Li Lu: The Prospects for Value Investing in China

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First, thank you to the Guanghua School of Management and thank you to Professor Jiang Guohua for establishing a course like this to focus on the principles of value investing. Launching a value investing class at this time, in my opinion, is of great significance. As I understand, this is the first and only class of its kind in China. There aren't many similar classes around the world either. As far as I know, the class at Columbia University may be the only other – that is, the class first offered some 80 or 90 years ago by Buffett's teacher, Benjamin Graham. Himalaya Capital is proud to support this class.

I would like to discuss four topics with you today:

First, since many of the students enrolled in this class are likely to join the financial services or asset management industries, I would like to begin by touching on the unique features of these industries, and the moral bottom line required of practitioners.

Second, as asset management professionals, we must know, from a long-term perspective, which financial assets can grow in a sustainable, effective, safe and dependable manner?

Third, are there any effective means by which through hard work you can become an outstanding investor capable of providing your clients with an honest and dependable service to protect and grow their wealth? What is the 'true path' in the world of investing?

Fourth, are the investment techniques proven in mature, developed countries suited to China? Or is China an exception? Can value investing be practiced in China?

I have considered these questions for several decades now and will discuss them with you today.

1. Unique aspects of the asset management industry and the moral bottom line required of practitioners

Asset management is a service industry. Compared with other service industries, what are its distinguishing features? In which aspects does it differ? I believe there are two differences.

The first is that in the overwhelming majority of cases, the consumers of this industry have no means or idea of how to judge its products. This is different from almost every other industry. For example, someone can easily tell you if a car is good or not; or if they out eat out, they can tell you immediately what the food was like and if the service was good. If you stay in a hotel or buy some clothes… in almost every case, you can evaluate a product just by using it. However, consumers of asset management products in most instances have no way of knowing if a product is good or bad, or if the service they are receiving is poor or outstanding.

Not only consumers and investors but even practitioners – including some of the industry's top stars who have joined us today – will have a hard time evaluating an investment product or service. This is the key difference between finance – and especially asset management – and practically every other industry. If you give me a year or two of results, I will have absolutely no way of evaluating whether they are outstanding. It would be similar even with five or ten years of results. You must look at what investments were made, and still you can probably only make a useful judgement after an equally long period of time has passed. Precisely because there is no way to properly evaluate products and services, the overwhelming majority of theories get things ass-backwards.

Another key difference is that overall compensation in this industry is higher than others, and often detached from results. In fact, the actual service provided to clients in most cases is very limited, and many products often deliver the best return to practitioners. The industry's pricing structure fundamentally reflects the benefits of practitioners, not clients. In most industries, one hopes to lift one's standards in a way that is obvious to clients and which will allow for some kind of premium pricing. But in asset management, irrespective of good or bad performance, everyone uses a method of calculating fees based on a percentage of net assets. So regardless of whether one makes money for one's clients or not, one will still get paid. The worst is private equity where the percentage of net assets charged borders on the outrageous. If your client makes money, you get paid; if your client loses money, you still get paid. Even though clients can buy passive index products, as a fund manager, you can still earn a lot of money even if you underperform your index by a wide margin. This is very unreasonable.

I think everyone thinks about joining this industry is in part for the intellectual challenge and in part for the compensation. While the compensation is undoubtedly very high, it's very hard to determine whether most managers are worth it.

Taken together, these two unique characteristics create some obvious drawbacks. For example, abilities are mixed, bad products are passed off as good ones, and many managers seem to be there just to make up the numbers. Standards in the industry are confusing. There is a flood of specious statements and fallacies which confuse consumers. Even some managers cannot see things clearly.

These characteristics pose two fundamental moral requirements on all members of the industry.

I would like to discuss this issue first today because many of the students sitting here today will become practitioners in the future. Moreover, since one of the ultimate goals of this class is to train the future leaders of China's asset management industry, I would like before you enter the industry to keep in mind two unbreakable, bottom line moral requirements:

First, make the pursuit of knowledge and wisdom your moral responsibility. You must consciously reject any ass-backwards theories. Once you enter the profession, you will quickly realise that almost all theories are of this kind. If you don't think about this closely, you will soon confuse your interests with the client's. This is just human nature; no one can avoid it. Because this profession is complicated, it is full of specious points of view. Even though there are many judgements, it is not an exact science. So I really hope that any young people who are wholeheartedly trying to enter the profession can let this kind of moral bottom line take root; you must make the continuous pursuit of knowledge, truth and wisdom your moral responsibility. As an informed practitioner, don't knowingly trot out those theories which are good for you but not your client. Don't let yourself be confused by specious theories. This is very, very important.

The second is to firmly establish an awareness of fiduciary duty. What are fiduciary duties? You must treat every dollar of client money as though it were the fruit of your own parents' labour, saved up piece by piece over a lifetime of diligence and thrift. Even if it's not much, it took years of struggle and sacrifice to accumulate. If you can understand the responsibility this entails, then you can start to understand the meaning of fiduciary duty.

I think the concept of fiduciary duty is innate: people either have it or they don't. Everyone sitting here today, whether you enter the industry in the future or entrust your money to someone in the industry, you must see if you have this trait or else find someone who does. Those without cannot be taught it by any means. And it really will be tragic if you give your money to someone like that. So if you want to enter the industry, you must ask yourself if you have this sense of responsibility. If you don't, I urge you not to because you will most certainly become the wrecker of countless families. The financial crisis of 2008-09 was in large part the result of the so-called 'success' of people who did not understand their fiduciary duty. This kind of 'success' is extremely harmful to all of society.

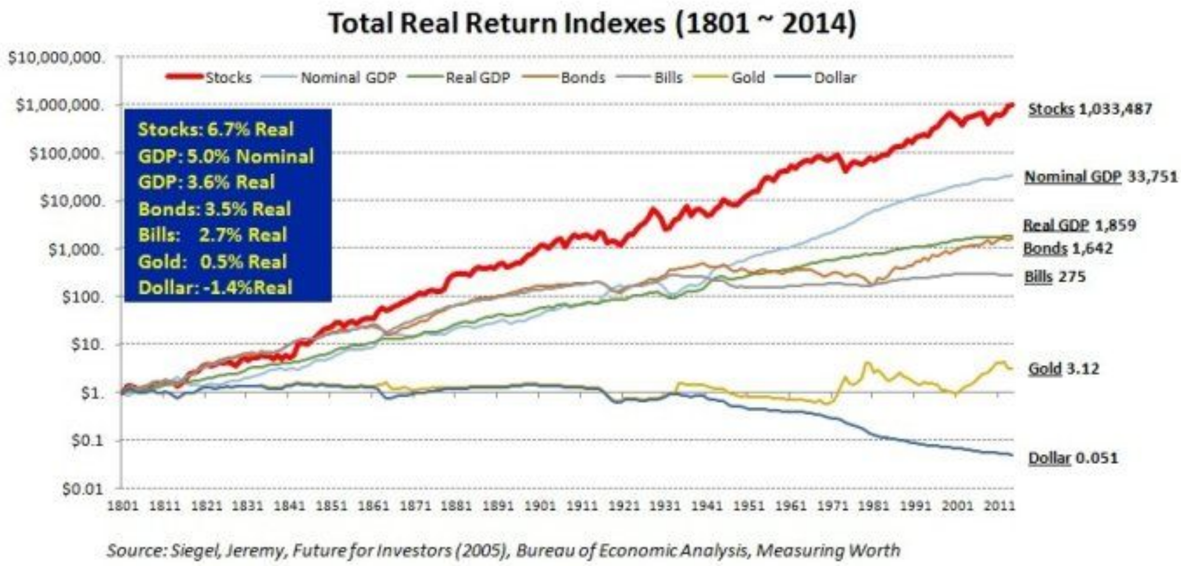
These are the two moral bottom lines I wanted to share today with everyone thinking of entering the asset management industry.

2. As the asset management industry, we must know, from a long-term perspective, which financial assets can grow in a sustainable, effective, safe and dependable manner?

