Li Lu's talk at Columbia 2006

Li Lu is a possible Berkshire Hathaway CIO candidate. Tariq Ali (The Street Capitalist) recently posted his notes from Lu's lecture at Columbia in 2006.

Li Lu

This past weekend was the Berkshire Hathaway (NYSE:BRK.A / BRK.B) annual shareholder meeting. At one point during the Q&A, a questioner asked Warren Buffett about the status of Berkshire's CIO candidates. Charlie Munger remarked that one candidate who he is particular close with was up 200% in 2009 with 0 leverage. Some people think that the person Munger is referring to is Li Lu, a fund manager who turned Munger and Buffett onto BYD.

Lu personally owns at least 2% of BYD, which rose 400% in 2009. I don't know anything about his investments beyond that one position, but I know he is a huge believer in taking concentrated, high conviction positions. If that is the case here, BYD's spectacular results must have contributed a lot to his returns for 2009 which may make a 200% for the year possible.

Here is a brief bio on Lu:

Li Lu was born in China in 1966. He attended Nanjing University in China and later came to the U.S., and earned three degrees (BA, JD, MBA) simultaneously from Columbia University. After graduation, he worked in an investment bank until 1997, when he founded Himalaya Capital Management, which today manages both LL Investment Partners and Himalaya Capital Ventures, funds focused on publicly traded securities and venture capital. Li Lu was named a global leader for tomorrow by the World Economic Forum in 2001, and a Henry Crown fellow by the Aspen Institute in 1998. He is a member of Council on Foreign Relations and Young Presidents' Organization.

Fortune: Barnstorm Green

There isn't a whole lot of information about Lu's investing style out there. But I thought I would share some notes from a lecture he gave to Columbia Business School back in 2006. All of this is paraphrased, so don't take anything as a direct quote and there may even be some inaccuracies. Still, I believe you will find these notes insightful, especially with respect to improving your own abilities as an analyst and investor. Even if Lu is not a Berkshire Hathaway CIO candidate, he is an investor with a tremendous work ethic that we could all learn from.

Below are my notes from Lu's lecture:

Li Lu at Columbia Business School – 2006

-15 years ago, Lu was accidentally brought in to a lecture by Warren Buffett. Had epiphany moment, Lu thought he could do something in the investment business.

-At the time, Lu had just escaped China. Did not know very many people. No money, deep in debt. Worried about making a living in the US.

-In the middle of Buffett speech, made him think differently about the stock market.

-The more Lu thought about it, the more he thought it was something he could do.

-Value investors see themselves as owners of a business. Therefore, fortunes are up and down with the nature of the business.

-You demand a margin of safety.

3 Traits of a Value Investor:

1. Basically, you don't think of yourself as a paper shuffler who constantly buys and sells securities. You think of yourself as a real owner of the business.

2. You only own a small piece of the business, so you demand a huge margin of safety.

3. Because you think of yourself as an owner, not trading all the time, you think everyone else is different — like Ben Graham's Mr. Market

On Value Investing

-Under 5% of all assets are run under value investors, a real minority in the investment world.

-The stock market is created for the other 95% of people, that is where your opportunity and challenge is.

-That was one lesson that stuck in Lu's mind when listening to Buffett's lecture.

-Biggest challenge: understand whether you are the 5% or the 95%

-It is tempting to do what the other 95% of people do. Emotionally very difficult to be in the 5%, but value investors typically have better returns. The money is really for traders and they tend to amass more assets.

-5% have a spectacular return, but 95% of money probably always resides to somewhere else.

-Understand who you are. You will be tested. You will have to ask yourself whether you are or aren't a value investor.

-If you are a value investor, you are probably genetically mutated and comfortable being in the minority. This is unnatural to human beings. You have to be comfortable being by yourself. You have to adopt the idea that you are right because your reason and evidence, not because others agree with you.

-You will probably spend most of your time being an academic researcher rather than a professional. You are a researcher or journalist, with insatiable curiosity. You are trying to figure out how everything works.

-The more you know, the better you are as an investor.

-Politics, science, technology, literature, poetry, everything can affect businesses and help you.

-Occasionally you can find insights that will give you tremendous insights that other people don't have.

-Then you find if the business is cheap. Is the management good? What else? Why is the opportunity there?

-Started fund in late 1997. Been through really traumatic events: Asian Financial Crisis, Tech Bubble.

