries of the circle beyond their competence are destined to be destroyed by the market



at some point or somehow. As I stated previously, the market is a mechanism that discovers your weaknesses. Any fault/defect you have will be magnified infinitely, to the point of complete destruction.

Therefore, one basic requirement for professionals in this industry is to be completely and one hundred percent intellectually honest. It is easy to deceive oneself, particularly in this industry, but one should never do it. From where you sit, you can tell people all kinds of lies. When you tell them over and over again, you begin to believe them yourself. However, these kinds of people will never become outstanding investors. Rather, they will be destroyed sooner or later by the market. That's why the industry has not produced many long-term superstar investors. Some of those we talk about as superstar investors might have 20% returns for 10 plus years in a row. But when they close their funds we find they have suffered losses of more than 50%. The funds start small but get larger as they start to lose money. In the end, the amount of money they have lost for investors is much greater than what they have made. However, they make plenty of money for themselves in the process. Based on the overall history of these kind of funds they should not get a penny. This is the point I made earlier about the most distinct feature of this industry.

The wide open path is so far away from the ultimate destination of success. This frightens away many potential travelers. At the same time, the market gives people the impression that they can make money. It is true that there can be large swings in the value of short-term assets, which can give people the illusion that they can make huge profits in a short time. People naturally spend their time, efforts and intellect on making short-term predictions. That's why many will forsake the right way and take shortcuts, which will lead them off track to dead ends or swamplands given enough time. Most will exhaust their clients' money, and some their own. This is why when we look at the US trading records for the long-term, we cannot find successful long-term investments that are based on short-term-oriented theories and strategies. The great long-term investments have all been made by value investors.

The performance of short-term investment is often influenced by the market, and based on luck rather than competence. For example, you can always find 'stock market geniuses' who succeed over a very short period of 1 or 2 years, or even 1 or 2 weeks. China has produced a countless number of them in the past eight months. Some ended up committing suicide by jumping from buildings. You find very few winners in the long run. Even a good track record as long as 5 or 10 years may not be a good basis for predicting future performance. For example, I cannot judge if an investor's outstanding performance over such a period is the result of good fortune or his own competence without seeing the actual positions in his portfolio. Whether an investor is lucky or competent is a key question for value investing.

During a continuous run of 15 years in which the market provides an average compound return of 14% you don't have to be a genius at all. All you need to do is to get in the game and ride the market to see excellent returns. The table can also be turned to where the market shows negative returns for 10 plus consecutive years. If you can succeed under these market

conditions, you are a true genius. This is what I meant when I said that without looking at the specific content of your investments it is generally difficult to judge your competence. However, if my investment manager can maintain excellent performance for more than 15 years, and he does his research in the right way, then he will generally become a competent professional. When we can tell his performance is due to competence more than luck we can essentially say he is a successful investor. In other words, you need to work at this for a long period time before you make it, and it may take you more than 15 years. It is not surprising to see so few riders traveling this wide open path to success, even though it has little traffic and is never congested. Precisely because of this, those who are willing to take to this open but long path have the opportunity to succeed. In addition, when they reach their destination their success will be regarded as true and well deserved. The success you have worked tirelessly for will be sustainable and applauded by others with an objective view.

I sincerely hope all of you here today make up your mind to become a successful person by taking the right path. You will have peace of mind when you reap the benefits. You will no longer play with your clients' money in order to quickly turn a profit at their expense. However, if you lack the two cardinal moral principles I outlined earlier in this lecture, you will surely turn into a killer of many peoples' wealth while you may claim successes along the way. If so, you do more harm than good. I am asking those who are still in school and aspire to enter this profession to take a hard look at yourselves and find out if you have the DNA and the sense of fiduciary duty. If the answer is no, please heed my advice and don't join this profession. If you do, you will cause great harm to society. You may become rich while harming others, but would you be able to sleep soundly at night and live with a clear conscience? Some may, but I definitely would not.

If you don't have the DNA for fiduciary duty, but become an investment professional, you will likely join the crowd which takes short cuts. This will lead you to some dead end, or swampland, with your clients' money in hand. If you are not too smart, you may even take your own as well. This is inevitable. If you are not willing to search for truth and wisdom, set higher ethical/moral standards, or if you don't have the DNA, and a sense of fiduciary duty, if you don't treat every penny of your clients' money as though it were your parents, I would urge you not to join this profession.

I hope you will take these principles to heart and choose the right path in your career as an investment professional.

#### **4. Is value investing applicable to China?**

Next I will discuss the last topic of today's lecture: Given value investing is the right way, can it become a reality in China?

