Know What You Don't Know

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"Investing is about intellectual honesty. You want to know what you know. You want to know, mostly, what you don’t know."
-LI LU

Sometimes our newsletter has been accused of writing too technically about financial markets. Truth be told, it’s a constant juggling act to write something that caters to casual market observers as well as to those who pore over the meeting minutes every time the FOMC convenes. If you don’t know what FOMC* stands for, HINT- you’re in the casual camp. I am optimistic that I’ve threaded the needle with this week’s piece, but you be the judge.

Not too long ago, we got a call from a friend of the firm who told us that someone had moved to the Seattle area that we should meet. He told us that this individual was in the investment industry, like us. Generally speaking, I don’t like people in our line of work because they either are after our clients or they have clients who we think should be ours. After digging a bit deeper into his business, it turned out he’s not a competitor and more importantly the guy is a rock star among the investment community having earned the respect and confidence of, among others, Warren Buffett and Charlie Munger. The man is named Li Lu. He runs a celebrated hedge fund, serves on the board of trustees at Columbia University and has a life story so inspiring it’s been made into a documentary called *Moving the Mountain*.

As we’ve golfed and dined, I’ve come to appreciate that his brilliance and determination are unequaled. He’s made a series of astoundingly good investment calls, but I won’t ruin too much of the story told through the written interview below. Every time he speaks it’s like hearing a TED talk. I hope readers will find him as interesting as we do.

**FOMC: Federal Open Market Committee*

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The following is an excerpt from a 2013 interview with Li Lu in the Graham & Doddsville Newsletter. You can read the full interview at Graham & Doddsville here.

How did your unique experience as a Tiananmen Square protest leader lead you to where you are today, running Himalaya Capital?
When I first came to Columbia University, I was dirt poor. I did not choose to come here – I just ended up here because I had nowhere else to go, having just escaped from China after Tiananmen. I was in a new country where I didn't understand the language, didn't know anybody, and didn't have a penny to my name. So, I was desperate and afraid.

In retrospect, that is good inspiration for trying to figure out how to make money! I just wanted to know how to survive. For the first couple of years, I really struggled with the language, but I eventually became much more comfortable. I always had this fear in the back of my mind of how I was going to make a living here. I didn't even think about success at the time – I just wanted to pay my bills.

I grew up in Communist China and never had much money to my name, and then all of a sudden I had giant student loans. So naturally I tried to make a buck or two. One day, about two years after I arrived, a friend of mine who knew my issues said, "If you really want to make money you have to listen to this fellow. He truly knows how to make money." I wasn't sure what it was all about. I just remember thinking that there was a "buffet" involved.

So, I assumed that it was some kind of talk with a free lunch! I said it was a good combination – a free lunch plus a talk about how to make money. So, I went. To my dismay there was no lunch. There was just a guy with the name "Buffett." Mr. Buffett really made a lot of sense during that talk. It was like a punch in my eyes. It was like I had just woken up and a light had switched on.

His honesty came through right out of the gate. And I thought this fellow was just so intelligent – he could put very complex ideas into such simple terms. I was immediately drawn to value investing. By the time the lecture was over, I thought that this was what I was looking for; I could do this.

At the time, I couldn't really start companies, and I didn't want to work in a big company because of the differences in language and culture. Investing, on the other hand, sounded like it required a lot of reading and mathematics, hard work, and good judgment – I was confident that I could do those things well. And the fundamental principles of value investing appealed to me – buy good securities at a bargain price.

If you're wrong, you won't lose a lot, but if you're right you're going to make a lot. It fit my personality and temperament very well. Warren used to say, "Value investing is like an inoculation – either it takes or it doesn't." I totally agree with him. There are few people that switch in between or get it gradually. They either get it right away or they don't get it at all. I never really tried anything else. The first time I heard it, it just made sense; and I heard it from the best. I guess it turned out better than a free lunch.

How did your investing process develop differently from Buffett's?
Part of the game of investing is to come into your own. You must find some way that perfectly fits your personality because there is some element of a zero-sum game in investing. If you buy, somebody else has to sell. And when you sell, somebody has to buy. You can't both be right.

You really want to be sure that you are better informed and better reasoned than the person on the other side of the trade.

It is a competitive game, so you’re going to run into a lot of very intelligent, hardworking fellows. The only way to gain an edge is through long and hard work. Do what you love to do, so you just naturally do it or think about it all the time, even if you are relaxing, and even if you’re just walking in the park.

