Li Lu's Lecture At Columbia: April 2010

The transcript of the lecture was done by Tariq Ali.
In fact, Tariq makes a good case that Li Lu is among the top candidates to become the CIO at Berkshire Hathaway when Warren Buffet "retires."

Li Lu is quickly rising to become a cult figure among value investors.

According to Bruce Greenwald (who teaches a value investing course at Columbia), Li Lu manages all of Charlie Munger's money, and has suggested the Warren Buffet would give money to Lu if he (Buffet) ever retired.

Li Lu's comments regarding how to look at any company (understand it as though you just inherited it as the 100% owner of a family business), and how to determine and identify what you know and what you don't know, is absolutely fundamental to an appropriate investing strategy.

Bruce Greenwald: Warren Buffett says that when he retires, there are three people he would like to manage his money. First is Seth Klarman of the Baupost Group, who you will hear from later in the course. Next is Greg Alexander. Third is Li Lu. He happens to manage all of Charlie Munger's money. I have a small investment with him and in four years it is up 400%.

[Applause]

Li Lu: Columbia is where my whole life in America started. I could barely speak the language. In Columbia it was where I had a new life. It was really in the Value Investing class where I got my career start. I was really worried about my student loan debt at the time and a friend told me about this class and said I need to see a lecture from Warren Buffett.

What I heard that night changed my life. He said three things:

1. A stock is not a piece of paper, it is a piece of ownership in a company.

2. You need a margin of safety so if you are wrong you don't lose much.

3. In the market, most people are in it for the short term. It allows you a framework for dealing with the day to day volatility.

Those were three powerful concepts. I had never viewed the stock market like that. I viewed it negatively as a place made up of manipulators who were lining their own pockets. I embarked on an intensive two year study learning everything about Buffett.

Two years after that I bought my first stock. After I graduated I worked at an investment bank for a year and realized it was a mistake. I tried to start a fund but I didn't have a track record. The first year I managed money I lost 19%.

Being a value investor means you look at the downside before looking at the upside. Before becoming an investor you need to look at how you can fail at this game. There are all sorts of ways you can fail. You need to examine who you are and see if you could be good at it. If you could ever find something you can do well that you really like — that will be your best investment. You will do better than competitors. If you can do it with intrinsic passion, that really over time will add enormous value to you.

Back to the game of investing. This concept of margin of safety is an essential concept to be a good investor. The future is unpredictable, you will always be dealt surprises, some positive most negative. You need to build in a level of safety so that whatever happens, you will not get crushed. If you can really successfully know what you are getting into, you can pretty much navigate. Most people are troubled by what they don't know. The world is divided by those who know and those who don't know. If you really know — you will not pull triggers like Wall St. traders. If you are truly intellectually honest, you would not do anything.

This class teaches you to know what you are getting into, especially accepting what things you don't know. The game of investment is really continuous learning. Everything affects an investment, it constantly changes. You are not investing in the past but the accumulative cash flow of the future. You have to want to find a certain set up where you can know something that most people don't know. There are plenty of things I don't know but they don't factor into the purchase because I am using a huge margin of safety. Buying a dollar at 50 cents. So if things turn against you, you will be okay. That is not easy. This business is brutally competitive. It is so impossible to know everything and know exactly what is going to happen to a business from now till the end that you really have to accept that what you don't know.

Finding an edge really only comes from a right frame of mind and years of continuous study. But when you find those insights along the road of study, you need to have the guts and courage to back up the truck and ignore the opinions of everyone else. To be a better investor, you have to stand on your own. You just can't copy other people's insights. Sooner or later, the position turns against you. If you don't have any insights into the business, when it goes from $100 to $50 you aren't going to know if it will back to $100 or $200.

So this is really difficult, but on the other hand, the rewards are huge. Warren says that if you only come up with 10 good investments in your 40 year career, you will be extraordinarily rich. That's really what it is. This shows how different value investing is than any other subject.

So how do you really understand and gain that great insight? Pick one business. Any business. And truly understand it. I tell my interns to work through this exercise – imagine a distant relative passes away and you find out that you have inherited 100% of a business they owned. What are you going to do about it? That is the mentality to take when looking at any business. I strongly encourage you to start and understand 1 business, inside out.