Over the past several hundred years, investing in stocks has proven capable of generating enormous returns for investors in the long run. I have already explained why this is the case, though we know it has not been so throughout human history. Rather, it is a new phenomenon, which emerged about 300 years ago when mankind ushered in a new age of civilization, known as modernization. I call it Sci-tech Civilization 3.0: a combination of modern science & technology and the free market. Is it the case that the phenomenon of sustained long-term return on stocks only can be found in US and European nations, and not in China, as it is an exception? When discussing a number of issues related to China many will say it is special. In fact we can find many areas of difference between China and the West (including the US). We are only interested in the particular question of investment, which is the focus of our discussion today. Is China special?

When the majority of investors are speculative investors, market prices often become wildly detached from the intrinsic value of the underlying assets. Under such market conditions, how can you tell with some certainty that the future stock markets in China will follow the trends of the US economy and its stock market over the past 200 years? If everyone is throwing 'bad money after good,' prices will continue to defy the intrinsic value of the underlying assets and stay detached from the real value for long periods of time. What can I do as an investor if this trend lasts so long that I can't protect my assets? What can I do when China no longer follows the fundamental principles of a market economy? The last question is the key, and involves making predictions concerning the next several decades. Simply put, what will China be like in 30 to 50 years?

Here I will share with you my personal views concerning the question of whether value investing can become a reality in China, which has puzzled me for many years. Investing in Chinese companies means investing in China. Will we see a repeat of 1929 (the great US depression) or 2008 (the subprime mortgage crisis) in China? Everything seems possible. As a matter of fact, many people have thought at some point during this year that we have come to such a point in time. It is also possible that we will come across the same situation in a few months. If you invest, or have money in the game, you will always face this problem. Before you take any action, you need to take a step back and think it through, as you cannot avoid this problem.

First, we let the data speak for themselves. Let's look at some historical data collected on China and other markets and compare their performances. Chart 5 shows US data from 1991 to the end of 2014. We can see the trends are exactly the same as the ones in the past 200 years. Returns on stocks continue to outpace others, whereas cash continues to lose value. The reason, as discussed earlier, is continued GDP growth. This is essentially identical to the last 200 years.

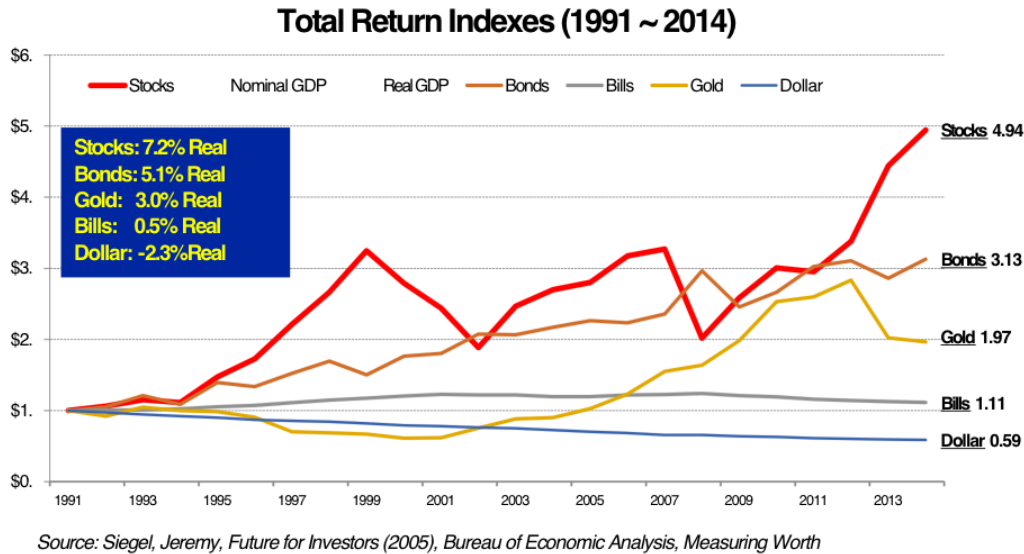


Chart 5: Return on Major Classes of Financial Assets in US 1991-2014

Next, we take a look at the data for China since 1991. In 1990, China saw 8 stocks being offered as pilot projects, but it was in 1991 when stock indexes were established. What do you think the trends look like for this period? (1991-2014)? We know what happened to the Chinese stock markets in the last 3 months, a very sorry sight. Will the trends for this period be similar to what we saw in the past 3 months? Let's look at Chart 6.

