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## Value Investing - Making it work in China and Asia

*A Presentation by*

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*Organized by*

**Columbia Business School's  
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**Professor Bruce C. N.  
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*Robert Heilbrunn  
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and Asset Management  
at Columbia Business  
School.*



Unfortunately, Dean Hubbard could not be here today, so I am on this platform without a leash, and I intend to make the most of it. So, the more time you can give me, the more grateful I will be.

All right, if you have read your programs, you will see that this is now the 20th version of this breakfast. I would like to see a show of hands – how many people were actually here at the first [Graham & Dodd Breakfast] in the broom closet at the Intercontinental Hotel? Okay, well, it has been an extraordinary development over that period, and there are people who are due credit for the expansion to the extraordinary group that you see

here today. So, first I would like to acknowledge Helene and Sid Lerner, whose family actually made the Graham & Dodd Center possible, which of course runs this breakfast.

Bob Bruce, who is unfortunately not here, who funded the first breakfast, Mario Gabelli and GAMCO, who are responsible for the original internationalization of this event, who are funding and have continued to arrange the simulcast of this event to London, and obviously to Fidelity, who are providing their offices in London. I think it is being transmitted also to Hong Kong this time in some form, at the behest of the EMBA-Global program in Hong Kong, which is a collaboration of Columbia Business School, London Business School, and the University of Hong Kong, all of which 20 years ago was completely inconceivable. We are obviously extraordinarily grateful to Value Partners Ltd., for making Mr. Cheah available on this occasion, but, I think, most of all, I would like to acknowledge all the people in this room who represent what is increasingly a vibrant and

valuable community of value investors, as the name implies. So, thank you all for being here and for your long-term support, and I look forward to the 40th of these to occupy the whole of this hotel.

There have in the past year also been some fairly monumental changes at the Graham & Dodd Center at Columbia University. One in particular I would like to acknowledge on this occasion. Erin Bellissimo, after eight years and an extraordinary degree of productivity that not only involves taking programs at Columbia Business School and out of the Heilbrunn Center from nothing to what you see today, but who also produced four children in that time, is leaving, I think, right after this breakfast. So, first of all, I would like to get a round of thanks to Erin for all her efforts. I mean, Erin stand up, they won't notice, but you should anyway.

We are very lucky to have the Louisa Serene, who has so far in the last six months proved to be an extraordinarily able replacement for Erin and will carry on that work. Louisa, if you'll stand up, that would be good, too.

Before I start to do the substantive introduction to today's breakfast, let me just talk a little bit about procedure. I'm going to do an introduction that I hope will only take up all the rest of the 10 minutes I have. Then, I am going to turn it over to Mr. Cheah who has prepared remarks that should run some 45 minutes to nine o'clock. Then, we will take questions from the floor. If you're worried, I actually have a couple of questions to start with, but you should feel free to ask your questions at the end of his prepared remarks.

All right, with that as housekeeping, the developments of the last three years have had an extraordinary impact. I think it is clear for investors, in particular, on attitudes towards macroeconomic factors. When we started this breakfast 20 years ago, if you mentioned the word 'macroeconomics', people would act as if you had transgressed some of the deepest taboos of the profession. As we stand or sit here today, almost everybody is suddenly a macroeconomist in some degree. The success of some investors in anticipating, and, in many cases, profiting from the severe economic declines in 2008 and 2009, has obviously led a lot of people to think about the

extent to which they can anticipate similar market developments.

“ There has, I think it's fair to say, been an extraordinary amount of excitement about the former economies, for good or ill. ”

One aspect of this focus on relatively high-level phenomena has been that people have begun to look around and remark on the extraordinary differences in economic performance – both pre-crisis and post-crisis – around the world. In particular, the differences between the rates of growth in emerging markets – Brazil, India, Russia, and the other resource exporters and China on the one hand, and the traditional developed industrial economies of Europe, the U.S., and Japan on the other. There has, I think it's fair to say, been an extraordinary amount of excitement about the former economies, for good or ill.