Over time, you can accumulate a huge advantage if it comes naturally to you like this. The ones who really figure out their own style and stick to it and let their natural temperament take over will have a big advantage.

The game of investing is a process of discovering: who you are, what you’re interested in, what you’re good at, what you love to do, then magnifying that until you gain a sizable edge over all the other people. When do you know you are really better? Charlie Munger always said, “I would not feel entitled to a view unless I could successfully argue against the best counterargument of the smartest opponent.”

He is right about that. Investing is about predicting the future, and the future is inherently unpredictable. Therefore, the only way you can do it better is to assess all the facts and truly know what you know and know what you don’t know. That’s your probability edge. Nothing is 100%, but if you always swing when you have an overwhelmingly better edge, then over time, you will do very well.

How did you become friends with Charlie Munger? Do you have a friendship with Warren Buffett as well?
Charlie and I have some very close mutual friends. Over time, we started talking about businesses, and then it evolved into a strong bond. I view him as a mentor, teacher, partner, and friend, all in one. I am also friendly with Warren, but not nearly as close as with Charlie because Warren is in Omaha. I admire him, and I learn more about him from his writings and deeds than through interpersonal interactions. I have a lot of interaction with Charlie, so I know him both as person and through his writing and personal deeds.

How would you define your circle of competence?
I let my own personal interests define my circle of competence. Obviously, I know something about China, Asia, and America – those are things that I am really familiar with. I have also over the years expanded my horizon [in terms of analyzing businesses]. I started out looking for cheap securities. When you start out, you really have no choice. You don’t have enough experience, and you don’t want to lose money, so what do you do? You end up buying dirt-cheap securities. But over time, if you are interested in businesses in addition to securities, you begin to become a student of businesses. Eventually, one thing leads to another and you begin to learn different businesses. You learn the DNAs of businesses, how they progress, and why they are so strong.

Over time, I really fell in love with strong businesses. I morphed into finding strong businesses at bargain prices. I still have a streak in me that favors finding really cheap securities – I just can’t help it! But over time, I’ve become more attracted to looking for great businesses that are inherently superior, more competitive, easier to predict, and with strong management teams. I’m just not quite satisfied with the secondary market. As I said, there is an aspect of the securities business that is zero-sum. And that’s the area in which I don’t feel entirely comfortable. I’m more interested, by my nature, in win-win situations.

I want to create wealth together with the business operators and employees when I invest. So that led me to venture businesses. I try to apply the principles of intelligent investing there, but I actually can contribute quite a bit, so it becomes a win-win situation.

Over my career, I've had the satisfaction of building a number of different venture businesses. Some of them became enormously successful, even after we sold them. You could say we sold them too early! I was the first investor in Capital IQ, and then look at what happened. If we would have kept it, we would have been far richer! It's not like we didn't make a lot of money in that investment. We did. But I like it that way.

I like to create something that everybody finds useful. We created employment, and we created a beautiful product that's sustainable, and everybody made a lot of money, even the people who bought the business from us. I like win-win situations. I do not complain about selling Capital IQ too early. We made a lot of money on that investment, and we contributed a great deal. I remain friends with the founders. That aspect gave me enormous pleasure. But the venture side is hard to scale; you must put in a lot of effort. So, over time, I gradually moved into helping in a different way. Even in public securities, you can still be very helpful and constructive. So, that's who I am. I'm still learning, and I'm still interested. I'm still young, and still incredibly curious. So, who knows? Hopefully, I will continue to gradually expand my circle of competence.

How were you able to figure out that Capital IQ would become so successful?
In the beginning it was Bloomberg. We wanted to create something just like Bloomberg, and in the process, we grew to appreciate Bloomberg much more because it was so hard to compete with them.

Then we realized the investment banking side was not fully penetrated. So, we basically applied what we learned about Bloomberg and created a similar product for the investment banking side. Over time, we also penetrated different businesses like private equity. We learned quickly that we couldn't really compete with Bloomberg.

You don't short stocks at Himalaya, correct?
That's right; not any more. That change occurred nine years ago. Shorting was one of the worst mistakes I've made.

Is your lack of a short book due to your desire to be a constructive third-party for companies and their management teams?
Yes. But also, you can be 100% right, and you could still bankrupt yourself. That aspect of shorting just frustrated me too much!

Three things about shorting make it a miserable business. On the long side, you have 100% downside but unlimited upside. On the short side, you have 100% upside and unlimited downside. I do not like that math.

Second, the best short has some element of fraud. However, a fraud can be perpetrated for a long time. Of course, you borrow to short, so they could really just wear you down. That's why I could be 100% right and bankrupt at the same time. But, you know what, you go bankrupt first!