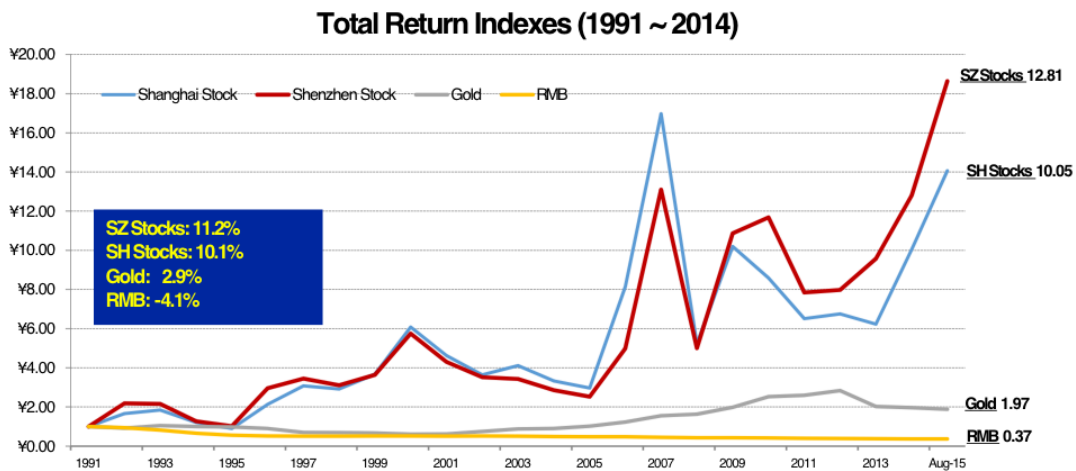


Chart 6: Return on Major Classes of Financial Assets in China since 1991

What we see in this chart is almost exactly the same pattern as the US over the past 200 years. Among the major asset classes, the value of the RMB fell from 1 to 0.37, similar to the

USD, between 1991 and 2014. Gold also lost value. During the same period the Shanghai and Shenzhen stock indexes continuously gained value. Return on fixed income also demonstrated an upward trend. There is, however, one difference: fast GDP growth. Because GDP grew more rapidly than in the US, stock index growth also outpaced the US market. It is surprising to find this peculiar pattern in a developing nation. We observe the following in the past several decades. First, trends are basically identical to the US. Second, the main driver is also GDP growth. China's higher GDP growth rate during this period created the attendant higher inflation. Cash lost its value at a faster rate, while stock value grew more rapidly, all in spite of the similarities in basic trends, an interesting phenomenon indeed!

Index Name	Dividend Yield		Total Return			
	Avg	Current	From	To	Cululative	IRR
<b>USA</b>						
S&P 500 INDEX	1.97%	2.18%	1/2/92	8/31/15	662%	9.0%
DOW JONES INDUS. AVG	2.27%	2.57%	1/2/92	8/31/15	812%	9.8%
NASDAQ COMPOSITE INDEX	0.88%	1.28%	1/2/92	8/31/15	863%	10.0%
<b>China</b>						
SHANGHAI SE COMPOSITE	1.75%	2.01%	1/2/92	8/31/15	1406%	12.1%
SHENZHEN SE COMPOSITE IX	1.04%	0.66%	1/2/92	8/31/15	1864%	13.4%
HANG SENG INDEX	3.25%	3.82%	1/2/92	8/31/15	959%	10.5%

Chart 7: Comparison of US, China Stock Indexes 1992-2014

GDP Growth												
Country	Nominal GDP growth% (local currency, bn)						Real GDP growth% (local currency, bn) -- base year 2000					
	From	Index	To	Index	Cululative	IRR	From	Index	To	Index	Cululative	IRR
USA	1991	6,174	2014	17,348	181%	4.6%	1991	7,328	2014	13,071	78%	2.5%
China	1991	2,190	2014	63,646	2807%	15.8%	1991	4,040	2014	36,957	815%	10.1%
Hong Kong	1991	691	2014	2,256	226%	5.3%	1991	960	2014	2,245	134%	3.8%

Chart 8: Comparison of US, China, HK GDP Growth 1991-2014

We now look back at China's development in the past two decades. When China first embarked on the path of Civilization 3.0, its growth started to show the same patterns and trends, though at a higher velocity, than that of the US. Despite the fact that the Shanghai and Shenzhen indexes have grown 15 times in the past 25 years with an annualized return of 12%, I dare say none of the investors, including every one of you here, has achieved this rate of return. However, there is one entity that achieved such returns on the first day the stock exchanges were established: the government of China. She received this return on the very first day. Many people are worried that China is too highly leveraged, but they often forget the Chinese government enjoys these tremendous returns. It is because she (the Chinese government) owns the lion's share of the stocks traded in the markets. The rest of investors are not so lucky. Initially, no one believed trends in China could track so closely with those of the US, because their development paths/models were so different. However, when China returned to the right track of modernization, Civilization 3.0, it achieved the same outcomes as the United States.

