# Harvard Business School Investment Conference Keynote Speech

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Thank you, Rhonda. You and Dennis have done a marvelous job in putting this event together. I have learned a lot today and I am delighted to be back on the Harvard Business School campus. I believe there is a group of people from my home team Columbia University. Anybody there? Please raise your hand. See, there is a whole support team! Thank you!

A room like this reminds me of an experience earlier in my career. It was almost 30 years ago when I came to the U.S. from China, newly enrolled in Columbia, and barely spoke English. I was petrified of my huge debt in student loans. So I asked my classmates on how to make a living in this country. One day a classmate handed me a flyer and said this is somebody who is going to talk about making money and you should go listen to it. I had been to some of these lectures and several provided food. I looked at the flyer and this lecture also provided food, so I decided to go.

I went there and it was a room just like this one. I was surprised how big the room was, but when I looked around, there was no food! I asked others where is the buffet? And it turned out that the guy standing on the podium --- his name is Buffett. You see back then I could not tell the difference between one T and two T's!

Anyway, since I was already there I decided to stay through the lecture and listen to what this guy had to talk about that would be better than free food. I stayed and Warren talked about fundamental value investing. Somehow it clicked with me. Therefore, I thought today maybe I will say something, especially to those who claim there is no road for value investing in the future. Because

30 years ago, Warren's lecture changed my life. After that lecture, I studied for a whole year about Buffett, Munger, and Berkshire, then bought my first stock with borrowed money a year later. I have never done anything else for the past 25 or 26 years.

Since we talked about many fundamental topics this morning, I think I should spend a little time to talk about the market in general from a fundamental perspective. What is a stock market? It is a mechanism to pool small savers' money into investing in enterprises. You can see that from the design of the market, that it has the future to turn into this wonderful self-reinforcing win-win mechanism -- if the enterprise does well, the small savers will do well as a shareholder, as a consumer, and/or as a worker who work for the enterprise and earn a salary from it. As the savers get richer, they pool more money into the enterprise and the enterprise will grow. If this phenomenon grows in scale, it is fundamentally good for society. That is the original idea of the stock market.

Of course, the biggest problem is that most of the small savers don't really know how to value securities. Many securities will fail as many enterprises will fail. In a sense, you need a critical mass for that self-reinforcing win-win mechanism to occur. We need most of the savers, if not all of them, and most of the enterprises, if not all of them, to be part of this exchange, to make this mechanism very efficient. And that's essentially what happened in the end.

But how did it happen? At the beginning of all stock markets, they all have this one feature that allows people to trade away their ownership contract instantaneously, any time of their choosing after they bought it. That feature appeals directly to a fundamental part of our human nature. **No matter what we say we are, by nature we are all lazy and greedy.** If we can get more than what we pay for, we do it; if we can take a little less time to get more, we do it. That trading feature appeals to that part of human nature. That turned out to be the trick. More and more people got

into the market, and as more and more people came in, more and more enterprises came in. This feedback loop begins to form.

Every stock market at its beginning is full of bubbles, full of speculation, full of trading, and full of ups-and-downs. And you start to think, why something so crazy ends up having endured time? Because it has a fundamental element to it. There are actual savers who need to invest in growing enterprises and enterprises need money to grow. Once you reach the critical mass, the market overall becomes more efficient. And that's what happened.

From the very beginning, there are two fundamental forces for the stock market. There is the fundamental element of investment, of supporting the right enterprises at the right price. And there is the other element of trading, to allow more and more people to participate, to entice them to participate, and that becomes the price. Except that after a while, once you reach the critical mass, that trading force becomes stronger and stronger. You already know which force wins in the end. It is the trading force –- to the point that some people claim that you don't need the first force, just let the machines do trading, and that will be fine!

No. If that were the case, then something exactly like that exists -- it is called gambling. The reason gambling is not of a big scale is that it does not provide a fundamental function to the society. The market exists first and foremost to provide a very fundamentally useful function to the society. If you always remember that point, you always know there will be a role for fundamental investors. It just happened to be that the fundamental force is relatively small in the market.

The market is dominated by people with trading tendencies. Even people who claim themselves to be fundamental investors also say they are attuned to the market. That qualification quickly moves them into the other camp, where they pay huge amounts of attention to what’s happening in the marketplace. They are also judged by the market movement, sometimes by yearly, quarterly,

monthly, or weekly performances, sometimes even by the minute. This is where we are today. Of course, these behaviors are also legitimized by the Nobel-winning theory that the market is always efficient, that supply and demand are driven by people who are rational. But as you heard this morning, in the most successful trading organization, nobody can read a balance sheet! Here you go, the efficient market theory.