Lastly, it screws up your mind. Shorts just grab your mind and take away from the concentrated effort that is required to do proper long investing. So, those are the three reasons why I just stay away from shorting. It was a mistake on my part. I shorted for a couple of years. I don't discard people who are really doing well at shorting – it's just not me.

If I want to add a fourth reason, it is that the economy overall has been really growing at a compounding rate for 200-300 years, ever since the modern science technology era. So, naturally, the economic trend favors long positions rather than short. But you cannot live life without making a mistake. Every time I make a mistake I learn something.

How were you able to get Charlie Munger interested in a company like BYD [a Chinese company which manufactures electric cars, batteries, electronics and solar equipment] given that Berkshire Hathaway typically shies away from technology-oriented companies?
I don't think that Warren and Charlie are ideological. Neither am I. It's really how much you know. The story of BYD is relatively simple. This guy, who is a really terrific engineer, started the business from just a $300,000 loan with no additional money until the IPO. He created a company with $8 billion in revenue and 170,000 employees and tens of thousands of engineers. He solved a whole bunch of different problems. So, you have to admit the record is impressive. They also happen to be in the right industry and the right environment, and they get the right support from the government. Their engineering culture consistently demonstrates its ability to tackle big, difficult problems. It works. So, it's hard not to be impressed by the record the guy has. At the time we invested, we had quite a bit of a margin of safety.

They play in a big field with open-ended possibilities and have a reasonable chance of being successful. As I said, nothing is a sure thing, but this strikes me as having as good of a chance as any.

Charlie was equally impressed by the company, which then led to the investment. Berkshire is not ideologically against technology stocks. They're just against anything they don't feel comfortable with. They have that $11 billion investment in IBM, which, I can argue, is a technology company. But I can guarantee that's not how they think about things. It has nothing to do with whether it's a technology stock or not.

Buffett admitted in a 2009 Fortune article that he doesn't really understand BYD.
That is true. Warren and Charlie have a great partnership and Charlie knows more about BYD than Warren. But I would not bet against the collective track record of those two. It's not that they don't make errors from time to time. Everybody is capable of doing that. They have a few, but very, very few over a long investment career.

Can you talk about your investment process?
Ideas come to me from all sources, principally from reading and talking. I don't discriminate how they come, as long as they are good ideas. You can recognize good ideas by reading a great deal and also by studying a lot of companies and constantly learning from intelligent people – hopefully more intelligent than you are, especially in their field. I try to read as much as I can. I study all of the interesting and great companies, and I talk to a lot of intelligent people. You know what? In some of those readings or conversations, ideas just click. Then you do more research and then you get comfortable or you don't get comfortable.

Are the people that you talk to fellow investors or are they people like customers, suppliers, and management?
All of them. I don't talk to as many investors – very few. I am more interested in talking to people who are actually running businesses and entrepreneurs or CEOs or just good businessmen. I

read all of the major newspaper publications and annual reports of the leading companies. I get a lot of ideas out of those too.

How do you assess if the management is being forthright with you? How useful is it to speak with the management?
Well, management always has a big influence on your success, no matter how good or how bad the business is itself. Management is always part of the equation of making the company successful, so the quality of management always matters. But to assess that quality is not that easy.

If you can't assess the quality of management, you may have to make a decision in spite of that. That's just part of the process. So, you have to figure out other ways such as looking at the quality of the business, the valuation, or something else until you can justify an investment. If you do have a way to assess the quality of the management team, either because you're an astute student of human psychology, or you have a special relationship with the people, then you'll take that into consideration. Why wouldn't you?

The management team is part of what really makes a company. But, it's not that easy. It's not that easy to have an in-depth, solid understanding of the management team. Very few people are able to do that. I admire people that say, "Hey, look. Whatever the information, whatever the kind of presentation they make, I will never be able to learn about management beyond that. I know it's a show for me, so I might as well just discard it." I respect that. Investing is about intellectual honesty. You want to know what you know. You want to know, mostly, what you don't know. If understanding the management team is not in the cards, it's not in the cards.

How do you make your sell decisions?
One should make sell decisions on one of three occasions.