If this is true on a macro level, will it also be true at the company level? Let's look at the following well-known Chinese companies: China Vanke, Gree Electronics, Fuyao Group, GD Power Development, Yunnan Biaoyao Medicinal, Yili Group, Wanhua Chemicals, Kweichow Moutai, Yuyuan Tourist Mart, and Henan Shuanghui Investment and Development Co. These companies all started very small but have grown into giants. The highest growth in market capitalization is more than 1,000 times the original value, while the lowest is about 30. (Refer to Chart 9).

*Data from IPO Date to 8/31/2015*

Company Name	Based on IPO Price		Based on First Day Close				Mkt Cap		
	Cumulative	IRR	First Day	Cumulative	IRR	IPO Date	Years	(RMB bn)	P/E
万科	<b>1151x</b>	33.0%	1058%	98x	20.5%	12/19/90	24.7	153	9.6x
格力电器	<b>837x</b>	43.1%	1900%	41x	22.0%	11/18/96	18.8	111	7.8x
国电电力	<b>584x</b>	41.2%	1727%	31x	20.7%	3/18/97	18.5	86	12.4x
福耀玻璃	<b>350x</b>	30.1%	2640%	12x	11.7%	6/10/93	22.2	30	10.7x
云南白药	<b>264x</b>	29.3%	211%	84x	22.7%	12/15/93	21.7	72	27.5x
伊利股份	<b>162x</b>	29.9%	41%	114x	27.6%	3/12/96	19.5	99	21.8x
万华化学	<b>38x</b>	28.3%	0%	38x	28.3%	1/4/01	14.7	40	19.7x
贵州茅台	<b>37x</b>	29.6%	0%	37x	29.6%	8/24/01	14.0	245	15.3x
豫园商城	<b>31x</b>	15.1%	-41%	53x	17.6%	12/19/90	24.7	22	20.8x
双汇发展	<b>30x</b>	22.4%	0%	30x	22.4%	9/15/98	17.0	59	15.5x
								<b>Avg P/E</b>	<b>16.1x</b>

Chart 9: Top performing Chinese A share companies 1991-2014

Do we know any investor who has seen a return of 1,000 times the original value on investment in the past 20 years? He could have accomplished this merely by investing in China Vanke. The only investors who achieved a thousandfold return were those who held the state-owned initial shares. Their initial share price saw a ten on the first date they were listed. I singled out returns based on IPO price in my studies. After the IPO, anyone could buy stock on the market, and still make close to a hundredfold return (based on first day close price of China Vanke). You would have received a 110 times the return by buying Yili. The data shown in this chart are real companies rather than abstract market indices. These companies, which actually exist, were once miniscule but have grown into giants since their IPOs.

You can find the same pattern in Hong Kong, but the concept of initial shares does not exist there. If you invested in Tencent on the first date of IPO, you really would receive 186 times the return. Tencent went public in 2004 and has grown 186-fold in 10 years. Many of these companies do business in China. (Refer to Chart 10) In the chart, you can find the following companies: Tencent Technology, HSBC, HK&China Gas Co., HKEx, Li&Fung Ltd., Everbright International, China Overseas Land & Investment Co., ENN Energy Holdings, and Anhui Conch Cement Co. There are other companies (which generate superior returns) like the ones included here. I chose them because they are better known to you. I use these examples to make one point: there are real companies underlying stock indexes; the indexes are not merely abstract ideas.

Data from IPO Date to 8/31/2015

Company Name	Based on IPO Price			Based on First Day Close			IPO Date	Years	Mkt Cap (HKD bn)	P/E
	Cumulative	IRR	First Day	Cumulative	IRR					
腾讯控股	186x	59.4%	0%	186x	59.3%		6/15/04	11.2	1,239	39.1x
中国生物制药	160x	40.6%	0%	160x	40.5%		9/28/00	14.9	45	25.1x
汇丰控股	95x	16.8%	0%	95x	16.7%		4/2/86	29.4	1,199	11.8x
香港中华煤气	82x	16.2%	0%	82x	16.2%		4/2/86	29.4	169	22.1x
香港交易所	82x	33.8%	0%	82x	33.7%		6/26/00	15.2	218	31.x
利丰	61x	19.5%	14%	54x	18.7%		7/1/92	23.2	43	11.5x
中国光大国际	46x	16.4%	0%	46x	16.3%		3/21/90	25.5	45	23.9x
中国海外发展	43x	17.8%	29%	33x	16.4%		8/20/92	23.0	224	6.1x
新奥能源	38x	29.1%	0%	38x	28.9%		5/9/01	14.3	43	11.8x
海螺水泥	38x	22.7%	-32%	56x	25.2%		10/21/97	17.9	119	10.3x
									<b>Avg P/E</b>	<b>19.3x</b>

Chart 10: Top performing companies in HK Stock Market 1991-2014

If we look at the US market during the same time period or earlier, there are some familiar names on the list. Since its IPO in 1958, Berkshire's stock (class A) price has grown 26,000 times in value. Its IRR is about the same as China Vanke. Chinese companies listed in US stock market such as Baidu, C-Trip have topped the IRR growth list. (Refer to Chart 11.)