In what follows, we will answer the second question: from a long term perspective, which financial assets can really deliver for clients and investors a dependable return? We've just experienced a stock market crash and many people feel that cash or even gold are the most dependable assets. Do we have the means to assess the past performance of these assets? And how long is 'long term'? I think the longer the better. And the best statistics will be the oldest, most continuous statistics. Because only with this kind of data will we have any persuasiveness. In modern society, the developed western countries are the birthplace of the modern economy and saw the earliest development of modern markets. Because they have the largest volume of market data, and the largest economies, they can shed the most light on this question. And for this reason, we will focus on America because it has good data which goes back for almost two hundred years. So in what follows, we will look at America's performance.

Professor Jeremy Siegel of the Wharton School at the University of Pennsylvania has worked hard over the past decade to compile a set of reliable statistics showing the performance of various financial assets in America going all the way back to 1802. Today we will look to see which financial asset performed best over this time.

Figure 1: Performance of Financial Assets in America from 1801 to today



The first major category of asset is cash. Recent volatility in the stock market has increased many Chinese people's awareness of the importance of cash. Perhaps many people now think that cash can best preserve its value. So let's look at cash's long term performance. If you had a dollar in 1802, how much would it be worth today? What could it buy? As you can see from Figure 1, the answer is five cents. Over two hundred years, cash has lost 95% of its value, of its purchasing power! We should all be able to guess the reason why: inflation. Now let's look at the other asset classes.

For many traditional Chinese people, gold, silver and heavy metals are an excellent means of preserving wealth. Western countries held to the gold standard for many years during which time gold did hold its value. However, the 20th century saw a continuous decline in its value. Using gold as the best representative of precious metals, how much would a dollar of gold two hundred years ago be worth today? What would its purchasing power be? We can again see from Figure 1 that it would be worth 3.12 dollars today. So gold has kept its value and even appreciated 3-4 times over two hundred years, beating expectations although not really appreciating that much.

Let's look at the performance of short-term government bills and long-term bonds. The yield on short-term government bills is a good proxy for the risk-free rate, never too high and just above the rate of inflation. Over the last two hundred years, bills have appreciated by 275 times and bonds by 1600 times, a little bit more.

And on to equities, another of the major asset classes. Many people perhaps think that stocks add risk and cannot hold their value, especially after the ups and downs seen in the stock market over the last three months. Having gone through both a bull and bear cycle in the last eight months, many people will now be much more aware of the risk of equities. So how have equities performed over the last two hundred years? If we had invested a dollar in the American stock market in 1802, how much would it be worth today?

The result is that a dollar invested in the stock market, even after allowing for inflation, would have appreciated a million times to be worth 1.03 million dollars today. Even that remainder is worth more than what other asset classes have returned. And why have equities been able to produce this perhaps surprising result? The answer is that even after the effects of inflation, equities have returned a compound average rate of 6.7%. This is the power of compound interest and the reason why Einstein could call it the eighth Wonder of the World.

These results raise an important question: why does everyone think that cash, an asset which over two hundred years has lost 95% of its value, is safer than equities, an asset which has appreciated a million times over two hundred years? And that million times is even after allowing for inflation. Why have the performance of cash and equities diverged to this degree over two hundred years? This is a question all of us professional investors must consider.

There are two causes of this phenomenon.

The first is inflation. Annual inflation in America over the last two hundred years has averaged around 1.4%. This is equivalent to saying that your purchasing power has declined by around 1.4% every year. Over two hundred years, this 1.4% has made a dollar worth just five cents, eroding 95% of its value. We can understand this very easily from a purely statistical point of view.

Another reason is growth in the economy, measured by growth in GDP. America's GDP has increased by about 33,000 times over the last two hundred years, equivalent to an annual growth rate of a bit more than 3%. If we can understand economic growth, we can understand other phenomena. Stocks are a proxy for large companies and their sales growth is in turn a function of GDP growth. All companies incur expenses, some of which are fixed and bear no relation to sales volumes. In this way, profits can grow at a faster rate than sales. If a company can grow sales by 3-4%, its profits should increase by about 6-7%; and so the value of the cash the company generates should also increase at the same rate. Actual results seem to confirm this. The core value of a stock is the value today of future profit growth. Over the last two hundred years, stocks have been priced at an average of 15x price to earnings, the inverse of which is about 6.7%, reflecting the growth rate of the market's earnings. In this way, equity prices have also grown at 6-7% for two hundred years, resulting in an appreciation of a million times. So statistically, we can understand how equities in aggregate will grow at this rate.

This is the initial conclusion then: inflation and GDP growth can explain the difference in performance between cash and equities.

Another important question is how was the American economy able to produce two hundred years of long term, continuous compound growth? All while there has been a persistent inflation? How did the economy grow almost every year? Of course, there were contractions in some years, and in other years, growth was stronger. But overall, the direction of the economy over the last two hundred years has been upwards. If we take the year as the unit of measure, then GDP increased almost every year in a way that was cumulative and compounding. How should we explain this phenomenon? Were the conditions unique to America? Have they existed throughout history? Obviously, in China's three or five thousand years of recorded history, they have never appeared before. They are indeed a modern phenomenon without precedent in China until about thirty years ago.

So do we have a way to estimate the pattern of GDP growth throughout human history? Is there a phenomenon of continuous economic growth?

We need to refer to another Figure to answer this question. We must make clear what kind of changes occurred in mankind's history after the dawn of civilisation to overall GDP, overall consumption and the level of production. If we were to increase the timespan of our study, to go back to the days of the hunter gatherers, early farming and early agriculture, how much would we find mankind's GDP growth to be? This is a very interesting question. Fortunately, I happen to have just such a figure. It was produced by a team at Stanford University led by Professor Ian Morris and uses modern scientific methods to estimate the progress of mankind over the last ten thousand years. This only became possible thanks to advances made over the last twenty or thirty years. For the vast majority of mankind's history, economic activity consisted of finding energy and using energy. Correlation between this and the GDP growth we are discussing is extremely high. So in the last sixteen thousand years, how have the conditions been for mankind's economic growth?

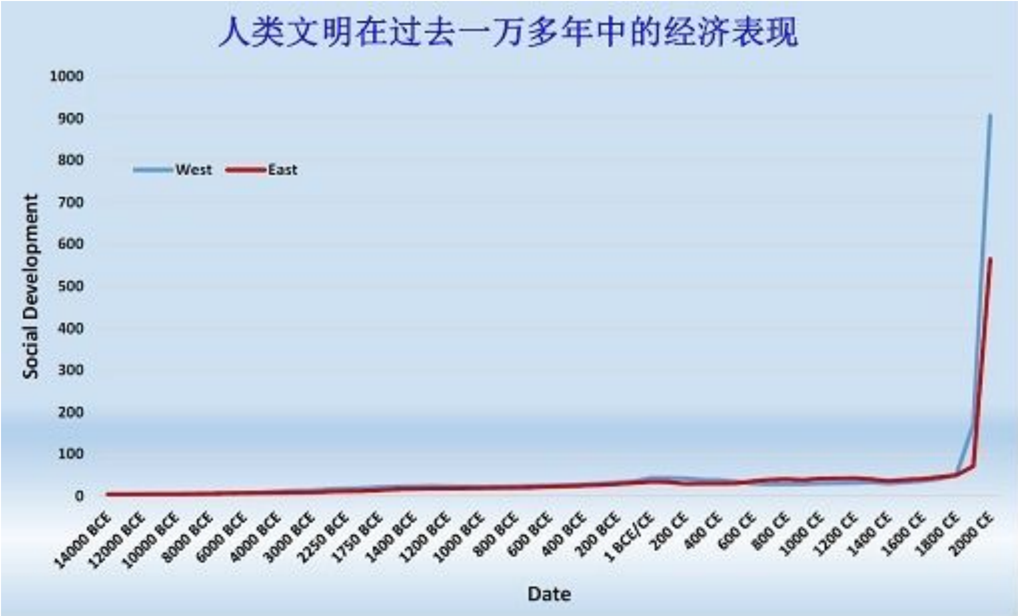


Figure 2: The economic progress of human civilisation over the last ten thousand years

Source: Ian Morris, Social Development, 2010

The figure above (Figure 2) shows the results of the Stanford team's work. The most important comparison is between Eastern and Western civilisation.