I think it is important in this process of looking at macro forces, to look at different economic contexts around the globe and not lose sight of fundamental value principles. And there I would start with Warren Buffett's two rules of investing: rule #1 is don't lose money; and rule #2 is don't forget rule #1.

First and foremost, I think value investing is about avoiding permanent impairment of capital. That means preeminently, I think, no bubbles – not Japan in 1989, not tech and telecom stocks in 1999, and not housing and financial stocks in 2008. The problem of course with that prescription is in recognizing when you are in the middle of a bubble. There are, I think, well established symptoms that we can look at. First, all these bubbles are associated with an extraordinary degree of enthusiasm and certainty about the prospects of a particular asset class or a particular group of stocks or the prospects for a particular country. The problem is that sometimes this enthusiasm is justified.

I think the second and more reliable measure is when you are in the middle of these bubbles. I would have to say what I think is the most likely bubble out there at the moment is US treasuries; the returns that are available from the favored securities are disproportionately less than

comparable returns, or in many cases, less risky returns that are available on other securities. So, for example, you can get 2.5% on treasuries today, because we are in uncharted macroeconomic territory (at least, with a substantial possibility of inflation undermining the value of that investment.)

Treasuries are not risk-free, I think, in the present environment. At the same time, there are extraordinary franchise businesses that are selling with 3% or more dividends – with earnings returns that are very stable – of 5-8% that are not susceptible to the ravages of inflation, because they have pricing power and are able to pass along increases in costs that are not particularly susceptible to deflation, because, by their nature, they are insulated against competition. And, if there is any growth, you are looking in these lower-risk opportunities at returns of 8-11%, versus the 2.5% that is available on treasuries.

“ How that is going to play out and what that is likely to mean for profits, I think nobody without long-term substantial expertise in China is going to be able to discern particularly effectively. ”

The problem is that in the case of the emerging economies, trying to do similar calculations is by no means an easy task. And there, I think, you have got to rely on the second fundamental Buffett principle, which is: know what you are buying; understand where your margin of safety is coming from.

What that means is coming to terms with the help of experts in these areas and in the nature of these economies. China, in particular, is okay. I do not know if any of you have tried to look at the national-income statistics from China. The last that are available on the official website that I looked at are from 2005, and they are pretty rudimentary. Also, at the national level, what they tell you about that economy is that it is an economy of a kind we have never seen before.

In a typical developed economy, or even in most developing economies, wages account for roughly two-thirds or slightly more, of national income. If you [can believe it], wages in China

account for less than 40% of national income. How that is going to play out and what that is likely to mean for profits, I think nobody without long-term substantial expertise in China is going to be able to discern particularly effectively.

At the level of firms, there are accounting differences, and in China and also in many other emerging markets, there is a degree of government involvement and involvement of state-run enterprises in those economies that is unprecedented. We don't have a lot of experience about economies that evolve over time towards higher-end products, and how those state-run enterprises are likely to adapt. Accounting, reporting, and financing requirements in such environments are just very different from what we are used to.

On the other hand, whether it is Warren Buffett and Charlie Munger with their investment in BYD on the long side, or Jim Chanos with his effective commitment on the short side, people are going to engage in the investment climate and with the investment possibilities in China. Under those circumstances, it seems to me the best we can do is provide a reliable guide as a starting point with that engagement, and we are therefore extraordinarily privileged today to have Cheah Cheng Hye as our speaker, who is – I think it is fair to say – over the last 20 years, the preeminent value investor in China, and in Asia, more generally.

He is the chairman, co-founder and co-chief investment officer of Value Partners, which manages \$6 billion. If you read the press, this is particularly appropriate since Mr. Cheah began life as a reporter, which means there is hope for everybody, no matter where they start. Value Partners has been widely recognized in the press not only for being the leading value practitioner in China and Asia, but also for being one of the very best investors and most highly regarded investors. Since China is not notably sympathetic to a value approach, it is a true testimony to the value of his advice. So, it is a great honor to present Mr. Cheah Cheng Hye.