That is better than any training possible. It does not have to be a great business, it could be any business. You need to be able to get a feel for how you would do as a 100% owner. If you can do that, you will have a tremendous leg up against the competition. Most people don't take that first concept correctly and it is quite sad. People view it as a piece of paper and just trade because it is easy to trade. But if it was a business you inherited, you would not be trading. You would really seek out knowledge on how it should be run, how it works. If you start with that, you will eventually know how much that business is worth.

When I started in the business in 1997, it was in the middle of the Asian Financial Crisis. A few years later there was the Internet bubble. A couple years ago was the Great Crash of 2007 – 2008. They are billed as once in a century disasters but happen every few years. Every time it goes against you, your net worth or value of your investments might go down 50%. This is really where that insight and temperament comes in. In a sense, you have to have a certain confidence in your own judgement and not be swayed by other people's views. It is not easy. But that is life. It is just a given. It happens to everyone. Berkshire had at least three times when the stock went down 50%. It happened to Carnegie too. It happened to Rockefeller. It happens to everyone. If you really made a mistake, it would not stop at 50% but go to 0.

This happens to even mighty companies. Look at the top 50 companies in America every 10 years. By the time 20-40 years go by, 2/3rds of them will be gone. By the time it goes to 100 years, there might be only a couple left. It's just the way it is. Look at what happened to the once mighty General Motors. So thats why I'm saying is, investing is a continuous learning process because your investments are constantly changing

So for those of you that have curiosity and the temperament, this game couldn't be better. Capitalism rewards people who are talented at capital allocator. So if you have the aptitude and temperament, it is the great game. If you don't have that then I urge you not to go and become a nuisance. That is really what Wall Street did, they don't really create anything they just move money around. Letting the financial industry get too big is bad for the economy, it is just as bad as getting addicted to casinos, drugs, and alcohol. None of them are really useful, they just transfer wealth. That is what I think happened on Wall Street over the last several decades. So avoid being harmful.

With that I am open to questions.

Q: Mohnish Pabrai recently spoke about his reluctance about investing in China due to the multiple accounting books / the possibility of fraud. How do you deal with this given your own investments in China?
Li Lu: Well, you know I think he is right. Every thing has an exception though. Just because a next door neighbor is a fraud doesn't mean you are. That is one question to ask — whether you can trust the accounting and people running the business. That can have a huge impact on the business. I suggest you spend a lot of time looking at these factors, especially if you are investing for the long haul.

Q: Why did you decide to go into venture capital? How is that different than your other investing?
Li Lu: I always had this bent that I want to build a real business. I started a venture and it was really a lot of fun. Overall, it is a tougher game than simply investing in securities because you have to evolve to the day to day changes in operations and it is just not as easy to build great businesses. Every generation has a handful of great businesses that come from no where and come to dominate their fields. It is much more rewarding as an investor to pick those. Also, you are more likely to find managers much more capable than yourself. Overall, I learned a lot. I learned a lot in how businesses succeed and how businesses fail. It really was a lot of fun. I probably carried it too far — I eventually ran one of the businesses and it was of course a mistake.
Q: I read that when you look at an industry, you look at the most miserable failures of that industry to see whether you will invest in it. Can you talk a bit about that?
Li Lu: It goes back to understanding the business. Once you have that understanding you can extend it to understanding an industry. A certain industry might have characteristics that make it different than others. In certain industries you might have better prospects than others. Find the best of the players in the industry and the worst players. And see how they perform over time. And if the worst players perform reasonably well relative to the great players — that tells you something about the characteristics about the industry. That is not always the case but it is often the case. Certain industries are better than others.

So if you can understand a business inside out you can then eventually extend that to understanding an industry. If you can get that insight, it is enormously beneficial. If you can then concentrate that on a business with superior economics in an industry with superior economics with good management and you get them at the right price — the chances are that you can stay for a very long time.