From Figure 2, we can see civilised society's economic performance for the last ten thousand plus years. The blue line represents Western civilisation, from the earliest times in the Fertile Crescent to ancient Greece and ancient Rome, and finally to Western Europe and America. The red line represents Eastern civilisation, from its earliest times in the Indo-Gangetic plain and China's Yellow River basin, later entering the Yangtze River basin, and finally emerging in Korea and Japan. The left hand side is from sixteen thousand years ago; the right hand side is from today. Without using any special knowledge of statistics, you can say that these two civilisations have been quite equal over history. There have been minute differences over time and you would be able to see even more minute differences if you really dived into the statistics. But overall, growth has been very similar throughout history. Yet over as much as sixteen thousand years of history, you wouldn't say there was no economic progress but you would have to say it was minimal. There have been ups and downs, but overall it has been as though we were unable to break through a glass ceiling.

We came close three or four times but always reverted to fluctuating in a narrow range. However, once we arrive in the modern era, we can see that in the last three hundred years, radically different conditions emerged and human progress shot up. You can see this looks almost like a ‘hockey stick’; it looks like one dollar becoming a million.

If we enlarge Figure 2 and zoom in on these two or three hundred years, you can see that this segment is very similar to Figure 1. The performance of equities over the last two hundred years strongly resembles GDP growth over the same period. And if you zoom in again, you can see that the line is almost vertical. Mathematically speaking, this is the power of compounding. But the conditions allowing for compound growth have never before existed in human history; they are a purely modern phenomenon.

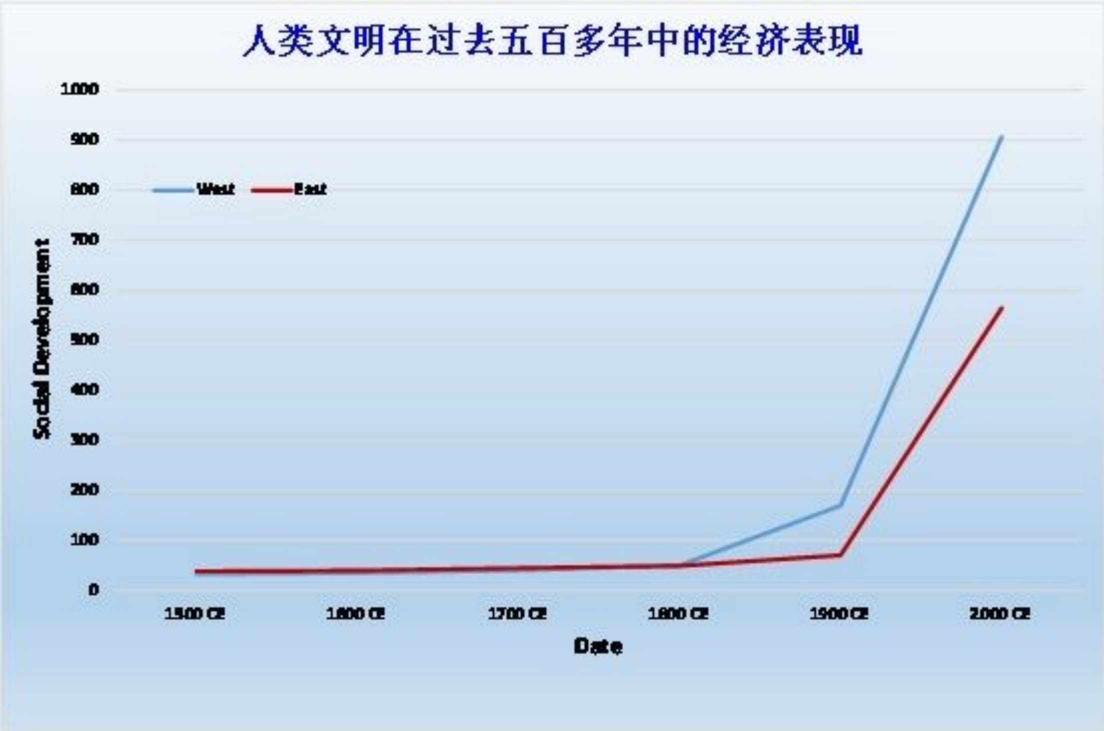


Figure 3: The economic progress of human civilisation over the last five hundred years

Source: Ian Morris, Social Development, 2010

In the long history of the world, GDP has basically been flat. This is especially so in China. Taking the example of the last five hundred years, we can see the sudden ascendance of the West and that the East trailed by about one hundred years. The rise of the East one hundred years ago is largely the contribution of Japan.

Anyone who wants to understand the performance of Equities over the last two hundred years and their performance over the next two hundred years needs to understand this line – the course of human civilisation. If you don't understand this, it will be very hard to stay rational during a stock market crash. Each time we get into a situation like 2008 or 2009, it will feel like the end of the world. The most important thing in investing is predicting the future but as the saying goes, "forecasting is hard, especially when it's about the future". Why has mankind's economic progress been like this over the last two hundred years? It's very hard to make any kind of forecast without understanding this question. I have thought about this question for almost thirty years and put my thoughts into a monograph titled "Sixteen Lectures on Modernisation". Anyone interested is welcome to have a look. It's available on the web and Professor Jiang has also brought along a few copies today. You can find it on my blog, Google or Baidu by searching for "Sixteen Lectures on Modernisation".

I've divided human civilisation into three stages. The first stage is the earliest era of hunter gatherers. I call this Civilisation 1.0 and it began about 150 thousand years after the appearance of mankind. For a very long time, human civilisation was not much different from other animals. The biggest changes emerged in the 9th millennium BC when agriculture and animal husbandry appeared in the Fertile Crescent. Similar changes appeared in China's Yellow River region around the 5th or 6th millennium BC, bringing about the second leap in human civilisation. Our economic strength at that time was already quite strong compared to the hunter gatherer era. I call this Civilisation 2.0 and it was based on agriculture and animal husbandry. This carried on relatively consistently for several millennia until about 1750 AD. Suddenly from here GDP began increasing every year at a constant rate, to the point where we consider it a major event when GDP does not grow. It is even considered a major event when China's GDP growth slows from 10% per year to 7%.

This is a very modern phenomenon which has already become ingrained in our hearts. Its cause is modernisation. I tentatively call it Civilisation 3.0.

This kind of demarcation can help us understand more clearly the essence of Civilisation 3.0: the entire economy exhibits continuous, cumulative and compounding growth and development. You can only discuss capital allocation, stocks and cash when investable financial assets appear. This kind of discussion has no meaning prior to that point. In this way, if you want to understand investing and growing wealth, you must understand the source of wealth creation. The principle source is that human civilisation has enjoyed over the last two hundred years continuous, accumulative and compounding GDP growth. So what is the essence of Civilisation 3.0? In this time, for a variety of reasons, modern science and free markets appeared and their combination shaped what we see of Civilisation 3.0.

In the "Sixteen Lectures on Modernisation", I explain in detail the process of mankind's evolution over the last ten thousand plus years. I also use two formulas to understand the free market economy: '1 + 1 > 2' and '1 + 1 > 4'. The most fundamental evolution in the modern era is free exchange. In the analysis of Adam Smith and David Ricardo, free exchange is how we achieve '1 + 1 > 2'. When society adopts the division of labour and allows free exchange, the economic value created by two people or two economic systems can be greater than the value of what could be produced in isolation. And the more people participate, the greater the additional value created. This kind of exchange did exist in the agricultural era but the appearance of modern science intensified the benefits which arose. The reason was that exchange moved beyond products, commodities and services to the exchange of knowledge. The value created by the exchange of knowledge is much greater. According to my lectures, this is '1 + 1 > 4'. When two people exchange knowledge, they learn more than just what the other is thinking; their meeting will also create the sparks of new ideas. The sharing of knowledge requires no exchange like trading corn for milk. But when you combine knowledge you begin to see growth happen in large increments thanks to the benefits of compounding. Only when each exchange can produce such large incremental benefits will society be able to speedily create wealth.

This kind of continuous inter-personal exchange multiplied billions of times created the modern free market economy. And this is Civilisation 3.0. Continuous, sustainable economic growth is only possible with this kind of exchange. This kind of economic system is the only way to fully release mankind's energy and true motivations. This system is probably the greatest innovation in the history of mankind. It was only after the appearance of this system that we saw the other phenomena we have discussed, specifically, the continuous growth of the economy. Those students who wish to learn more can read my monograph; I won't say anything more about this today.