**Mr. Cheah Cheng Hye**  
*Chairman and Co-Chief Investment Officer, Value Partners Ltd.*



Thank you very much, Professor.

Professor Bruce Greenwald, I appreciate the opportunity to speak today. I want to say thank you again to the Heilbrunn Center for Graham & Dodd Investing and Columbia Business School, and of course I am deeply grateful to all of you for coming. I will try my best to share with you what I know about how to apply the value investing discipline in my part of the world, East and Southeast Asia.

Now, before I go on, I need to tell you, according to Compliance regulations, that the statements that I am about to make to you represent my personal opinions and not those of Value Partners.

As for Value Partners, we are the only listed asset management company in Asia, outside Japan, and even in Japan there is only one listed company, so there is ample documentation available on who we are and what we do; there is a lot of transparency.

The company was listed in 2007 by Morgan Stanley and JP Morgan. The mission of the company is very straightforward. Our mission is to build a temple of value investing for East and Southeast Asia. This phrase was coined by yours truly. Actually, I used to be a journalist; I worked for *The Wall Street Journal* in the 1980s. But seriously, what we are really trying to say with this phrase is that we are first and foremost a value investor, and only secondly are we a China investor. The distinction is quite important, because up to now, China has been what I call a 'story' market. A lot of people buy and sell China based on stories they read in the press or on what somebody has told them about. In the process, it can be very difficult to carry out fundamental value investing according to the textbook definition.

So, we are trying to go the other way. Our standard textbook throughout the 1990s was Graham & Dodd's *Security Analysis*. We actually

applied it quite religiously; we used to call it the Bible. But in more recent years we switched to a different book. I am not plugging the book, just telling you what we do. It is a book by a guy named Martin Fridson, whom I never met, called *Financial Statement Analysis*. It is a simpler book, but pretty much the same thing as *Security Analysis*.

“We've conducted about 2500 company visits per year, excluding phone calls. That is the real source of our power; just old fashioned kicking the tires.”

So, we do a lot of financial modeling. We've conducted about 2500 company visits per year, excluding phone calls. That is the real source of our power; just old fashioned kicking the tires. What we are good at is that we put into practice the theory of value investing that my colleagues and I have read about and we've study very seriously.

I actually do not believe we have anything original to say about the theory, but I think we have gained some valuable insights that I will share with you about its actual application; this is what we are actually good at. Now, before I go on to the next slide, I want to tell you that by the roughly mid-to-late 1990s, I was coming up against the big "what if" question, as I tried to create a sustainable business model out of the concept that I wanted to carry out value investing in this very immature market that we call China. Because I began to ask myself what if we can create a business model – a value investing firm – that performs, but that is not dependent on having a genius or a star performer or some kind of a magical black box within the firm?

I even began to wonder if there was some kind of a conspiracy, maybe by the marketing people or the press, to try to tell the story that to beat the market you needed to have a genius or a star performer or a black box, and I thought to myself that this was not a very sustainable way of doing the job. So, I began to ask myself very straightforward questions like, is there a way that normal people, ordinary people that you recruit out of college, can become very good value investors, at least with respect to the China region?

So, that became a kind of quest for me. Initially, it was just intellectual, but as I am going to explain to you over the next 15 minutes, we turned it into a reality.

First of all, you have got to understand that if you do not have good people you cannot create a good product. So, the first answer to the puzzle or the question I just raised is to create a very good corporate culture. And the second thing we do, which is, I think, a bit more interesting, although I know that sometimes when I say this, I am greeted with a bit of hostility from people who do not want to hear about this. I believe I have succeeded, to some extent anyway, in industrializing the value investing process, transforming it from a boutique craft into a process of mass manufacture. It sounds pretty elaborate, but actually is very simple.