For the 26 years I've been in this business, I would never say at any moment that the market is exactly efficient in terms of pricing the securities that I know something about. They do go through waves, but in the end, I think that the market tends to evolve with the fundamental force which make the market exist in the first place.

What are the elements of fundamental investing that we call value investing? There are only four basic concepts to it -- the first three were articulated by Ben Graham over 100 years ago and the last one was articulated and exemplified by Buffett, Munger, and Berkshire Hathaway. First, stock is a piece of paper which you can trade, but also signifies ownership; to own a piece of stock is to own a piece of the business. The second concept is stock denotes the company so how the company performs will determine the value of the security. The future is really difficult to predict and therefore you need to have a margin of safety. As Seth Klarman said this morning, his whole investment philosophy, approach, and experiences illustrates better than most people the importance of margin of safety.

Then thirdly you need to come up with a theory about the majority of participants in the market. It is called **Mr. Market**, which says that you can imagine the overall market as an energetic guy who wakes up every morning and shouts some random price at you. Most of the time, you can simply ignore him. Sometimes this guy gets really crazy, with a neurotic mood swing, and some days he would throw at you a ridiculous price that you can either buy or sell, and you can take advantage of that.

Those are the three basic concepts of value investing articulated by Benjamin Graham. But there is one problem. By the time you get into the real world, you will realize that Mr. Market are real people, people who sit in this room, your classmates, people who sit on the panel. They don't look that crazy. They have PhDs in mathematics. They have won this award and that award. They are all very smart people. All of us will say, is this Mr. Market? Could it be that 99 percent of all people are wrong and I'm right?

Then you say, well they have the Nobel-winning efficient market theory behind them. **More importantly, another part of human nature kicks in, which is our bias for conformity**. If enough people who we respect and you know personally, who also have the personal integrity and ethical standards that we admire, all think the same way and worry about the movement of supply and demand, then, all of a sudden, we begin to question ourselves. Do I really know? Maybe they are right and the market movements day in and day out are important. Maybe we should be into the guessing game about how the supply and demand changes and how prices would evolve. And that might become our primary job. That is why no matter what ideas you begin with, by the time you get deeper into your job or your career, you lose half of those ideas along the way, and you become a part of this gigantic trading force. You spend all the time, money, and energy in guessing the supply and demand and the price movements. You start to use computers, the latest technology, whatever at your disposal to guess how the prices will move. It used to be every year, two or three years; now it's every minute, two or three minutes. Now you have to study weather!

This is when the fourth concept becomes very important. **This concept is articulated by Buffett and Munger and it is called the circle of competence.** We are in the business of predicting the future which is inherently unpredictable. What you get is a probability. Some probability is higher than the others. Through persistence and hard work over a long period of time, you will be able to study a few things so well that you are better than all the other people in terms of predicting what

most likely will happen to a certain company, a certain security at a certain price. That is your edge. Once you form that expertise, form a circle of competence, then you can act with confidence. This means that even if everybody else disagrees with you, you are most likely right, because in the end, the fundamental force of ownership still takes root. This goes back to **Graham's saying that in the short run the stock market is a popularity contest, but in the long run it is a weighing machine.** The fundamental force will win.

**The most important part of the concept of the circle of competence is how you define the edge of it.** In other words, without the edge there won't be a circle. It means you have to know what you don't know. If you don't know what you don't know, you surely do not know what you claim or think you know. In other words, if you have an answer, you want to qualify it, so you know when that answer is wrong. And you constantly stand to be tested when new facts emerge. This is a continuous learning process. Yes, it is difficult. It is not easy. But through long-term patience and persistent efforts, you will be able to come into deep understanding of a few things. Your circle, which starts very small, will expand gradually. A truly great value investor has a lifelong journey of continuous learning. But the good news is that your expertise does not get wasted. It accumulates. It compounds almost in the same way that your money compounds. In fact, knowledge can compound at a faster pace. To me, that is a very fascinating journey and rewarding life. I can testify that after 26 years, if I still only know what I knew when I started, I would not be standing here, and you would not want to listen to me.