(Clarification: continuous GDP growth is the means to measure continuous economic growth)

Inflation is a monetary phenomenon. Inflation will occur when the supply of money in the economy outstrips the supply of goods and services. Why does the supply of money increase? The continuous expansion of the economy requires continuous investment. In a modern economy, this investment must go through the banks. Banks must pay interest to attract society's idle capital. Since this interest rate must be positive, banks must also charge a positive lending rate. And so if you want to grow the capital in the system, you must increase its quantity. And if you want to achieve growth in the real economy, there must be investment. The timing difference between these two actions creates inflation almost as an associated phenomenon of economic growth. If you want to invest, this investment will first become a deposit, then semi-finished goods and finally the finished goods themselves. And once you deposit that investment, the supply of money will automatically exceed the supply of goods and services in the economy. It's this timing difference that creates inflation. These two phenomena – continuous economic growth and inflation – explain the large difference in performance between Cash and Equities.

3. What is the 'true path' of investing? How do you become an exceptional investor?

For an individual investor, a relatively good method is to invest in equities and strenuously avoid cash. But equity markets are volatile and always fluctuate up and down. And in the short term when we need capital, those fluctuations can be very sizeable. Let's look at this table below:

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

Figure 4: US Equity returns by period from 1802 to 2012

From Figure 4 we can see that the average long term return from American equities has been 6.6%. Moreover, the average return every six decades or so has been roughly equal to this number and fairly constant. But when we look closer at shorter periods of time, we see that performance is very different. For example, the average return in the post-war period from 1946 to 1965 was about 10%, a lot higher than the long-term average. But in the following fifteen years from 1966 to 1981, not only was there no increase; values fell continuously. Then in the next sixteen years from 1982 to 1999, equities returned an average of 13.6% a year, another high rate. But then in the following thirteen years, equities entered another period of continuous declines. Throughout this time, values were falling. This is why Keynes famously said that "in the long run, we are all dead." Each one of us has a finite investment horizon. Most investors with a public record have only ten or twenty years of results. But if you missed 1981 and started in 2001 or 2002 instead, your ten years of income might all be negative. So as investors, if we look at equities this way, then an index might be OK. But an individual's returns can be specific to a specific time period. You might have ten years of continuous negative returns. But in another period, you might feel like a Rockstar and earn 14% annual returns without lifting a finger. If you don't know how this return was obtained, you will have no way to determine if it was through luck or skill.

If we assume a ten-year investment period, you would find it hard to guarantee a considerable return. This is a problem. At the same time, the stock market's volatility at different times can be very strong. So the question we must address is: is there a reliable way to invest across different periods of time which can produce a superior return to the index while still protecting client assets? Which can allow clients to achieve a long term, reliable and exceptional return by participating in that process of economic compounding? Is there a way to invest – nothing heterodox – which can be repeated and studied, and which can bring us this kind of result over the long term? This is the question we will seek to address.

In the last few decades, as far as I know, there has been every kind of investment style. And as far as I can observe and speak to with statistics, there has only been one style which has reliably and safely brought investors exceptional long term returns: value investing. I realised that there are scant few long term track records to use to illustrate this, and that of those I could find, practically all were value investors.

The biggest hedge funds in the market today primarily invest in bonds and have produced good results over ten years or more. But over that time, the return on risk-free, long-term bonds has gone from 6-8% to practically zero. If you had used two to three times leverage, you would have earned 10%. If you had used five to six times leverage, you would have earned about 13%. It's very hard then to tell if these funds' results are due to luck or skill, even with more than a ten-year track record. Every era has value investors who can produce good, long-term results. Today, Buffett has a 57-year track record. Others have twenty or thirty year records. Without exception, these people are all value investors.

If I was in the audience today, I would want to figure out what is value investing and understand how these investors obtained their results. When I first heard about value investing, it was Buffett's first ever lecture at Columbia University and I had come completely by accident. The audience was as small as this one today. I wanted to figure out what value investing was and how these people could continuously produce such good results in such a challenging environment.

So what is value investing? Value investing is a system devised by Benjamin Graham which first began to take shape eighty or ninety years ago. It's leading figure today is none other than Warren Buffett. But what does it mean? Actually, it's very simple. There are only four principles of value investing: three from Graham and one from Buffett, his unique contribution.

First, stocks aren't just little pieces of paper that you buy and sell. Each one is in fact a certificate bestowing fractional ownership of a company. This is the first important concept. Why is it important? Investing in stocks is actually investing in a company. And as that company grows along with the economy, when the market economy continues to grow, value itself will be continuously created. As fractional owners of that company, the value of our fraction will grow along with the value of the whole company. So if we invest as owners of a business, we will benefit as a product of the growth in the value of that business. This is sustainable. What is the right way to invest and what is the wrong way? The right way is to earn what you deserve. So this way of investing is the right way. Very few people are willing to look at stocks this way.

Second, understand the role of the market. Stocks represent the fractional ownership of a business but on the other hand, they are also tradeable securities which can be bought and sold at any time. And in this market, there is always someone quoting a price. How should we understand this phenomenon? Value investors believe the market is only there to serve you. It can give you the chance to buy a small piece of a business. And many years later when you need money, it can give you a way to sell and turn that small piece back into cash. This market can never tell you what the true value of something is. It can only tell you what the price of something is. You must never let the market become your master. You can only let it be a tool to serve you. This is the second very important principle. But practically 95% of market participants understand the opposite.

Third, investing is inherently about predicting the future. But predictions can never reach 100% accuracy; they can only fall between zero and something approaching 100%. So when we make a judgement, we need to leave a large buffer. This is called the margin of safety. Because there is no way to ever be sure, you must always remember the margin of safety no matter how many other things you grasp. The price at which you buy should always be far, far below the company's intrinsic value. This is the third important principle of value investing. Because we have the first principle, we know that our stock is a fractional interest in a company, and that company itself has an intrinsic value. And because we also know that the market is there to serve us, we can wait to buy until the price is far, far below the company's intrinsic value. And when the price far, far exceeds the company's intrinsic value, you can sell. This way you won't lose too much money if your prediction of the future is wrong. Even if your prediction proves 80% or 90% correct, you will still never be 100% correct. And when that remaining 10% or 20% probability materialises and has an adverse impact on the intrinsic value of your investment, you won't lose too much. And if you do turn out to be right, your return will be much higher than others. Demanding a huge margin of safety each time you invest is one of the skills of investing.

Fourth, in his fifty years of practice, Buffett has added one more principle: through unremitting hard work over a long period, investors can build up their own circle of competence. This can give them a deeper understanding than others of a company or an industry, and allow them to make better judgements of future performance. Your unique strength lies within this circle.

The most important part of the circle of competence is the boundary. An ability without a boundary is not an ability. If you have a point of view, you must be able to tell me the [unsatisfied conditions] for it to be a real point of view. If you just give me a conclusion, it will almost certainly be wrong and unable to withstand scrutiny. Why is the circle of competence so important? Because of 'Mr. Market'. What is the point of the market? As far as market participants are concerned, it is to discover the weakness of human nature. If there are things that you don't understand, or if you have any kind of psychological or physiological weakness, there will be a situation in the market which exposes you. Anyone who's been in the market before will understand exactly what I'm talking about. The market is an aggregate of us all. If you don't know what you're doing there, there will be a moment when the market knocks you down. This is why you only ever hear stories about people making money in the market. But in the end, everyone loses it all. You only hear stories about new people making money because the old ones have all disappeared. The market can see through your logic and all your problems. If you stray outside of your circle of competence, or if your circle has no boundaries, or if you don't know your boundaries – there will be some moment when the market takes you to the cleaners.

Only in this sense does investing carry risk. It's not the price of a stock bouncing up and down; it's the risk of a permanent loss of capital. Whether this risk exists or not depends on whether you have a circle of competence. And this circle must be very small and very well defined. Only within this tiny circle of competence will you be able through hard work to make good predictions about the future. This is Buffett's concept.