Data from IPO dates to 08/31/2015

Companies	Total Return		Since IPO	Years	Mkt Cap (bn)	P/E
	Cumulative	IRR				
<b>USA</b>						
<b>Top 10 companies by cumulative return</b>						
BERKSHIRE HATH-A	26543x	19.6%	09/01/58	57.0	332	20.3 x
HOME DEPOT INC	4625x	28.2%	09/01/81	34.0	150	22.9 x
WAL-MART STORES	1926x	19.2%	07/01/82	33.2	208	13.4 x
FRANKLIN RESOURCES	1192x	17.4%	07/01/71	44.2	25	11.0 x
MICROSOFT CORP	847x	25.7%	03/13/86	29.5	348	16.8 x
VF CORP	689x	10.7%	04/01/51	64.5	31	23.2 x
ALTRIA GROUP INC	660x	7.3%	03/15/23	92.5	105	19.7 x
MEDTRONIC PLC	643x	17.2%	12/01/74	40.8	102	23.6 x
LEUCADIA NATL	627x	14.7%	10/07/68	46.9	8	15.3 x
AFLAC INC	597x	16.8%	06/14/74	41.2	25	9.8 x
					<b>Avg. P/E</b>	<b>17.6 x</b>
<b>Top 10 companies by IRR</b>						
BAIDU INC-SP ADR	54x	48.7%	08/04/05	10.1	52	25.1 x
NETFLIX INC	106x	42.2%	05/22/02	13.3	49	258.9 x
COGNIZANT TECH-A	301x	39.3%	06/18/98	17.2	38	24.6 x
AMAZON.COM INC	341x	37.5%	05/14/97	18.3	240	N/A
CF INDUSTRIES HO	18x	34.3%	08/11/05	10.1	13	14.1 x
CTRIP.COM-ADR	29x	33.7%	12/09/03	11.7	9	N/A
SALESFORCE.COM	24x	33.4%	06/23/04	11.2	46	N/A
MEDIVATION INC	192x	31.6%	07/02/96	19.2	7	30.3 x
BUFFALO WILD WINGS	21x	30.1%	11/21/03	11.8	4	37.8 x
TASER INTL	40x	29.8%	05/07/01	14.3	1	49.1 x
					<b>Avg. P/E</b>	<b>62.9 x</b>

Chart 11: Top companies in US stock markets 1991 to 2014

I am not going to talk about individual stocks here. I merely use this chart to shed some light on this phenomenon. Stock indexes are not abstract, but composed of individual companies. In the past 200 years, China has traveled down many different paths. However, when China chose the right course of Civilization 3.0, the outcomes for her economy were actually almost identical to those of other nations in Civilization 3.0.

How can we explain this phenomenon? What are the conclusions we can draw from China's performance of the past several decades? More importantly, we have to ask whether we will see the same phenomenon in the Chinese stock market in the next several decades. Will there be a new group of companies which display superior performance like the ones in the charts? Will it be possible for investors to achieve a several hundred thousandfold return in value either by investing in the same companies or new ones?

To answer the question of whether China is unique, we have to examine China's history of modernization, which began in 1840. China didn't initiate modernization. Rather, it was forced upon her. If China had followed her own development path, she would not have arrived at her present situation. The main reason was the very powerful role government played in the economy, which made the formation of a free market economy impossible. In fact, China had several opportunities to develop a market economy throughout its history. All attempts to do so ultimately failed however. From the time of the Han Dynasty onward (206 BC-220 AD) China had the largest and most powerful government. Furthermore, it demonstrated the greatest stability and depth in ruling. The characteristics of the Chinese government are correlated with its geography, terrain and topography, which we will not discuss in detail today. Suffice it to say, China had been very powerful and stable in the past 2,000 years. Therefore, it was not possible for her to be the birthplace of Civilization 3.0. However, this did not mean that civilization 3.0 could not be introduced to China.

Modernization, as we see it today, does not simply entail the modernization of institutions. This fact is key to understanding the changes which occurred in China after 1840. It was not the culture, or economic system, which was transformed in China, but its civilization. The changes we encounter today are a transformation of the state of civilization.