Again, I will explain to you, but I am trying to get away from a system that relies on geniuses, and trying to get a system that I turned into a sustainable and a scalable process. In fact, we have been doing this in Hong Kong since the late 1990s – sometimes with great difficulty. Sometimes, we thought better to just give up, but we stuck to it and we have in the process created, what I think, is a pretty valuable business that in fact has consistently been able to beat the market.

“ I believe I have succeeded, to some extent anyway, in industrializing the value investing process, transforming it from a boutique craft into a process of mass manufacture. It sounds pretty elaborate, but actually is very simple. ”

The first part of what we do is that we had to start from almost ground zero in terms of creating an appropriate culture to implement and execute this concept. Here, I have to take two steps backwards and explain to you the context in which I operate, because here I am in a market that, unlike in the United States, is a very young and immature market. The first companies from Mainland China were only listed in 1991 or 1990, I cannot remember; there is a company called Brilliance China, and it was listed in New York with the help

of Merrill Lynch. That was the first mainland China company. Today, of course, it is the partner of BMW in China.

Things happened at Value Partners too quickly; there was not enough time to put together an in-depth and appropriate culture of professional integrity. That is why you sometimes hear some great horror stories. Very basic concepts that should have been instilled in the market when people first joined, concepts like put a client's interests first, be transparent in your dealings, identify and be wary of potential conflicts of interest... You would be amazed by how many people in my industry, in my part of the world, have never heard about it or only pay lip service to it.

So the first thing I did was – actually not the first, but sometime in the mid-to-late 1990s – I put together what I call *My Promise*, and I asked my staff to sign it, individually. I framed it and put it in front of them, in front of their computer, so they would be reminded of it every day. And we do a lot of this brainwashing thing, you know, that we have elaborate ceremonies and kind of assure one another that we are very serious about our Promise.

So, here is a copy of the promise and it basically just encapsulates basic concepts that you need, because value investing is really a kind of a very vigorous philosophy and deep exploration of reality, but if you don't have people who are intellectually even honest, there is no way you can carry out the mission.

### *My Promise*

As a Value Partners person, I pledge to:

- ❖ Be honest and straightforward
- ❖ Put my pride, not my ego, into the job
- ❖ Always strive for self-improvement
- ❖ Put clients' interests first
- ❖ Be fair and responsible to shareholders
- ❖ Keep our workplace free from office politics
- ❖ Keep secrets, maintain confidentiality
- ❖ Uphold our reputation for creative, high-value solutions
- ❖ Emphasize a user-friendly, cost-effective approach
- ❖ Focus on concrete results, not excessive procedure

Now, we then go on to the actual investing process. When I talked about using words like

mass manufacturing and industrializing a craft, what I really meant was that I have broken it down into a set of skills. Each skill can be mastered by fairly ordinary people with probably just a college education, and the process is teachable, is repeatable, is sustainable, and is scalable. It is definitely not magic, it is definitely not driven by genius, but it is all the above that I mentioned to you.

I would identify each of these skills to you, but the starting point for this is that there are a number of images I can draw for you to try to communicate what I am actually trying to achieve.

One is, I was very frustrated by the idea that no matter how smart a human being is – even the President of the US, for example, who is after all just a human being – his potential for excellence is almost defined by the limitations of being human. But what I really want, if possible, is an operation or situation that can be almost beyond human – superhuman – and then I thought of the concept of the ant colony.

There is a saying that in case of an all-out nuclear war, the human beings won't survive but the ants will. Why is that? Each ant is probably a pretty dumb animal or insect, but together, by socializing the process involved in survival and production, they are incredibly strong. You can't really kill them all, they are repeatable, they are scalable, etcetera.

“ Each human being has different strengths and weaknesses, but together we make a formidable team. ”

Finally, I thought about what Chairman Mao said, or was alleged to have said. I was too young actually, but there was something about using socialism to help capitalism. So, as a company, we are a pretty socialist company. I won't go into big detail, but people have compared us to being Israelis on a Kibbutz – everyone helps each other, but we are actually doing all this in cause of the capitalist system actually.