Now let's come back to the important thing again. **To define the circle, you need intellectual honesty.** You really need to know what you don't know. That is the most important thing. Intellectual honesty also extends to the way you look at your duties, the way you look at your profession in general. One of the most difficult aspects of asset management as a profession is that there is so much certainty, there are a lot of theories and ways to make money -- many of them, pardon my expression, are bogus. Asset management is a service industry, just like a restaurant or

a hotel. But the difference is that in most service industries, customers are the best judge of whether the service is good or not. If you stay in a hotel, I guarantee you can tell right away if it is a good one, or if it is not, whether the price charged is reasonable or outrageous. If you go to a restaurant, you know whether the food is good or bad, even before you eat it, you just smell it. If you go to a dry cleaner, you know if it is good or not. In most service industries, the customers are the best judge, the ones who are being served are the best judge of whether the service is good or not. Not in this industry.

For most people, if someone is pitching you to run your money, it is extremely difficult to tell whether that person is good or bad. The person can say, I have this record of last month, or I have a record of last year, or five years. But you can't really tell, because there are so many things that can influence a record. You could never quite tell whether it is luck or ability. You need to see a sufficiently long record and you also need to know how the person achieved it. If the person is a stock picker, you need to understand a couple of the stocks to truly understand the investment process, before you can say this person is good. That is very difficult to do and not for just anybody. This creates huge room for fuzzy calculation. That is why most theories, if you think through them, are all "what you say determines what you think". The logic behind all this is very simple -- if it's good for me, it has to be good for the client. This is one of the reasons why this profession pays very well. Whenever there is fuzzy math, the pay is always good!

I always say, if you're really honest with yourself, then **imagine every dollar you take from your client as if it comes from your parents** -- middle-class parents who worked very hard all their lives to send you to Harvard. They spent almost all their money on your education and this is the very little money left. Now that you have graduated from Harvard Business School, they think that you are able to do something with it, to help them grow it. Think of every dollar from your clients as if it comes from your middle-class parents' life savings after supporting you for all these years. What will you do with it? I don't think you are going to trade it away. You will have a different

appreciation about this very concept of fiduciary duty. You will pay very close attention to what you do.

You're going to think in a fundamental way on how that dollar is spent and how that dollar supports a fundamental aspect of the society, of our economic life. You are going to look for a win-win situation. You are going to patiently study a few things over a long time until you are certain you can forecast for multiple years ahead, of how this company is going to do with a very high degree of probability on your side, particularly on the downside. **If you don't lose money on the downside on a permanent basis, then the upside will take care of itself.** You are not going to say that the market is crazy, this Mr. Market, everybody is neurotic. No, you just say I don't know. You can just safely say I don't know. I only know a few things. That is outside my circle. It is okay that I don't know anything about it, as long as I truly know a few things in my circle.

By the way, in order to be extraordinarily well off and successful, you do not need a lot of things in that circle. You really don't. As Warren and Charlie said, 15 ideas probably account for 90 percent of their success. Berkshire Hathaway came from 10 or 20 million dollars in market cap without issuing any real meaningful shares, and now it is worth 500 billion. That's a lot of money from a few ideas!

I can say that myself. I started from net worth of sub-zero and I am doing okay now. I can take care of myself. Again, it is maybe 10 ideas for 26 years. So, you don't really need that many ideas. But the ideas you are going to invest in have to be ones you really understand. Most of the time you don't have to invest and that is true intellectual honesty. **That requires a temperament which allows you to stay outside of the mainstream, outside of what everybody else says. You ignore them, not by saying that they're crazy, but just by saying I don't know.**

It is okay that you don't know. Actually it is dangerous to say data predicts anything. What is data? Data is a record of things that happened in the past. Am I right? Am I wrong? To claim that data would do everything is basically to claim that whatever happened in the past will safely predict the future. Was that ever the case? I don't think so. Does anybody disagree? But it is important that if you spend so much time to understand a few things, to focus on them, then over time you can predict with higher probability. If that higher probability happens to also minimize downside, you can achieve a pretty good result safely, no matter what happens in the market. That's more or less what most of the successful value investors or fundamental investors, whatever you call them, have done. That is unfortunately the minority. But the minority is important because that minority represents why the market exists in the first place. If the market did not exist for that reason, it would be an enlarged gambling parlor. I don't think we, as a society, need that big of a gambling establishment, do we? I don't think so.

The fact is that we spend so much money in doing nothing but trading. If you're trading for profit in the short term, you are basically playing a zero-sum game. You're basically winning or losing among a fixed set of people. What does it do to society, to an advanced civilization such as ours? I don't know. It's a good question to ask.

But if you are a fundamental investor, you support a company worthy of your support, a company you understand and one you can safely predict that over time it will become better and bigger, that its value will increase, and you share in the earnings proportionately to the shares that you own. How wonderful is that? It gives you a sense of accomplishment. What you do is good for society, good for your parents, and good for you.

And that is my sermon on fundamental investing! Now I open it up to any questions.