This transformation in the state of civilization was similar to the agricultural revolution of 9,000 BCE. The emergence of agricultural civilization during this period (Civilization 2.0) was accidental. The end of the first ice age in the Middle East allowed for agricultural activity. In Mesopotamia, people discovered edible wild plants and wild animals that could be domesticated. Agricultural Civilization happened by accident and quickly spread to every corner of the world. Today, we see Civilization 3.0 as the free market economy + modern technology. This new state of civilization was indeed produced by the combination of a free market economy and modern science & technology. The spread of Civilization 3.0 in the past 200 years demonstrated a pattern similar to the spread of Civilization 2.0.



The development of Civilization 3.0 followed that of the Civilization 2.0. It happened almost by accident, as certain events, of which the occurrence was not ensured, took place in particular geographical locations. As a result of its location, Western Europe first discovered the American continent. It was 3,000 miles from the continent, in contrast to China, which was some 6,000 miles (or 9,000 miles with the ocean current) away. In addition, China had no motivation to undertake expeditions and discover the American continent. The Atlantic Economy was created after Europe discovered the New World. The most prominent feature of this new economic system was its freedom from government intervention. A brand new economic system, in which the main participants were market-oriented companies and individuals, was born. The emergence of this economic state of affairs began to challenge the traditional view of the world, leading to the modern scientific revolution. This, in turn, brought about a Revolution of Reason, referred to as the Enlightenment, in which people were testing and questioning the validity of traditional knowledge. Civilization 3.0, the civilization of science & technology, emerged against this backdrop after a series of historical events.

It is almost impossible for this kind of development to take place under the Chinese social system (for Civilization 3.0 to first emerge in China). However, if we examine the spread of Civilization 2.0, we see once a new civilization emerges, it will spread quickly to the rest of the world, regardless of the origin of that civilization. The new civilization will quickly replace the old ones. This is related to human nature. According to studies on the biology of our human ancestors, everyone is evolved from the same *Homo sapiens*, and has origins one common place. Thus, all have the same human nature. Around 50,000 to 60,000 years ago, modern humans migrated out of Africa, and it took them 30,000 to 50,000 years to reach every corner of the world via different routes. One branch reached Asia, China, and later the American continent. Therefore, the distribution of human nature in a large population group is very much the same, as is the distribution of intelligence, ambition, empathy, etc. As a species, we all strive for equal outcomes and accept equal opportunity. The inherent nature to seek equal outcomes allows a new and more advanced civilization to spread quickly once it has emerged, while the ability to accept equal opportunity allows each society to develop its own cultural spirit and institutions. In the evolutionary process, this cultural spirit, and these institutions, have permeated every fiber of society, even those areas where there could be resistance. The process of shaping a society into a place of equality is no doubt a painful one.

It is fair to say a civilization must eventually spread. It will do so at a faster rate in regions that already have a relatively high level of civilization and culture, and will also spread more rapidly in regions that were never or only partially colonized. This is why Japan was the first to become civilized in Asia prior to China. It was never colonized. India, having been colonized in its past, was civilized at a slower rate.

We won't go into details on these issues. Generally speaking, China started to undertake modernization after 1840. However, people do not completely understand what the essence (nature) of modernization is. China experimented with various means and modes of

modernizing from 1840 on. It started with the Westernization Movement (Self-strengthening Movement) in which she tried to learn and introduce western technologies, while maintaining Chinese practices in all other matters. Later, she found this approach did not produce the desired results, as China had failed in her attempt to modernize. In addition, the movement was interrupted by the Taiping Rebellion. During that period, China also engaged in the Sino-Japanese War for more than 50 years. China did not follow in the footsteps of Japan on her modernization path. The main reason was that China thought she had to move in the opposite direction. If we fast forward to 1949, we see China tried a different development path in the ensuing 30 years: a collective economy, which is a form of planned economy. China attempted almost every possible path on her road to modernization. At the end of the 1970s, China began her reform and opening up. At last, she had returned to the true course and was moving toward Civilization 3.0, i.e. a free market economy + modern science & technology. The first 150 years of modernization, in which China experimented with many different approaches, was a complete failure. In the previous 35 years China has only attempted 2 new things: a free market and modern science & technology. There has been no significant change in her political system or culture. However, we see a striking similarity between the patterns in China's economic growth and all other Civilization 3.0 nations.

In other words, China has only truly returned to the core of Civilization 3.0 in the past 35 years. Before that, for a variety of reasons, she spent 150 years in search of the right way on a tortuous road which never quite reached the core.

Thirty-five years ago China finally returned to the core of Civilization 3.0, in which the free market meets modern science & technology. Once on the right track, we see that China's economic growth trended closely with other 3.0 civilizations. The charts shown earlier all support this observation. The stock market and other major classes of financial assets, including individual stocks and companies, have all shown amazing growth. On the specific point of the essence of civilization China is not all that unique. Her uniqueness is mainly expressed in her culture. Her political system is also different. But they don't appear to be the essence of Civilization 3.0.