Anyway, so what we are really doing is that we have broken down each skill into steps and here are the steps, these are the so-called seven specialist skills.

The first skill, obviously, is originating ideas. Original ideas itself is an important skill. We have a matrix, let us call each of it A, B, C, D. I'm quite proud to tell you that I actually scored A in originating ideas, but unfortunately, in some other skills I have like a C.

Each human being has different strengths and weaknesses, but together we make a formidable team, I think. So, for originating ideas for a value investor in China and Hong Kong, the key is to find ideas that are very contrarian. Perhaps I should illustrate it on the board. I will go through each skill step by step and tell you or highlight the salient points that we use to train people for each skill.

For originating ideas skills, which I claim to score an A, we have a universe of several thousand stocks: Taiwan, Mainland China, Hong Kong, and in the case of Value Partners, some Korea, Japan and Southeast Asia. We simply divide all the stocks into category 1, 2 and 3.

One is undervalued, so your job if you work for me or in my team is that you must try to identify Category 1 stocks and then do research on it. Category 1 stocks are undervalued. Category 2 is fair value. We find a lot of sell-side brokers tend to recommend Category 2 stocks.

And, when you sit in a taxi and the taxi driver tells you about stocks, it is probably Category 3.

So, technically, our objective is to buy 1 and sell at Category 2.5. Later I will start telling about the problems, but anyway, right now I am just giving you the theory. For Category 1, generally, the most fertile area to find these ideas are stocks that are unpopular that nobody cares about – definitely not an index stock, or that something bad has happened. It sounds so simple, but in real life it is quite difficult to do because maybe it is Asian culture or human nature, but people do not feel safe sticking their necks out to look at these unpopular companies.

So, in China-related stock markets, there are actually quite a lot of Category 1 stocks because it is a very emotional market, very momentum driven, so stocks fall in and they fall out of favor fairly quickly, and, in fact, in a rather predictable way. Now, in case you can identify good Category 1 stocks, your next step is to start looking at the research part of it. Remember, I said this was skill number 2.

Research, now for a firm like Value Partners, and I think a number of firms around the world, is

quite difficult to push out to the frontier intellectually. We have standardized our spreadsheet, and we look at all the obvious details and financial numbers and number crunching. The only thing new I can say about research is that in the China context, we have been moving increasingly away from quantitative analysis to qualitative analysis. When I first started in the 1990s, there were very few companies with superior business characteristics in China. What you were really buying were pretty lousy companies trading at very cheap prices, and that, in fact, it was quite difficult to be a long-term investor because some of these companies got chopped up, or competitors came in and they are gone.

So, we were pretty much a traditional classic value investors trying to get the last free puff of the cigarette. But in more recent years, the trend has been much more encouraging. You are finding more companies that may fit the description of a good franchise. I.e. a sustainable, competitive advantage, durable advantage we call it, and to do that it is very difficult to quantify in numbers.

“ So, in China-related stock markets, there are actually quite a lot of Category 1 stocks because it is a very emotional market, very momentum driven, so stocks fall in and they fall out of favor fairly quickly. ”

You have to look at the characteristics of the management and the business model. But in summary, we are looking for something called the three R's: the Right Business, run by the Right People at the Right Price. And as I mentioned earlier, we are seeing a trend where the original emphasis of Value Partners on just the Right Price, because it was the only thing we haven't found, is changing more and more to the Right Business run by the Right People.

The third skill was originally not considered a skill until I began to realize that decision making is in fact a teachable skill in itself. Actually, the real problem is the lack of decision making, because although we had a team of almost 30

people who were analysts and fund managers, few people actually wanted to stick their neck out and make a real decision.

We call that a lack of killer instinct – this is one of my phrases. Nobody really wants to kill anybody anymore in our civilized world, you know. So, we even have a guy who has since left the company, we called Mr. OTOH.