-Fall of 1998: Lu's search process is very general. Got hooked on value line, loved to read the whole thing from beginning to end. The best kind of education, you should do this if you want encyclopedic knowledge of companies. Go through it page after page, it is enormously helpful.

-First thing Lu checks is new low list. New low P/Es, P/Bs, etc.

-Does not care where something traded before.

-First looks at valuation. If the valuation doesn't fit, doesn't go beyond it.

-If you see a low P/B ratio, ask – What is in the book? How much is the book?

-Encyclopedic knowledge is helpful when looking across different industries.

-Look at pre-tax and pre-interest earnings. Look from an un-leveraged basis. Figure out how much capital is deployed in the business. Look at ROIC.

Example: Timberland

-Start by giving a 5 second look at the business. Timberland. The business is trading around clean book value, consisting mostly of tangible liquid assets, working capital, plus 100M in real estate. Deployed capital is 200M with 100M return.

-Then check why the business fell apart and became cheap. Think if you had owned the entire business at that price.

-At the time, was the height of the Asian Financial Crisis, saw their sales falling off the cliff in Asia. Any thing with exposure to Asia was falling apart. Try to check what other people are thinking about this. You may not listen to their advice but you may want to know what other people are looking at.

-Timberland had no other analysts covering it.

-Why no coverage?

-Look at business across years. Timberland has been growing, pretty profitable, did not need financial markets. Family owned. Owns 40% controlling 98% vote.

-Immediately, that is a turnoff to most people. You can do a quick data search.

-You need to have a curious, active mind to ask questions and find answers.

-Timberland had most of the vote, no analyst coverage, a bunch of shareholder lawsuits. If you were a member of the other 95% of the investment business you might say maybe management is milking the business.

-Download every court document lawsuit. Read it. You NEED a very curious mind to figure out WHAT is happening. Dig every single time. READ EVERYTHING.

-The first time, it takes a couple minutes to look over financials. Then gather questions and do deep research.

-Most lawsuits came from Timberland missing guidance, annoying investors, which annoyed the owner of the business. They decided to stop talking to Wall Street. So it was not about milking the business or fraud. They were not crooks.

-How do you determine if they are good managers? Decent people?

-Act like an investigative journalist. Most business owners leave a trail for you to follow and see how they deal with different situations. Most professional managers would not see this as part of their job, but YOU are part of their 5%.

-Go to their community, visit people they know, their Church, their Synagogue, introduce yourself to their friends and neighbors. It is worth it to spend as much time as possible, to find what these business people have done and what their neighbors say about them to accurately get an idea of their personality.

-The father seemed like a simple, decent guy, just a high school graduate. the son went to business school, was already COO of the company even though he was Lu's age. Lu saw what boards the son sat on, and noticed that they had a mutual friend. Managed to get himself on the board with the son and became friends quickly. Came to realize these where high quality, very ethical businessmen.

-After all that, saw the stock was still trading low. Decided he did not miss anything. The other 95% may not have done enough research to see this or have some kind of institutional imperative that prevents them from owning.

-If you are not a good analyst, you will never be a good investor.

-But we decide to buy. How much do we buy? Imagine having $900. The other 95% will take tiny positions, 50 basis points. You need to use concentration, a $200 position. Think of how much work you did. Lu visited all the stores to see how margins improved – they had a fad going on where kids wanted the shoes. Their asian business is tiny, reduced earnings by less than 5%.

-Lu put a ton into Timberland. What happened after next 2 years? Stock went up 700%. Propelled by earnings. No real risk – went from trading at 5x earnings to 15x with earnings growing 30% a year. It adds up.

Be a Learning Machine

-When an investment opportunity comes, you have to seize it. Devote day and night so you can act quickly. Do everything complete but do it fast. You have to train yourself to jump on opportunity.

-When opportunity presents itself you can smell it. The only way to do that is by training yourself and reading page after page of financial report.

-Uses S&P manuals for viewing foreign stocks.

-As an owner, don't think about per share information.

-Use your brain, when looking at stock manuals, each page should really only take 5 minutes. Don't use calculators. Use mental math.

Example: Korean Company

-60M market cap, pre-tax earnings of 31M, roughly 2x pre-tax earnings.

-Book value of 230M, what constitutes book value? If you are an owner, look at: fixed assets, working capital, don't count on goodwill.

-Basically you see with 60M in market cap, 30M in pre-tax, $240M in book value ($180M in fixed assets)

-It might be cheap.

-Determine what the earnings is. The book. The working capital.

-Use common sense, common logic and think about the business.