Number one, if you make a mistake, sell as fast as you can, even if it's a correct mistake. What do I mean by a correct mistake? Investing is a probability game. Let's say you go into a situation with 90% confidence that things will work out one way and a 10% chance they work out another way, and that 10% event happens. You sell it. Then there's a mistake that your analysis is completely wrong. You thought it was 99% one way, but it was actually 99% the other way. When you realize that, sell as fast as you can. Hopefully at not too much of a loss, but even if it is a loss it doesn't matter – you have to sell it.
The second time you want to sell is when the valuation swings way too much to the other end of the extreme. I don't sell a security because it's a little overvalued, but if it is way overboard on the other side into euphoria, then I will sell it. If you are right and hold a company for a long time, you have accumulated a large amount of unrealized gains. A big portion of those unrealized gains act like borrowings from the government interest free and legally. So, when you sell that position, you take all the leverage and you take a bunch of the capital out, so your return on equity has just become a little less.

The third occasion when to sell is when you find something that is better. Essentially, a portfolio as I said is opportunity cost. Your job as a portfolio manager is to constantly improve on your basket. You start with a high bar. You want to increase the bar higher and higher. You do that by constantly improving the opportunity costs; you find something better. Those are the three reasons that I would sell.

Do you have any advice for students who are interested in getting into investment management, especially for those readers who can't go and listen to Warren Buffett

speak during their lunch break?
If you do get a chance to meet Mr. Buffett, I'd run to it if I were you. I wouldn't even take an airplane; I would just run to Omaha! Start by learning from the best – listening, studying, and reading. But the most important thing in understanding the investment business is by doing it. There is no substitute to actually doing it.

The best way to do it is to study one business inside and out for the purpose of making the investment – you may not actually invest. But having gone through the discipline of understanding one business as if you own 100% of that business is very valuable.

To start, take an easy-to-understand business. It could be a tiny business – a little concession store, a restaurant, or a small publicly traded company. It doesn't matter. Understand one business and what really makes it tick: how it makes money, how it organizes its finances, how management makes its decisions, how it compares to the competition, how it adjusts to the environment, how it invests extra cash, and how it finances the business.

You should understand every aspect of one business as if you own 100% but you don't actually run it. This causes you to be desperate to understand every aspect to protect your investment. That will give you a sense of a disciplined approach. That's how you truly understand business and investing.

Warren always says that to be a good investor, you need to be a good businessman, and to be a good businessman, you need to be a good investor in terms of capital allocation.

Start by understanding one thing within your control that you can understand inside and out. That is a terrific starting point. If you start from that basis, you are fundamentally in the right direction of becoming a great security analyst.

OUR CURRENT LIKES AND DISLIKES

No changes this week.

LIKE

- Large-cap growth (during a deeper correction)
- International developed markets (during a deeper correction)
- Cash
- Publicly-traded pipeline partnerships (MLPs) yielding 6%-12% (buy carefully after the recent rally; long-term, however, future returns look highly attractive)
- Gold-mining stocks
- Gold
- Select blue chip oil stocks (as with MLPs, be selective given the magnitude of the recent rally)
- Mexican stocks
- Short euro ETF (due to the euro's weakness of late, refrain from initiating or adding to this short)
- Investment-grade floating rate corporate bonds
- One- to two-year Treasury notes
- Canadian dollar-denominated short-term bonds
- Select European banks

NEUTRAL

- Most cyclical resource-based stocks
- Short-term investment grade corporate bonds
- Mid-cap growth
- Emerging stock markets, however a number of Asian developing markets, ex-India, appear undervalued
- Emerging bond markets (dollar-based or hedged); local currency in a few select cases
- Solar Yield Cos (taking partial profits on these)
- Large-cap value
- Canadian REITs
- Intermediate-term investment-grade corporate bonds, yielding approximately 4%
- Intermediate municipal bonds with strong credit ratings
- US-based Real Estate Investment Trusts (REITs)
- Short yen ETF
- Bonds denominated in renminbi trading in Hong Kong (dim sum bonds; neutral rating now due to the recent strength of China’s currency)

DISLIKE

- Small-cap value
- Mid-cap value
- Small-cap growth
- Lower-rated junk bonds
- Emerging market bonds (local currency)
- Emerging market bonds (local currency)
- Floating-rate bank debt (junk)
- US industrial machinery stocks (such as one that runs like a certain forest animal, and

another famous for its yellow-colored equipment)
- Preferred stocks
- Long-term Treasury bonds
- Long-term investment grade corporate bonds
- Intermediate-term Treasury bonds (moving to “dislike” on longer bonds due to recent breakout above 3% on the 10-year T-note)
- BB-rated corporate bonds (i.e., high-quality, high yield; in addition to rising rates, credit spreads look to be widening)
- Long-term municipal bonds