OTOH stands for 'On The Other Hand'.

Yeah, I'm sure all of us know about this, that the analyst will always give analysis in about 30 pages that take you half the night to read, and the conclusion is: however, if, but, and on the other hand, you know. So, in the end, you don't know what you are supposed to do, if anything.

So, I am trying to kill the Mr. OTOHs in my company, but it is not easy, and I began to realize that it is possible to train and be good in decision-making. One clue to the way we are doing it is borrowed from the Buddhist philosophy, which I am a follower. It is to remove yourself, your sense of self from the equation, when you are trying to analyze anything. By injecting yourself or your sense of 'me' into an analysis, you distort the reality because your ego gets involved. Your perceived self-interest, your need to be given credit for something, gets involved. So, remove yourself from the analysis.

Now, the next cue, we call it "deal structuring." This again came about almost by accident, because I began to realize that by local Hong Kong standards, we are a very big company.

But anyway, we are a big guy in our little patch of the jungle, and we can demand good treatment from the brokers, and I began to realize that if we decide to buy something based on the research and our idea finding, we shouldn't just go and try to buy in the stock market. We should approach the company and say, let's make a deal: we'll buy 5% in your company, and you do it through a form of placement of a single block of shares or what the American people call "PIPES" transactions, which I think stands for privately something, something per equity, whatever, you know.

You always get better terms, more discount, or you can get them as convertible bonds. For your information, about slightly over a year ago, an American company called Affiliated Managers Group, listed in New York City – the chairman is over there. They bought 5% of my company through a negotiated deal.

All right, so due structuring in itself just brings a lot of benefits to clients.

Now, the next skill I think we'll mention is Execution. This is no longer done by our fund management team. It is actually done by a specialized team of full-time dealers; we have three of them in the office. It is in itself a specialized task.

Then, from here on my scores are dropping, for your information. I tend to get high scores here and lower scores as we go along because I get bored as we go down the sausage-making machine.

Maintenance – this is just a fancy word for saying, “after you buy the stock, don't forget about it.” Keep in touch with the company, update your research vigorously, and keep thinking how you can continue to enhance the value of the investment.

And the final thing is Exit. For people like me, Maintenance and Exits are weak points, and I tend to try to delegate it to other members of my team who are more interested in these particular skills. Exit means actually selling the stocks, and the prevailing wisdom for this is that you are supposed to exit when you figure that what you know about the company and the people in the company is quite common knowledge to everybody, so you have no more value to add to the investing process.

Then you should be getting out; in theory. In real life, we usually sell far too early. I think it is a thing about value investors. We see a lot of problems all the time.

“ I think it is a thing about value investors. We see a lot of problems all the time. ”

All right, sorry, just a short intermission. In case you are the CIO, you have to master these additional skills that I had not mentioned earlier. The additional skills are: providing leadership, to make things happen – macro strategy – which we didn't use to think about as a skill, because we were diehard, bottom-up value investors, until the Asian financial crisis. And then we realized that you actually better have some idea of what is the overall macro environment you are operating in; asset allocation and portfolio construction. This is

not done at the fund's managerial level; it is done at my level.

I am actually the Co-CIO with another guy named Mr. Louis So. We two guys are responsible for these skills, for better or for worse. We try to provide leadership to the team, motivating people. Here, the key take-away you should note is that there is an abundance of hard skills in Asia, but a shortage of soft skills. What do I mean by that? For your typical Asian people, if you can sit an examination and provide some text books, they would do very well; they have that kind of culture. But if you ask them to do things that are not so tangible like communicating with people, motivating people, providing leadership and leading, they are not so good. I am not sure why that is so, but it is a fact. So, we tend to struggle a little bit in finding people who are willing to be leaders or to even communicate properly with people in the office leadership.