Q: Did you have any specific example?
Li Lu: I have studied many over the years. As I have said, don't copy other people's insights because it doesn't work. Automobiles are amazing. If you look at the early days it started with several players and concentrated with just a few players that became enormously profitable. Then they became miserable. You then see how the life cycle turns with new automakers in China and India. Everything has a reason. If you want a good idea — look at General Motors from the early days, look every 5 years and see how the performance metrics change. The Graham and Dodd Center should collect all the data and perform some kind of commentary on it.
Bruce Greenwald: Do you want me to give you the answer to that? In the 1960s, their return on capital was 46%. In the 1970s their return on capital was 28%. In the 1980s it was 9% in the 1990s it was 6%. You want to guess how negative it is now?
Li Lu: So that is really fascinating. If you have that data, the amount of insight that would yield would be astonishing. So instead of just accepting the conventional wisdom that the auto business is bad — that is just not true. Or if you say well those guys just unbelievable money machines — that is not true either. So if you can really examine those statistics and

understand it that will give you an advantage for analyzing new situations like in China and India. That is really what turns me on. Understanding this gives you a tremendous leg up.
Q: I wanted to ask you about BYD. I heard that you thought it was important for them to introduce a model to the US and wanted to know why you thought that.
Li Lu: That might be a better question to ask the BYD chairman than myself. Well, If you are just talking about electric vehicles, you know the key — the heart and soul of the electric vehicle age the heart is the battery. There is the battery, electric motor, and the electric control control panel. The electric motor has been there for 100 years, control system is software that can be improved over time.

The battery is really where you get the biggest appreciation and is what determines the value of the electric vehicle. 100 years before the Model-T was introduced, the competition between electric vehicles and gasoline was not nearly as optimistic. Up and till then, 1/3rd of cars being produced were electric. It wasn't until Rockefeller got oil extracted easily enough that it worked. Henry Ford was able to make the internal combustion work even though it wasted 85% of the energy. He was able to build the engine and produce automobiles that were cheap enough for people to buy and it took off. That is where you find the real winners.

Now, years later, we know that the way that oil is burned contributes to global warming. If it continues, the planet might still be here but all the human beings might not. Human beings have only been on the planet for a tiny bit of the earth's history. So there are all sorts of good reasons for electric cars. Battery development has advanced so much that it is now comparable to the price and performance of traditional cars. So now with the help of companies like BYD, the balance is about to tilt towards where performance and price are getting to the level that makes them a desirable alternative. It will be desirable everywhere. Eventually, if you have a car that does all that, it will be sold everywhere.

Q: What about BYD versus others in the industry?
Li Lu: The market will determine that.
Q: Yeah – but why BYD versus others?
Li Lu: Well because we also studied all those other guys. We will see when the winner emerges whether we are right or wrong.
Q: Right – but what did you look at to reach that view?
Li Lu: There are a lot of people who have worked over 100 years making great cars. The technology for building a traditional car has been refined enough to where it can be learned in a short period. The place we are still seeing a curve of continuous rapid improvement is with the batteries for cars. Whoever is leading the charge will have a major advantage. There is really only one company that is a leader in battery manufacturing and automobile manufacturing. There is only one company. To put this together you need a Ford to put that together. So far those two elements need to be put together. It is not an easy process.
Q: So you went to BYD in 2005 and then you brought Berkshire as well. I saw that you sold a small amount of your BYD position at the end of last year. Was it just rebalancing? Can I just wanted to get your thoughts on that.

Li Lu: Actually I started my BYD position in 2002. I sold a small amount of shares because an investor of mine had an emergency redemption.

Q: We read your profile online. I had a question – do you have any problems when trying to invest in China?

Li Lu: Yeah I do have some difficulty. I did not really see a factory plant at BYD until the end of 2008. I really did not have a better understanding till then. That really causes you to question what it is before you make an investment. With investing, you have to work with imperfect information because you are buying a piece of the future. I did not really get a chance to get more information because the problem in Asia till much later but it did not stop me from making my investment decision. So there is a point, where if you have enough margin of safety– that is why I kept coming back to the elementary concept of margin of safety– you can allow much more uncertainty and unknowns. So the answer of the question is does that stop you from making the investment? No.