-Most employees never went to business school, Lu finds they are easier to train.

-Of the 70M in current assets, it is all cash

-Of 180M in fixed assets, they own 100% of a hotel, recorded 30M as book. Own 13% of a department store recorded as 30M.

-Look up the department store, it roughly has a market cap of 600M. 13% gives you roughly 80M. So the book value undervalues it by another 50M.

-They own 15% of 3 cable companies and a whole bunch of real estate.

-The department store has exactly the same profile. Trading roughly around cash and investments, good earnings, and own a whole bunch of assets. Turns out they are the second largest cable operator as well

-The department store operates like a hotel, do not take inventory, more like a shopping mall.

-They charge a percentage on the top line of all merchant sales.

-Put it all together: Paying 60M, 70M in net cash, another 100M in stock, 30M in hotel with a value that has not been changed in last 10 years while real estate market has gone up in 10 years. Went to Korea, looked at hotel and department stores.

-Checked recent transaction of properties in neighborhood, value is likely 2-3x what is on the book. But take what is on the book anyway, add 150M. Add that to rest and you get 320M in assets that you are paying 60M for and earning 30M annually from operations.

-Insiders own 50%

-Many factors going in your favor, but you need to look at how local investors see it. They need to be buying it for the price to go up.

-Department store used to trade at 22 went to 100

-This company was at 12 now trades around 70

-each went up 5-6x

Don't just listen. Do it.

-This type of an approach is not natural to an investor.

-If you decide your personality fits in with the mutated gene pool, that this is something you might be looking to do, there is a lot of money in it — proven by Ben Graham to Buffett

-You have to put in a lot of work into your analysis.

-You can make a lot of money if you are really interested, listening, and actually DOING IT.

-Lu benefited from listening to his value investing class and then actually going out and doing the work required.

-Value investing is not really about theory, it is about what works.

-Young analysts have energy and nothing to lose, so they should go and do the work.

-Before you become a good investor, you need to be a good analyst.

Lu says you need two things to be a good analyst:

1. Provide accurate and complete information. You have to go to an extra length to get it done. Most of the time you will stand alone against everybody else. If you are not competent about what you know, you cannot possibly take conviction positions when things go into free fall and everybody else is laughing at you.

2. Most money is not made in stocks from the examples. They do not provide out-sized returns. You can do the Tweedy Brown/Graham or the Buffett/Munger school. Your returns will come from a handful of stocks. You need tremendous insight by continuous intense curiosity and study.

Investment Mistakes

-Most mistakes come from inaccurate or incomplete information.

-Biggest mistake: most people wanted 2 week or monthly returns. They wanted to go up in down markets.

-Lu’s biggest mistake was straying, was working with Julian Robertson, started shorting — have to think like a trader when you are shorting because your downside can be unlimited. It’s like Charlie Munger says — having your hands tied behind your back while getting into a fight.

-Missed the opportunity to buy a business below cash, even though Lu knew the management and had great insights. The business subsequently went up 50-100x. Could not bring himself to buy it because of his mindset at the time.

-You make a mistake when you have not finished your work but like it enough. You start betting on probabilities instead of real analysis.

Constantly search for ideas

-In your life, you may only have 5-10 key moments of insight. You only get it from continuous learning. Find an American business and then find the Asian counterpart. Some businesses studied for 15 years. You need to know what that business is, how it ticks, so you can swing with conviction. If you cannot do that you will not make huge out-sized returns.

-If you do what Ben Graham or Tweedy Brown does, you will make 15-20% returns but you wont make the huge returns of Buffett.

-The biggest ideas can give 10,000x returns.

-Opportunities are not easy to find. They require a lot of factors to come together – Charlie Munger's lollapalooza. You need a whole bunch of things working together where you have the insight and are willing to bet.

-This is what drives Lu in business.

-Lu started in physics, mathematics, law, economics, got interested in other subjects. Wife has a PhD in biology, he has learned a lot from her.

-Learn from everything, be intensely curious

-Eventually you will stumble into one big opportunity.

-In the meantime, you will stumble into Timberland style investments which aren't bad.

-There might be years without opportunities, then years with a lot of opportunities.

-Depends on what becomes available to you.

-They do not come in a steady pace, not like once a week an idea.

-In 6 years, Lu had maybe 3-4 great ideas. But you get progressively better and better, improving the amount of opportunities for you since you will be quicker at your analysis.

-Go through every day by learning something. In a year you have to learn a great deal.