Macro strategy, I am not a macro expert, but because of my perhaps size and experience, I am plugged to people who are macro experts, and I make sure they give me the first call if they think anything is worth talking about. That is probably good enough, but you have to have some sense of the environment where you are trying to put money to work, although we remain primarily a bottom-up stock picking company, and asset allocation and portfolio construction must take into account your evaluation of the macro environment.

So, more or less as an example, we went from 10% cash in our funds to 1% cash in our funds between June and July this year, because, from a macro point of view, we concluded this is one of those windows that opened up for China investing where you should be very aggressive when putting money to work.

“ The right way to go to do our job is that if you enter a transaction if you are a buyer, you shouldn't be buying if you think the seller knows more than you. ”

Negative interest rates, soft landing, now increasingly evident for the China economy, and

various other factors, including inflation, are likely to increase a harder landing because the Hong Kong dollar and the US dollar are pegged, so we are importing a lot of loose money policies from the US, even though our own economy is actually doing very well. So, the adjustment is taking place through asset prices.

I want to share with you at this point, the halfway mark of my prepared remarks, that internally we no longer call ourselves ‘value investors’, although of course we are, you know, otherwise I don’t think I will be invited to speak to you today. But internally, we use another phrase now. I won’t write it because it’s easy to remember.

We call ourselves ‘advantage investors’, which is part and parcel of the seven skills approach I mentioned to you.

I have developed and written quite a number of memos internally on the concept that the right way to go to do our job is that if you enter a transaction if you are a buyer, you shouldn’t be buying if you think the seller knows more than you.

If you are a seller, you shouldn’t be selling if you have not clarified why the buyers are willing to buy from you. This is a simple advantage idea; that you must always have some confidence that you have an advantage over the counter party in any transaction, and we have developed many theories about advantage, most of it is based on the idea of having more research.

Here we are blessed, because unlike a relatively more efficient market like the US, our markets are extremely inefficient. We have all sorts of people who are not qualified to be in the stock market but who insist on being in it anyway. I had many experiences where I asked people, “what is the purpose of the stock market my dear?” And they are, “Oh! It’s there for you to make money.”

That is all they will say. They forget that the market is there to mobilize surplus savings of a society and put it to work in productive enterprises. Nobody cares about that actually; asset-wise, maybe.

But anyway, so if you take the trouble to research and do company visits, you have actually a pretty strong advantage over many other players in China-related stock markets who are actually quite, you will say, ‘uneducated’ in the true sense of the word.

You definitely can practice advantage investing. Portfolio construction at my level is mostly based on the idea of taking advantage of the macro environment and highlighting your core competence. Actually, we only have one real core competence: stock picking.

So, the portfolios that I run are all designed to – as Professor Greenwald mentioned earlier – to gather against the downside risks, while participating in the upside through a construction system that basically allows us to shine in the one thing we know best: picking stocks.

“ This process allowed us to grow our fund size in a way that couldn’t be done if our business model was based on a single human being, a certified genius running the fund. ”

I am going to go on because it is time to talk about overall things I learned about how to survive and prosper in China-related markets. Here, I am leaving one of my main subjects, which is how I think we are trying to industrialize the process of investing, but before I go away from the subject, I want to emphasize again that when I tried to describe this process to some clients, I noticed that they were not very happy, because they thought this is a some sort of a trick for us to become an asset gatherer, that the reason we have this industrialized process was because we want to get big.

This process allowed us to grow our fund size in a way that couldn’t be done if our business model was based on a single human being, a certified genius running the fund. But here we can have many, many people are doing it, right?

But I just want to assure you this is really not true. The truth is, from the 1990s onwards, I was very interested in knowing how we can develop a sustainable business model for running money, and yet beat the market consistently, and yet depend on hiring normal people to join our company. Not great people, but just normal people who can, however, become great, and also a system that we help each other with our weaknesses, in a very humble and frank manner.