Professor Graham's investment style found companies with no long-term value or growth. And the concept of the circle of competence arose from Buffett's own experience. If you can really accept these four basic concepts, then you can build long-term holdings at low prices in companies within your circle of competence, and through the growth in the company's own intrinsic value and the return of price to value, you can obtain long-term, good and reliable returns.

Together these four basic concepts comprise the entirety of value investing. Value investing isn't just something that's easy and clear to speak about; it's also the right road to follow. The right road is one that is sustainable. What is sustainable? Sustainable things all have one thing in common: from the perspective of others, what you receive has all been fairly earned. If your methods of making money were completely revealed to the public and they thought you were a cheat, then those methods would not be sustainable. If on the other hand they think your methods are true, good and admirable, then those methods are sustainable. This is what's called the 'true path'.

Why is value investing the right path to follow? Because it tells you that when you're buying shares, you're buying part of a company. Investing helps the market value of that company come closer to its intrinsic value. You aren't just helping the company to continuously grow its intrinsic value; as the company grows and creates value within Civilisation 3.0, its intrinsic value will grow. And the value of your fractional ownership of that company will grow. And at the same time, you will be giving your clients something of long-term benefit: a sustainable, reliable and safe return. Finally, the result is you will help the economy, the company, individuals and yourself. Earning returns this way will make others feel like you've deserved them. So this is the right path. You won't be thrown off course by the ups and downs of the market. You will be able to clearly assess a company's intrinsic value. You will have a deep respect for the future and know the uncertainty inherent in prediction. Therefore, you will use an appropriate margin of safety to manage risk. This way, you will not lose too much when you are wrong, and you will make much more when you are right. This way you can let your portfolio generate higher than market returns with less risk, in a sustainable and stable way.

If you start with nothing, take a 2% commission and then 20% of profits; and if you lose, you just close one company and start another the next year – what will everyone think when you tell them? Will they think that what you received is what you deserve? Or will they think that you deserve to be put in jail? But if you follow Buffett's method of leaving a big margin of safety and appropriately managing risk, everyone can be a winner. And when everyone wins and you collect a small fee, everyone will feel that you have received what you deserve. This is the right path to follow in investing.

This is the sum of value investing. It sounds easy and logical. But what about in practice? This kind of investor is few and far between. Every investment theory has its followers but there are very, very few true value investors. Consequently, one of the characteristics of investment is that most people will have no idea what you are doing. The result could become harmful to your wealth. The stock market crash we just went through is a great illustration.

So the right path in investing is clear and free from any traffic. Where is everyone going? The wrong way! They are taking the wrong path. Why? Because the right path travels slow. It may sound like you can stroll to the end but the journey is in fact very slow. In theory, value investing appears like something which can lead to success. But the journey is a long one. Perhaps when you buy the market really doesn't understand a company's intrinsic value and the price is far below what it should be. But you have no idea when the market will become more reasonable. And much depends on the company's management working hard to build the company's worth. We all know that a company's success depends on a lot of people, a lot of time, a lot of hard work and a little luck too. So this is a very difficult process.

Making predictions about the future is also very difficult. Investing is the ability to predict the future. You really need to understand a company and its industry and assess their outlook for the next five or ten years. Can anyone here tell me about a company whose future they can predict for the next five years? It isn't easy. Before investing, we need to know at a minimum what a company will look like in ten years and how it will behave in a downturn. Otherwise, how can you judge that the value of this company won't decline? To know what a company's future cash flows are worth today, we must know approximately what those cash flows will be in ten or twenty years. As the founder of a company, how do you know about next year? You say you know to clients and investors. Sometimes you even say this to your employees, things like your company will join the Fortune 500. But there is no way you can really predict how your company will develop over the next ten years or more. Those who can do so are very, very few. There are too many uncertainties for most companies and industries to make predictions that far out. Does that mean there are none at all? Of course not. After a lot of hard work, you will see which companies and industries have a clear picture of what they could become in the worst case. They will probably end up much better than this. But it will take years of hard work and study to reach the level where you can do this.

And when you can make this kind of judgement, you will start to build your circle of competence. At the start, it will be very narrow. And it will take a long time to even get there. This is why value investing is such a long and slow process. Although you will get there in the end, most people are unwilling to make the journey. It takes a lot of time and yet even after a lot of time, you may still not know very much.

You won't go on financial television to value all companies, immediately tell others that this company's share price should be that. If you are a true value investor, you would never dare speak this way. You also wouldn't dare to say that 5,000 points is too low, that the great bull market is just about to start or that you won't start bargain hunting until 4,000 points. You can't say these things and won't dare to make such predictions. If you are a real investor, these things will obviously be outside your circle of competence. Those who draw their circle beyond their ability will completely destroy themselves in the end. The market is a mechanism for discovering your weakness. If there is an area you don't completely understand, you will be found out and you will completely destroy yourself.

The most fundamental requirement of this profession is complete and utter intellectual honesty. You should never fool yourself because you are the most easily fooled, especially in this profession. You can talk bullshit to other people and eventually end up believing it yourself. But this kind of person can never become an exceptional investor. They will without a doubt come undone in a certain kind of market. That's why our profession basically cannot produce many exceptional long term investors. We've talked today about many so-called star investors with 20% CAGRs earned over ten or more years. But in the final year they close shop after losing tens of percentage points. When they start out, their assets are small. But when they lose, their assets are large. And so what they lose is far more than what they ever made. Yet they make a lot of money for themselves. If we counted from beginning to end, they really shouldn't have made a dollar. This is the unique part of the industry that we talked about earlier.

So even though this is the right road to follow, success is still a long way off. Many people are put off by this. In addition, the market will always tempt you with short term profits. Your can have big changes in your assets over a short period, giving you the illusion that you can earn a lot of money in a short period of time. So you will become inclined to spend your time and energy making short term market forecasts. This is why everyone willingly starts taking shortcuts, and isn't willing to follow the right path. And almost all these shortcuts turn out to be dead ends. Because almost all investment styles which focus on short term trading lose money over a long enough time. Not only will you lose your clients' money, you will lose your own. Therefore, at least in America, we see very few successful long term track records from investors of all stripes who focus on short term trading. And of those with real, exceptional long term track records, virtually all are value investors.

Short term results often benefit from luck and have no connection with skill. For example, take a short period, not even one or two years long. At any time, even one or two weeks, there will always be some rock stars. I don't even know how many rock stars emerged in China over the last eight months. Many came to a very bad end. In the short term, there will always be winners and losers. But in the long term, there are very few winners. One-, two- or three-year track records – even three to five year, or even five to ten year track records – are seldom any use for predicting future results. If someone tells me they've had good results, say over five or ten years, if I can't see their actual investment results, I still won't be able to judge if it's down to luck or skill. This is one of the core problems judging value investing: is it luck or is it skill.

The market can deliver 14% CAGRs over consecutive periods of fifteen years. In those times you don't have to be a genius; it's enough just to be there. But there are other times when returns are negative. Having a good track record in those years is not the same. So it's very hard to judge performance without seeing the context. But if someone can produce outstanding returns over fifteen years or more, then we can probably say they're something exceptional. It's safe to say there's more skill than luck over that time. But this also means that in this profession, it takes years of hard work before you can possibly identify talent – and it can be upwards of fifteen years. That's why although this road leads to success, there are so few people who follow it. But this is exactly the opportunity for those willing to face hard work and a long journey. As they progress, the success that they earn is seen by everyone as well deserved. This is the only kind of success which is sustainable. Your success will be a result of what you put in and everyone will be able to see this objectively.

I hope all the students here today can resolve to follow this path and earn their success in this way. You will also feel comfortable this way. You won't rely on short term games to turn your clients' money into your money. If you enter this industry but don't possess the moral bottom line I talked about earlier, in the process of becoming successful, you will definitely give the public opportunities to destroy their wealth. It will be a crime. I remind everyone, especially those still studying and thinking of joining the industry, to ask yourself honestly if you can be a good fiduciary. If not, I urge you not to join the industry. It will be harmful to society. Of course, you may get rich along the way. I don't think I could sleep well if it was me but of course, lots of other people can. I hope that you aren't that kind of person and that if you join the industry, you will not do these kinds of things.