Domestic and international investors alike are concerned with this question because China has a different political system. After all, China has endeavored to modernize for almost 200 years and taken different paths during this period.

China, since her establishment in 1949, had taken a path of centralized planned economy with nationalized properties for 30 years. This was a result of her political system. After taking the path of market economy for 35 years, will China back paddle and abandon the market economy under the same political system? Answering this question will bring clarity to how Civilization 3.0 will fare in China, and in turn, whether value investing will take root in China.

There are no right or wrong answers to these questions. In the past 200 years, generations of Chinese intellectuals have pondered these questions and not reached any

consensus. I have tried to solve this puzzle myself in the past several decades. Following I am sharing my personal thoughts with you.

Before we answer the question, we need to examine what the essence and iron law of Civilization 3.0 are. We touched upon them briefly and superficially earlier. The fundamental reason why Civilization 3.0 is able to continue to promote sustained, long term, and continuous cumulative economic growth is because free exchanges produce added value. When the free market is combined with science & technology, the outcome acts as an accelerator which creates added value at higher velocity. The more individuals, entities, and nations participate in this marketplace, the greater the value created. Adam Smith is the first person to offer this insight. Later, David Ricardo expanded upon this theory to include exchanges among nations and markets, thus laying the cornerstone for modern free trade. This theory states that, among different markets (independent yet competing), the ones with the largest number of participants will grow larger and have more advantage in economy of scale. They will eventually replace smaller independent ones. In other words, the biggest market will eventually become the only market.

This concept would have been inconceivable during the era of Civilization 2.0. Free trade originated in this basic insight. Without it, we would have not seen the development of free trade, let alone the globalization process of today. In the 18th and 19th centuries the United Kingdom promoted free trade. These efforts continued until the 1990s when globalization emerged, which proved the theory was right all along. With the emergence of globalization, we arrive at the new rule: **the iron law of modernization. It states that when there are two competing market systems, with the interaction of two forces of  $1+1 > 2$  and  $1+1 > 4$ ; the one with greater trade volume will see greater growth. When one system has greater volume, it will have greater velocity in its growth, and eventually create a single system.** This singular phenomenon appeared for the first time in history during the 1990s. Since then, there will never be another global market. Something of this nature is truly unprecedented. David Ricardo offered the theory that when two systems traded, they both gained, so free trade was beneficial and desirable. But little did he know that a single market would emerge out of the largest market. This reality only came about in late 1990s.

This is the historic trajectory of Civilization 3.0's progress over the past few decades. It began with the Atlantic Economy (represented by UK and US) when trade was introduced in their colonies. The world evolved into two independent market systems after the two world wars. One was the western market system with the US, Western Europe and Japan at its core. The other was led by the USSR and China. Obviously, the western market system was larger in volume. It also had higher velocity and efficiency because it was based on the free market. Though at the very beginning the systems were quite comparable in size, the disparity became notable within in a few decades, as evidenced by comparing the US and USSR, East Germany and West Germany, or China with HK and Taiwan. This difference is also evidenced by the present disparity between South and North Korea. With the collapse of the Berlin Wall in the

1990s, and the embrace of market mechanisms by China, the world witnessed the arrival of an unprecedented phenomenon called globalization. By then Civilization 3.0 had really shown its true nature. I call it **the iron law of Civilization 3.0, which states a global economic system will eventually emerge**. It is global, unified, and common. In addition, it is based on free trade, free exchanges and a free market.

The market possesses economies of scale. The more participants the greater the value it creates. Larger markets provide a more optimal allocation of resources, higher efficiency, and more wealth. They also give rise to more successes and advancements in science & technology. When markets compete, the winner will always be the largest one. It will eventually emerge as the only one. Any individual, society, company and nation staying outside of the largest market will continue to fall behind, and be forced to integrate into the system eventually. The way to enhance national strength is to tear down tariff barriers, and integrate into the largest global free market system. A closed-door isolationist policy will only make a nation a laggard. **Through market mechanisms, modern science & technology continue to produce an increasing number and variety of products at falling costs. This helps meet insatiable human demand and promote sustained cumulative economic growth. This is the essence (nature) of modernization**. We can easily explain the disparity between East and West Germany, South and North Korea, China (before reform and opening up) and HK, as well as Taiwan. It helps explain why Iran would abandon its nuclear program, a lifeline, in order to be part of the global market. With only one global market, a small closed market such as Iran's would not be able to make advancements in science & technology. In addition to Iran, China and the USSR would not be able to either.