Q: So I did some research on lithium ion batteries, and I saw that BYD has a manufacturing advantage with consumer batteries. But I saw that automobile batteries are much more complex. I did not think that the idea of a good consumer battery manufacturer + an automobile maker made much sense. So when Buffett looked at the stock maybe it was a better deal but today it is this dream of vehicles that is really priced in. It does not feel like a good value investor stock. So why would you own it today?

Li Lu: Well that is interesting. One of the most fascinating things about being an investor is that surprises are part of the game. When you get into situations like BYD, you see lots of good surprises. Chuanfu and his team have this fabulous culture, everything people thought they knew turned out to be a few years late. He got into battery manufacturing in that particular way because he really had no other option. He had no money, he only had $300,000 in venture capital funding before IPO and that was it. He raised money in an IPO and Buffett gave him $200M, now they have 160,000 employees. $6-7B in revenues, $500M in net profit. It is amazing. So he has this ability to adapt in a competitive environment. He has demonstrated that ability again again and again. The way he does automation is far cheaper than anyone else and more reliable. He continues to surprise me with his ingenuity, to figure out ways to do something better than everyone else. What he is currently doing is very different than what everyone else has done. At the end of the day, you might look at what he has done.

So how do you look at it as an investor with imperfect information? Well I suggest you look at what he has accomplished. 8 years ago I had no idea they would go into the automobile or laptop or cellphone battery business. So that demonstrates how he is. This investment is not easy to understand because it is changing so fast, at such a large scale. An almost unheard of speed. Their manufacturing capabilities will double soon. This year they will hire 10,000 college graduates, 8 or 9 thousand engineers. The scale is almost unparalleled. So this is why the study of history, of all the great corporations will give you a good insight in seeing what will happen with BYD. I suggested that we start with GM and analyze its performance every 5 years for 100 years to understand at least one aspect of BYD's business.

Q: One investor came in and said talking to management is a waste of time. They will say what you want them to say. Obviously it sounds like you don't agree with that. What do you think? Will you pay a premium for a business with a moat?
Li Lu: There is no general rule. The key in investing is to know what you know and know what you don't know. You can know about management teams without meeting with them. Every situation is slightly different. So I come back to the point that if you know enough on other things that there is enough margin of safety. Even if you meet with management, you may not learn something. Obviously, actions speak louder. You want to see what they have done. Everything being equal, the more you know about management, the more honest and upfront they are, the more motive they have, the better the situation is and the deeper the discount. You have to analyze it all. The key to analyzing it is you have to ask: do I really know what I think I know, do I really know what I don't know? If you can't answer that question, chances are you are gambling.
Q: What kind of preparation do you do before meeting a management team?
Li Lu: I don't really have a set method. Because I usually am just curious about the business and don't know a lot. So you are prepared and not prepared. If you are really curious, you want to learn more and study it more. When working at a hedge fund or mutual fund, you are expected to learn a business in one week. You can't truly understand everything about a business in one week. It took me 10 years and I am still learning new things about BYD. It is a continuous learning process. You could spend a lifetime studying a business or industry, but in a few seconds I can tell you whether or not I like it. You want to build knowledge by continually learning. There is not set preparation.
Q: Recently, Jim Chanos gave us his thesis on the China Syndrome with there possibly being a bubble.
Li Lu: Well, it is too big of a question for me. I don't know
Q: 20 years ago you said you challenged conventional wisdom in China. Out of curiosity, in terms of value investing what do you challenge in the conventional wisdom?
Li Lu: Well, the fundamental philosophy of value investing is very sound. Its basically the three things:

1. A stock is not a piece of paper, it is a piece of ownership in a company.

2. You need a margin of safety so if you are wrong you don't lose much.

3. In the market, most people are in it for the short term. It allows you a framework for dealing with the day to day volatility.

That is really an intelligent approach. So therefor any intelligent investing is really value investing. There is a certain level of intellectual honesty. If you have all that insight going into analyzing businesses I don't have any arguments with it.

Q: What is your point of view on long / short positions in value investing?

Li Lu: The most profitable kind of investing is long term investing. You want to allow the time that it might take because you don't know when the market will catch on. If you can find a business with good management with good industry fundamentals blowing it forward, you have a good opportunity and you can save money on taxes.