If you are one of those people without the fiduciary gene and you still do enter the industry, you will ultimately finish in a dead end. All the shortcuts will end in a bad way and you will take your clients' money with you. If you are not too smart, the only result will be that you will lose all your money. If you do not treat the pursuit of knowledge as a moral requirement; if you cannot cultivate the fiduciary gene; if you cannot treat every bit of client money as though it was money that your parents had scrimped and saved their whole lives to earn; I urge you not to join this industry.

So I hope that everyone entering this profession lets these principles take root, and follows the right path.

4. Is Value Investing practicable in China?

In what follows, I will talk about the final question: since Value Investing is a 'true path', can it be practiced in China?

Over the last few hundred years, equity investing has indeed given investors great benefits over the long term. We've explained why, why these conditions haven't been present throughout human history and how they only materialised in the last three hundred years. Mankind entered a new era, which we call modernity and which I call Civilisation 3.0. Modern science and technology have combined with a free market. So is China a special case? Is it only America and the European countries which can produce these conditions? Many people have concluded that China is an exception, with much that is different from America. But for the purposes of our discussion on investment, is China really a special case?

If most people are speculating, prices will at many times diverge from intrinsic value. So how can you determine if China will over the next few decades follow the path of the American economy and stock market? If bad money chases out the good money, prices can indeed go against fundamental value for a long time. How long is sufficient for ‘long term’? How can we guarantee our financial assets? And what if China does not implement a market economy? Answering these questions will be critical. They touch on our forecasts for the next several decades: what will China be like?

I have personally spent many years puzzling over whether value investing can succeed in China. Investing in a Chinese company means investing in China itself, and this country could well see a year like 1929 or 2008. In fact, many people believe that this year we have already encountered similar times, and that over the next few months we may see more. If you invest, you will always face such questions in the market. Before you do anything, you must carefully think over every problem. This question is unavoidable and must be addressed.

We will first use statistics again. I have collected what data I can to compare the performance of the Chinese stock market against other asset classes. Figure 5 shows the performance of American assets from the end of 1991 until the end of last year. We can see that their performance is almost the same as over the last two hundred years. Stocks have continuously gained value while cash has continuously lost value. This is because of the continuous growth in GDP, the same as it has been over the last two hundred years.

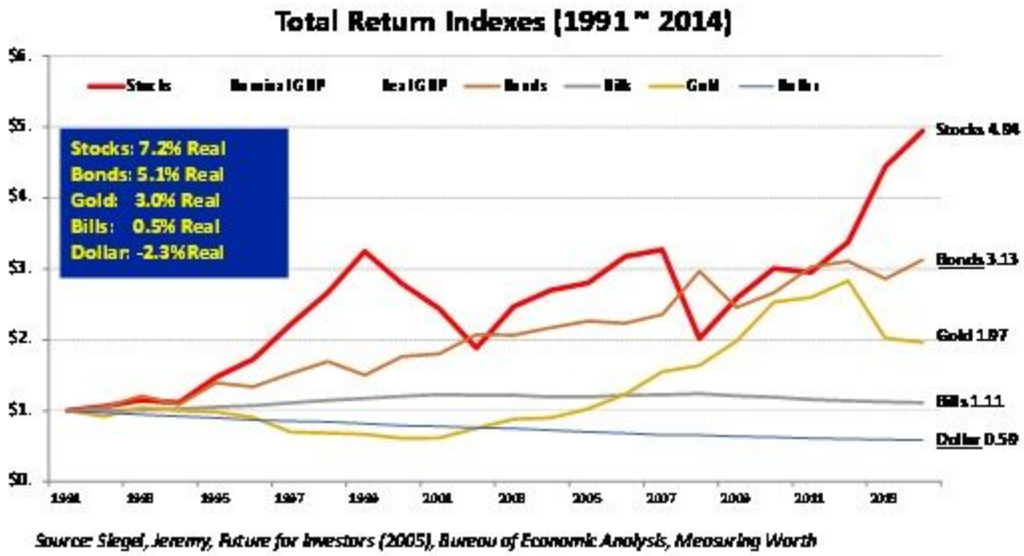


Figure 5: Performance of major American asset classes from 1991-2014

Next we will look at the statistics for China. The "Original 8" only launched in China in 1990 and the first real index in 1991. I'd like to invite everyone to guess what China was like in those days? We know that the Chinese stock market has been on a rollercoaster over the last three months. Did stocks behave the same way in the past? Let's look at Figure 6.

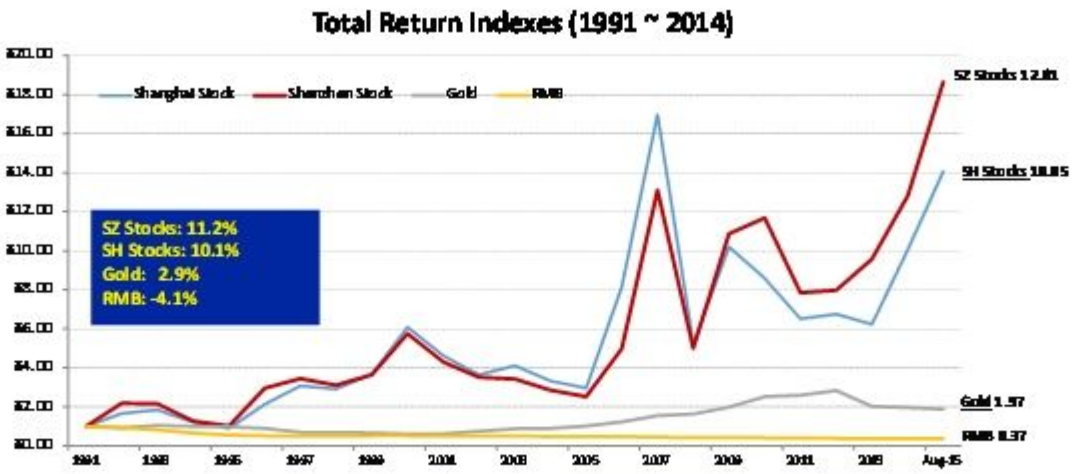


Figure 6: Performance of major Chinese asset classes from 1991-2014

What we see is that the results in China have been similar to America's over the last two hundred years. From 1991 until today, one dollar of cash has become 47.3 cents, the same as in America. Gold has been the same, of course. The Shanghai and Shenzhen indices have appreciated steadily. Fixed income has also appreciated. But the difference is that China's GDP has changed materially. As a result, the change in stock prices and indices is more in line with the performance of GDP. In other words, higher than America's. This is a special pattern we see in this emerging market. What we have seen is that over the last few decades, the basic result has been the same as America's and that GDP growth has been the same driving force. As a direct result of high inflation, cash has depreciated and stocks have appreciated at a higher rate. Otherwise, the basic result is the same. This is very interesting.

Index	Dividend Yield		Total Return			
Name	Avg	Current	From	To	Culumative	IRR
USA						
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%
China						
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%

Figure 7: Comparison of American and Chinese stock indices from 1992 to the present

GDP Growth

Country	Nominal GDP growth% (local currency, bn)						Real GDP growth% (local currency, bn) -- base year 2000					
	From	Index	To	Index	Culumative	IRR	From	Index	To	Index	Culumative	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%

Figure 8: GDP growth in China, America and Hong Kong from 1991-2014

We can see that over the last two decades China has started the path towards Civilisation 3.0 and that its performance has been like America's. Yet while the trend is similar, the speed has been faster. However, while the Shanghai and Shenzhen indices have risen 15 times – an annualised gain of 12% – I do not think that anyone has individually enjoyed the same result, including those investors sitting here today. Yet there is someone who has earned this return from the day the stock market was established: the Chinese government. Everyone worries about the high debt level in China but they often forget that the Chinese government is the major shareholder in just about every company. None of the stock market punters have achieved the same result. No one knew at the outset that China would enjoy almost the same performance as America because the road we travelled was not the same. But the results are the same when you adopt modernity and Civilisation 3.0.

Have individual companies also been like this? I've chosen several familiar companies to illustrate: China Vanke, Gree Electric Appliances of Zhuhai, Fuyao Glass Industry Group, State Power and Kweichow Maotai. They have all grown from humble origins to their current size, appreciating between 300 and 1,000 times.