-When Lu reads biology, physics, history, it is all searching for ideas. If one idea jumps out, it is all Lu does. Rest of the time is spent with wife and kids and Lu learns from them too, especially with seeing how human cognition develops which is enormously important.

Li Lu's Investing Checklist:

1. Is that cheap?

2. Is it a good business?

2. Who is running it?

3. What did I miss?

-Lu goes through the checklist, 'what did I miss' is greatly affected by psychology. This kind of cognition happens early on and Lu learns it from interacting with his girls.

Three characteristics of a value investor:

1. Business owner mentality

2. Difference in time horizon

3. Demand a huge margin of safety

Think like a Business Owner

-It all comes from one thing, that you are a business owner. You cannot force management changes, so you demand a margin of safety. You have a long time horizon because you think like an owner.

-But why dabble with stock market? Stock markets are made for people who can dream. That is why 95% of people never buy into value investing. Human nature prevents it.

-You do not belong to the stock market but you have to understand its perspective to position yourself properly. If you are truly think like a business owner, you will eventually leave the asset management business and run a real company. That is why Buffett and Munger left it.

-Or you become a private equity investor.

-The people who the stock market is designed for are fundamentally flawed people. Traders are bound to make mistakes due to fear or greed. They will always make room for value investors.

-Used to be strict about selling with great business. Now, sometimes Lu feels he has insights about the business that allows him to believe the probabilities are in his favor for the business actually improving year after year.

-That is the law of distribution in good businesses. The leaders perform spectacularly well.

-Selling makes you pay a huge amount of tax and you might not get that good buying price again.

-If a business can generate 50-100% ROIC, the mathematics get interesting very quickly.

-Caveat: you have to be very confident. Investment bankers use BS and project into infinity. You cannot project that long. There are only a few opportunities where you can project that long.

-If you are good, and spend your entire lifetime studying, across 50 year career maybe 5-10 opportunities where you can confidently project the next 10-20 years. At that point, you don't want to sell. By holding you don't pay the tax on capital gains, so you are really compounding 40% interest free, the business is deploying the capital at 40-100% a year in a tax efficient manner. That is what you do.

-You have to identify businesses that are getting stronger and stronger every year.

-What makes one business more successful than others? Why are they making more and more money compared to others?

-The only way you can find that is by studying the ones that are established.

-Look for great businesses, not just businesses owned by Warren Buffett

Example of a great business: Bloomberg LP

-Product was superior to others, high switching costs

-Bloomberg is a fabulous case study, it came out of no where.

-Gained market share little by little, crossed a milestone point, became a monopoly

-At a certain point, after being highly relied upon for daily work, the switching costs become to high so winner takes all.

-Suppose you have an opportunity to see how an industry evolves early on. At a certain point they cross the line

-Maybe when introduced to all businesses. There is a time when that line gets crossed and a public company is poised to benefit by becoming a monopoly business.

-Why did Microsoft succeed over Apple? Little by little they eroded Apple's 100% market share.

-Offices were using Windows. Today – do you have a choice of not using Bloomberg?

-Bloomberg visits almost every month and asks what you do, how you use the system. Bloomberg terminals have tens of thousands of functions, they don't give you a manual

-They want you visually hooked so it is a behavioral connection and you don't mind paying tens of thousands of years where you don't have a choice if they raise prices

-They keep coming back to you because they know you are a trader and want to provide you with more services so you are hooked.

-That is why Bloomberg is a fabulous business because you get hooked. Think about switching from that or a competitor coming up with a rival product. How do you compete with that?

-Lu doesn't know. Suppose you know the inflexion point. Do you want to invest? Lu would invest in Bloomberg at that point.

-You need insight. Study every business. They all have more or less this type of dynamic.

-Your job as a good financial analyst is to study that business ALL THE TIME. Observe those trends.

-Once in your life, maybe you will find that opportunity.

-Why doesn't Bloomberg want to sell? He doesn't need to sell.

-When you have a business like that, you don't need to sell.

-Lu has made many private investments, ex: CapitalIQ, which copies Bloomberg's business model. Same method with an investment in an engineering service.

-Lu likes to know as much as he can. He likes to be friends with people, with Timberland, the CEO and his son actually became investors in Lu's fund.

-You can learn and observe from everyday business decisions and learn dynamics.

-Nothing is constant. Everything is changing that is why you have to keep learning.

-Businesses change, Microsoft has threats now.

-You need an active mind, so you are prepared to act and you can seize opportunity due to your insights.