A short cannot be a fundamentally long term position. In the long game, the upside is unlimited. Your downside is 100%. In shorting it is opposite. Shorting is also essentially borrowing, so you need money and time on your side. If time is not on your side, you can be right but lose all your money. The best kind of short usually has some kind of fraud. In those situations, management is determined to keep the fraud. Look at Bernie Madoff, 20 years time. You cannot afford to borrow money for 20 years. So shorting is a short term game. When those positions go against you, there is huge leverage that can utterly crush you.

In theory, long / short is okay, but if you are trading all the time you need to be in tune with all the things moving the market. None of them might be fundamental to the actual business. So you spend all your time chasing noise than studying a long term situation. If you cannot concentrate on things in the long term, and spend all your time thinking about the short term, you will not be able to develop the kinds of insights necessary to identify great investments.

From time to time, you will lose some money on paper. But it is just part of the game. This is why I closed long / short. You know I went through three bubbles. The Asian Financial Crisis, the Internet Bubble, and this most recent financial crisis. The biggest mistake I made is not being able to pick up undervalued companies where I had a unique insight but was tied up with this whole long / short thing. The money I left on the table is still adding up. I am still paying for those mistakes.

Q: In a bull market environment, how do you re-evaluate your thesis?

Li Lu: I don't ever want to profit from a bubble. Soros does that, that is just not my game. I don't profess any ability to understand how long a crowd will buy into a bubble. I invest in things that appear to be compelling values that continues. So that is why this game is a continuous learning process – because everything affecting the investment is constantly changing. Including the price. Including the prospects and elements of business success. You really do want to never stop learning. This game looks to be easy but it is not easy.

Q: Given your focus on international investments, how do you think about diversifying your investments regionally?

Li Lu: First of all, I did not really specialize in international investments. I started off doing most of my investments in the US and Canada. In recent years, I just find better bargains outside of it. One of the great things about being an investor is you can look anywhere and find great pockets of opportunities. You cannot do that as a venture capitalist as I experienced myself. So you can look anywhere for opportunities. I do not take a regional approach to diversification. I have views towards certain countries and currencies, but it is not the driving force for a potential investment. If you have your fundamental things right, if you happen to have macro economic factors behind you, you can run a great wave.

Q: How is your investment style different today than when you started the fund?

Li Lu: A lot of things have changed. One bonus about this profession is you get better over time. Most professions, as you get older, you get out of the game. Take the example of competitive sports. If you are a figure skater or gymnast, after your teenage years you are out of the game. With investing, if you are doing it the right way, you get better over time. Your knowledge accumulates exponentially. When I look back at everything I have done, I would have done it all slightly differently, but that is because I am better at it today. So if you approach it in a fundamentally sound way, as you mature, you become better and better. That process and progression is like compounding money. In fact, you can compound knowledge faster than money. If you truly love this game, I would suggest that you don’t take short cuts. It might take longer but it is more rewarding.

Q: What is the difference between being a top political criminal in China versus a hedge fund manager today (referring to the ire directed at Wall Street)?

Li Lu: I don’t consider myself a criminal. I don’t think China considers me a criminal. What I think we are doing today with our investment in BYD in China is really helping China march towards a modern era of prosperity. BYD is providing a solution to both China and the US, to migrate from the past to a way that gets us out of the unsustainable carbon age that we live in. Global warming is a vital concern to every human being, so China is providing a great contribution to everybody with BYD. America has had a great history of invention and here is a great company in China that is about to make a major contribution to human civilization with cheap electric vehicles and solar power.

Ultimately we will have to get our energy from the sun. Most of the energy, even fossil fuels (plants that die and then go into the ground), all originally come from the sun. So if you can figure out a way to take energy from the sun and power vehicles, while using batteries to store it, inexpensively — will really make renewable energy power everything. The combination of those things holds the key to the future of industrial civilization that we are about to embark on. We didn’t set out with BYD with this in mind, it just happened that way. With great companies, it only looks logical in retrospect. Think about how Bill Gates started Microsoft. I don’t think he knew up front that he would take the entire market — at that time it did not exist. It is the same way with our investment in BYD. Ultimately, I think finding an inexpensive way to store energy that we harness from the sun will be a huge contribution for both China and the US, but more broadly our entire civilization.