Data from IPO Date to 8/31/2015

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

Figure 9: Performance of selected A-share companies from 1991 to present

Has anyone made more than a thousand times on an investment in the last twenty years? You would have if you had invested in China Vanke. Of course, only the pre-IPO state shareholder was able to because the company popped ten times on its first day of trading. So it's worth denoting this pre-IPO phenomenon. After the first day, everyone can invest; if you had bought then, you still could have earned just about 100 times for Vanke and 110 times for Inner Mongolia Yili Industrial Group. This isn't abstract; these companies are all real. They all grew from very small companies into very large companies.

It was the same in Hong Kong. If you had invested in Tencent Holdings, you could have earned 186 times. And that company only listed ten years ago, in 2004, which is not so long ago. These companies all do a lot business in China (refer to Figure 10). Anhui Conch, China Everbright International, Hong Kong Exchanges and Clearing, Li & Fung etc. It's not only these companies; these are just ones with which most of you are probably familiar. I just use these as examples to show you that it's not an abstract idea.

Data from IPO Date to 8/31/2015

Company Name	Based on IPO Price Cumulative	IRR	First Day	Based on First Day Close Culmulative	IRR	IPO Date	Years	Mkt Cap (HKD bn)	P/E
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
								Avg P/E	19.3x

Figure 10: Performance of selected H-share companies from 1991 to present

At the same time or earlier in America, there are a few companies that have achieved similar returns with which everyone should be familiar. Berkshire Hathaway has returned 26,000 times from 1958 until today. Many of the best performing companies in America have almost been Chinese companies like Baidu and Ctrip (refer to Figure 11).

Data from IPO dates to 08/31/2015

Companies	Total Return Cumulative	IRR	Since IPO	Years	Mkt Cap (bn)	P/E
USA						
Top 10 companies by cumulative return						
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
					Avg. P/E	17.6 x
Top 10 companies by IRR						
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
					Avg. P/E	62.9 x

Figure 10: Performance of selected US-listed companies from 1991 to present

I'm not trying to highlight any specific company. I just wish to prove that good returns like these exist. Stock indices aren't abstract things; they are constituted of individual companies like these. We've gone down many roads over the last two hundred years but once we chose to head towards Civilisation 3.0, the results have been almost the same as other countries.

How do you explain this phenomenon? How should we understand the performance of the last few decades? Most importantly, will the Chinese stock market produce similar results over the next few decades? Whether it's the same company or not, will it give you another 100 to 1,000 times return? Does this possibility exist? This is the final question we will answer today.

We must determine whether China is unique by examining the whole process of its modernisation. China's modernisation began in 1840 when it was made to modernise; this wasn't a pro-active decision. China never would have taken this first step if it had been left to its own devices. The primary reason is that the Chinese state was too strong and never gave space to allow a market economy to develop. There were several times in Chinese history when a market economy almost blossomed but it could never really take root. From the Han Dynasty onwards, the Chinese state has been the world's most stable, most big, most powerful and most profound. This is related to our geography but I won't go into that today. The most important thing is that because this country has been exceptionally strong and stable over the last two thousand years, it could never give birth to Civilisation 3.0. But that doesn't mean Civilisation 3.0 couldn't be forced upon it.

The modernisation we see today wasn't a simple modernisation of our system as the changes since 1840 are often understood. It wasn't a cultural change or a change in the economic system. It was a change in civilisation.

This change in civilisation is akin to the agricultural revolution seen 9,000 years BC. That revolution came about through accidental factors. After the last ice age ended in the

Middle East, agriculture became possible. In the Fertile Crescent, there were wild plants which could be farmed and wild animals which could be domesticated. And once agriculture had taken root there, it quickly spread to every corner of the world. Today's Civilisation 3.0 is a novel combination of a market economy with modern science and technology. As Civilisation 3.0 has propagated over the last two hundred years, we can see many similarities with the propagation of Civilisation 2.0.

The rise of Civilisation 3.0 resembles that of Civilisation 2.0: almost everything boils down to a set of fortuitous incidents created by geography. Nothing was inevitable. Because of its location, Western Europe was the first to discover the Americas. The Americas are only 3,000 miles from Western Europe but more than 6,000 miles across the Pacific from China and practically speaking, closer to 9,000 miles due to ocean currents. China was also not motivated to go to the Americas. Following this discovery, a trans-Atlantic economy emerged. The most special part of this economy was that the government was not involved. It was only under these conditions that a new economic model could emerge based on the absence of government, free enterprise and the primacy of the individual. This economic model challenged mankind's worldview and in response provoked modern science. Modern science in turn brought its own revolution, re-examining ancient knowledge and sparking the Enlightenment. It was only with this background and under these conditions that Civilisation 3.0 could be formed.

These conditions could never have materialised in Chinese society. But as we saw with Civilisation 2.0, once a new model appears, it will rapidly spread around the world to supplant the old model. This has to do with human nature. Per our understanding of ancestral biology, man shares a common nature, ancestors from a common location and from a common species. Man began his exodus from Africa 50 or 60 thousand years ago and took about 35 thousand years to spread around the world. His line followed many different paths, one branch of which became Europe, another China and finally once covering the American continent. As a result, human nature is evenly distributed, whether it is intelligence, enterprise or compassion. [As a species, mankind seeks an equality of outcomes and accepts an equality of opportunities.] Seeking an equality of outcomes spurs more advanced models of civilisation to rapidly propagate around the world. [The mechanism for accepting an equality of opportunities spurs each society to have its own culture and create its own systems, and to let them penetrate into even the most backward of places.] But this process from inequality to equality is a very painful one.

So the propagation of civilisation will happen sooner or later. Places with a relatively advanced civilisation and culture will assimilate quicker. Those without a history of colonisation will also be faster. This is why Japan was the first country in Asia to modernise. China has followed but India has been slower because it was fully colonised.

We won't go into those details now but suffice it to say that China has been undergoing the process of modernisation since about 1840 – but has never fully understood the nature of modernity. Since 1840, we have tried just about every method there is. The earliest was the Self-Strengthening Movement which believed that it would be enough to learn Western science and technology, and to leave everything else as it was. It didn't work and we saw the Taiping Rebellion and the Japanese Occupation. China never tried to emulate Japan's path to modernity, largely because we believed that we must do the contrary to whatever road they followed. In the first thirty years after 1949, we followed yet another path, the collective economy, a wholly planned economic system. We have more or less tried everything once. Then from the end of the 1970s, we finally tried something which would bring us to Civilisation 3.0: a free market combined with modern science and technology. We had tried everything else over a hundred and fifty years up until that point without success. The political system has not seen great change and nor has our culture. But in the last 35 years, China's entire economic system has suddenly become amazingly consistent with that of Civilisation 3.0.

In other words, China truly entered Civilisation 3.0 in the last 35 years. Prior to this, our path to modernity over the previous 150 years was tortuous. There are many reasons why but we never were heading in the right direction.

It was only 35 years ago that we [returned to] the essence of Civilisation 3.0, the free market economy and modern science and technology. But as soon as we started down this path, the performance of the Chinese economy has shown a striking similarity to other Civilisation

3.0 economies. As we've just seen in the table above, over the last 20 and 30 years, the performance of stocks and companies has been truly amazing. When China began to resemble Civilisation 3.0, the way it manifested itself was virtually the same as other Civilisation 3.0 countries. So in this respect, China is not unique. Where China is unique is that its culture and political system are different. But as we've seen, these are not the essential elements of Civilisation 3.0.

Can China deviate from this path? Because China's political system is different, many foreign and domestic investors have deep suspicions. After all, China has had this form of political system for almost two hundred years and has tested many different directions towards modernity. Could we head in reverse?

We know that in the first thirty years after 1949, China confiscated private property and pursued collectivisation. It could do so because of our political system. Could we do an about face now and abandon the market economy? This is a question that investors must consider carefully, otherwise it is extremely difficult to predict the prospects of Civilisation 3.0 in China and the potential success of value investing therein. If you can't answer, or think about it clearly, or are unsure in your heart, the market will expose you. Only if you aren't clear will you make a mistake and be shaken out.

There is no uniform answer to these questions, and they have been pored over by generation after generation of intellectuals over the last two hundred years. The questions I've shared today are my own, and are something I've puzzled over for decades.