Information is also growing at breakneck speed. Some people 10 years ago predicted that every 8 years the amount of data created would equal the total amount from the entirety of previous human history. I estimate this rate has increased even more rapidly in the past 10 years. The iron law of  $1+1>4$  has been repeating, and at higher velocity. A small market is destined to fall behind. 15 years have passed since China's accession to the WTO. Before that, this global market had been in existence for 20 to 30 years. In this context, any economy staying outside of this system would definitively be a small market. It would fall farther and farther behind as it stayed isolated from the system. If China were to change her market rules, or leave the common (global) market altogether, she would have quickly fallen behind again. I tend to believe that most citizens of such a mature nation, with a glorious history and rich cultural heritage, would not accept such an outcome. It may be possible for China to temporarily remove herself from the global system. But China would not want to be a loser indefinitely after thousands of years of success. It would quickly alter her course after briefly deviating from the main path of Civilization 3.0.

This revision of course may seem very brief when viewed through the lens of history, but it is very long when measured against a human lifetime. Even in this time frame, there is still a free market economy and a sufficient margin of safety. We can live with this short time frame

because it is no more frightening than an economic downturn of ten plus consecutive years. If you assume that China could abandon Civilization 3.0 in the future for some time, your understanding of its iron law will provide you with the comfort of knowing you can still be a value investor with an ample margin of safety.

Let's bring our discussion back to investment and look at the prospect of value investing in China.

I believe China is at interim stage between Civilization 2.0 and Civilization 3.0. Let's call it Civilization 2.5. China has come a long way but still has a long road ahead. Therefore, I think there is a high probability that China will continue on the main track of Civilization 3.0, as the cost of deviation is very high. If you have a good understanding of China's culture, people and history, you will agree that China will forge forward. This is particularly the case now that you have a better understanding of the essence of modern civilization. There is almost no chance of China leaving the common market, and the probability of China changing its market rules is also very small. Thus, it is highly probable that, in the next 2 to 3 decades, China will remain in the global market system, and adhere to free market principles, in addition to promoting science & technology development. There is a high probability that China's economy will be on the main track of Civilization 3.0. Besides, we know the course of Civilization 3.0 has little to do with political and cultural factors, and a lot to do with science & technology, as well as the free market. This is its true essence. This is also the biggest misunderstanding about China many investors have, particularly those from the West.

If China is to stay the course of Civilization 3.0, and adhere to the free market economy + modern science & technology, her returns on main classes of assets (stocks, cash etc.) will track the trends of the mature market economies in the past 300 years. Her economy will continue to grow cumulatively accompanied by inflation. Stocks will continue to outperform other classes of assets. The philosophy of value investing is the right way and main path in China as it is in the US. Value investing will provide sustained, stable, safer and more reliable returns for her investors. This is why I believe value investing can be realized in China.

What's more, I think the principle of value investing not only applies to China, but that value investors have more advantages, despite the fact that the market is still immature. 70% of the players in the Chinese capital market are retail investors focusing on short trades, even institutional investors. Prices are detached from intrinsic value, thus creating very unique investment opportunities. If you are not swayed or lured by short-term gains, but hold firm on long-term value investments, you will have fewer competitors and a higher probability of success.

China is at the midst of an economic transition. Financial reform will allow financial markets to play a greater role in financing rather than relying on indirect bank lending. The stock and bond markets will become the main sources of financing, and the major tools of resource allocation. Given this new landscape, the scale of development, institutionalization

and maturity of the financial market will be greatly improved in the near future. Many with short-term vision may complain that the government has been too heavy-handed in market intervention, or that it should not bail the market out, in addition to other criticisms. However, with longer-term vision, we find the Chinese capital market is continuing to move towards a more market-oriented, institutionalized, and mature system. It will play a more important role in China's economic development. Genuine value investors should play an increasingly important role as well.

Today, when I see your young faces here, I envy you a little. I think you are in the right place at the right time and, as value investors, will have many more opportunities than I did. I have been very fortunate to have the pleasure of studying under value investment masters during these past 20 years. I have been able to learn and practice under their guidance. You will be luckier than me. I hope you will not forget your original aspiration. In addition, never forget the two cardinal principles. The first is to understand and live up to your fiduciary duty. Treat your clients' money as your own, or your parents' hard-earned life savings. Only then can you manage it well. Second, consider it your moral duty to acquire knowledge and seek wisdom. Make conscious efforts to distinguish half-truths from truths. Try to gain true insight and search for real knowledge. Through relentless effort you will become successful. You will generate deserved returns for your clients. In the process, you will make your due contribution to China's economic development. It is a win-win situation for you personally, your family, others, and the country.

I sincerely wish you all the best on the true path to success. Be brave and soldier on. This path is a beautiful one with no traffic congestion. It is not a lonely road, because this industry is filled with all sorts of wonders, challenges and views. I believe you will travel it well. If you stay the course for 15 years, you will become stellar investors.