My thoughts are as follows. We must study the iron laws of Civilisation 3.0. We've already made a superficial study of how Civilisation 3.0 can deliver sustainable, long term and continuous compound economic growth through free exchange producing added value. Science and technology serve to accelerate this process. As more people and more countries partake in this kind of exchange, the value added they create becomes greater and greater. This was Adam Smith's insight and it was extended by Ricardo to incorporate trade between countries and economic systems, thereby laying the foundation for free trade. A natural follow-on conclusion from these theories is that scale advantages will emerge in larger markets. And thanks to these scale advantages, larger markets will gradually compete away smaller markets. That is to say, eventually, the largest market will become the only market.

This would have been unimaginable under Civilisation 2.0. Free trade was a result of these insights and without these insights, there would certainly not have been any free trade – not to mention the globalisation which followed. The final proof of this process which began with the British in the 18th and 19th centuries only came at the start of the 1990s with the first emergence of globalisation. Looking back from today to the emergence of globalisation, we can derive a new inference: when two different systems compete, and one is adding value at a rate of '1 + 1 > 2' while the other is adding value at the rate of '1 + 1 > 4', the pace of accumulation in the latter will eventually be so great that it becomes the only market. This had never occurred throughout history until the early to mid-1990s, and will never happen again. Ricardo believed that when two parties engaged in trade, both would be better off. This was the case for free trade. But he never expected that the process would result in all markets ultimately becoming a single global market – the largest market became the only market. This is what ultimately transpired in the mid-1990s.

This has been precisely the trend of history over the last few decades. In the beginning, there was the trans-Atlantic trade between Britain and America. They took this concept of trade and pushed it onto their colonies. They fought the two world wars. And after the second world war, two distinct but closed economic blocs took shape, one centred around the US, Western Europe and Japan; the other around the Soviet Union and China. The former was obviously larger and became ever more efficient because it subscribed to the principles of the market economy. The two blocs were well matched to begin with but after several decades, you could see a gap between America and the Soviet Union; a gap between West and East Germany; a gap between mainland China and Hong Kong and Taiwan etc. It's the same kind of gap that we see today between South and North Korea. The result was that in the early 1990s after the collapse of the Berlin Wall and China's embrace of a market economy, we saw for the first time in human history the emergence of a new phenomenon called globalisation. This is when the nature of Civilisation 3.0 became truly evident. I call this an Iron Law of Civilisation 3.0: a global, unified and common economic system with free trade, free exchange and free markets at its heart.

Markets enjoy economies of scale: as the number of participants and exchanges increase, the more incremental value will be created. The more efficient the allocation of resources, the more productive, wealthy and successful the economy will become, and the more able it will be to produce and support high-end technology. Between two competing markets, the larger market will eventually become the only market. And any person, industry or country which leaves the largest market will regress and ultimately be forced to re-join. The best way for a country to increase its strength is to lower tariffs and join the global economy. The best way for a country to fall behind is to shut itself off. Through the market mechanism, modern science and technology will continue to advance, and costs will continue to decline. Combined with mankind's insatiable demand, the economy will continue its cumulative growth. This is the essence of modernity. After this phenomenon emerged, we could understand the gap between East and West Germany; between North and South Korea; and between pre-reform China and Hong Kong and Taiwan. Why did Iran give up its nuclear weapons programme? To re-join the global economy, the only economy. A country as small as Iran could not sustain advanced technologies while sealed off from the world. And if you think Iran isn't a good example, how about China? Or if not China, then how about the Soviet Union?

The speed of new information is now such that we accumulate in just a few years the sum total of everything that came before. In the last decade, this pace had us doubling every eight years. In the next decade, I think it will accelerate further. The Iron Law of '1 + 1 > 4' will continuously repeat and at an ever faster speed. Small markets will fall behind. China has already been a member of the World Trade Organisation for 15 years, and before this had already had a market economy for 20-30 years. In this environment, any economic system which chooses to stand alone will in short order become a relatively small market, and will inevitably fall further and further behind. If China changes the rules of its market or leaves the common market, it will, in a relatively short time, rapidly fall behind. I am confident that in a country as mature, historically successful and culturally advanced as China, this would not be acceptable to most people. It's not that there is no chance that

China won't leave this big market for brief moments; it's just that China is unlikely to be a loser forever. Chinese people will not willingly lose after experiencing several millennia of success. So if there are brief moments when they deviate from the path of Civilisation 3.0, they will quickly make amends and come back.

However, while these deviations might look small in the long course of history, they might be relatively long in the course of our own lives. But in this stretch, there can still be free markets and we can still find a sufficient margin of safety. We can endure these periods. [These periods are no more scary than the continuous market lows we have seen over the last decade]. When you hold this to be true, your understanding of the Iron Law of Civilisation 3.0 will still allow to invest with a sufficient margin of safety.

With these reasons in mind, let's come back to the prospects for value investing in China.

I think that China is today somewhere in between Civilisation 2.0 and 3.0; let's call it Civilisation 2.5. We've already come a long way but there is still a long way to go. I believe that there is a high probability that China will continue along this course because the cost of not doing so is very high. If you really understand the history of the Chinese culture and the Chinese race, especially since they have come to understand the nature of modernity, then you would appreciate the probability of them reversing course is very low. The probability of China leaving the global common market is practically zero. The probability of China moving away from a market economy is also very low. Therefore, the probability of China remaining in the global economy and continuing to implement a free market economy and modern technology is very high. And we've seen that the relationship between Civilisation 3.0 and politics or culture is not very strong, while the relationship between Civilisation 3.0 and free markets and modern technology is very strong. This is the biggest misunderstanding most investors have of China, especially Western investors.

China will only be able to deliver returns in its major asset classes similar to the historic returns seen in developed markets over the last 300 years if it continues down the path to Civilisation 3.0 and persists with free markets and modern science and technology. If it does, the economy will continue its cumulative growth, creating the inflation which will see equities outperform other asset classes. And value investing will offer the same promise as in America to deliver clients sustainable, stable, safe and reliable investment returns. This is the primary reason why I believe value investing can be practiced in China.

I believe that value investing isn't limited to China, even though in its present immature stage China does offer value investors many advantages. Across China's capital markets, 70% of investors are still retail investors who focus on short term trading. Even institutional investors still focus on short term trading. Prices will often deviate widely from intrinsic value as a result, creating unique investment opportunities. If you can avoid being confused by these short term trades and really persist with long term value investing, you will have few competitors and your chances of success will be much higher.

China is carrying out a transformation of its economy to allow financial markets to play a greater role in financing. Indirect bank financing will no longer be the primary source of capital. Instead, the equity and fixed income markets will become the primary source of capital and the main tools for capital allocation. The scale, institutionalisation and maturity of the capital markets will all be lifted. Of course, if you limit yourself to what's in front of your eyes, you might complain about the government's excessive intervention in the market and its injustice. However, I believe that if you look further out, China's economy is still heading in a direction that will see the role of the market increase, with more institutional investing and a greater maturity. These will all play an important role in the next stage of development. True value investors will serve an ever greater purpose.

So seeing how young everyone here is today, I feel a little envy in my heart. I believe that in your time, as value investors, you will come across more opportunities than I have left. I feel very lucky that in the last twenty years I could study value investing under the tutelage of the great masters, and to learn and practice under their watch. You will be even luckier. But I still hope that everyone can always hold on to the feeling you have now, and always remember the two moral bottom lines. First, always understand your fiduciary duty. Treat clients' money as your own. Treat it as the nest egg that your parents sweated and slaved their whole lives to earn. Only then will you be able to manage it well. Second, you must make the pursuit of wisdom and knowledge your moral responsibility. You must consciously distinguish between the real and false theories in the market to pursue true insight. And only through hard work over a long period of time will you be able to succeed and earn the returns which your clients deserve to earn. And in this you will be able to make your contribution to the development of China's economy during this transformative period – a win-win-win for the country, your family and yourself.

I sincerely hope that everyone here can boldly go forward down the right path! The road is clear and the scenery is especially nice. Don't be lonely because this profession is full of every kind of curiosity, challenge and landscape. I have confidence that everyone here will have a good future. If you persist for fifteen years, you will definitely become outstanding investors! Thank you!