Okay, let us talk about Asia as a whole. First of all, I already mentioned it is basically a very

inefficient market. You don't necessarily make money by investing in superior businesses. As I said, there is a growing number of such superior businesses, but it is still much less than in America. You make money by taking money from stupid people who shouldn't be in the market; that is the truth about it – it's changing but it's still there.

You need to be familiar with the political and social context of the investment, not just the financials. We have problems sometimes with Asian people who came out of US Universities with an MBA or whatever, because we find that they are too focused on numbers alone. Actually, there is enormous baggage in Asia regarding its history. Some people are very sensitive about politics and social issues. You have to be sympathetic to it. You have to understand why sometimes so-called irrational things are done. I think even the Chinese Government, from my feedback now, is beginning to realize that growth for the sake of growth is not that ideal.

There are a lot of other things that are important, like having a clean environment, reducing the income gap between the rich and poor, countryside and cities, and not just growth for the sake of growth, and this is in the same context that you must understand what makes people do what they do. Because of their history, their social values, etc.

One exercise we try to do sometimes with some success is, we imagine what the newspaper will say about the company we are investing in, six months from today, 12 months from today, 36 months from today.

I think it is probably because of my own background as a newspaperman. It is very useful when you look that way; that you can imagine, close your eyes and imagine, because you will find that sometimes the outcome for your particular company, whether it is a car company or an agricultural company, is driven not just by numbers, but by government policies and sometimes even by, let us say, the phenomenon called El Nino, which is a kind of a temperature, climate thing that is sweeping the Pacific right now.

Now, the last one I will say again is something that I noticed. Sometimes, people don't want to hear from me but I have got a secret that I will share with you. When I first started my job with Value Partners in 1993, I was like every other US-

trained or US-inference fund manager. I believed in having a very concentrated portfolio. I used to go around telling everybody "you won't see more than 40 companies in my fund, these are my high conviction ideas," and I was very proud of it; and then as the years went by, I began to realize that our market was really very different from the US, because there are just a lot of crooks out there with very bad corporate governance, and some of these guys are very convincing.

“ I used to go around telling everybody “you won't see more than 40 companies in my fund, these are my high conviction ideas,” and I was very proud of it. ”

So, your high conviction idea may turn out to be actually your next lament, you know. But you won't know until you wake up the next morning and read about it in the newspaper that your investment, which makes up 5% of your concentrated fund, has just evaporated overnight.

It happened to me quite a number of times, so I have many scars with me. So, in the last, especially 10 years, I've swung to a different view. For emerging markets such as China, it is better to have a very diversified portfolio. Don't put more than say 1 to 2% of your fund in any particular idea, because you can then go to sleep much better and you can withstand all these nasty accidents that seem to happen every now and then, no matter how hard you work at it.

So, now we have a portfolio with typically over 80 to 110 companies inside. Now, why don't more fund managers do what I say; it's because there is a lot of self-interest. Few fund managers don't have the kind of research resources that I do. If you have a research team of maybe 5 people, it is already quite a feat to have a fund with maybe 40 ideas inside; but we have the resources. We have 100 companies and we still have the resources to come up with 100 top-notch ideas; and that is what we are doing. Keep it diversified, be able to withstand the unexpected bad guy who smiles at you, shakes hands with you, and then disappears with all your money very suddenly, you know.

As professor Greenwald was saying, it got the downside risks, you see, not the variation. Keep it diversified.

Now, the next phenomenon I want to tell you about is that our industry over there is surrounded by pirates; not Somali pirates. By this, I mean stock promoters whose full-time specialty is giving you very convincing presentations and getting you to put money into their projects or companies. I am very familiar with this phenomenon. I have lost some money to these guys, too.

It partly has to do with what I mentioned earlier, the fact that it is a young market and it takes time for the proper values and professional integrity to develop. So, you have all these well-dressed young men and women who specialize in talking to fund managers like me. They know that we control a lot of money, and unlike banks we do not really have credit evaluation, we just decide. Sometimes, within the same day, we can give you tens of millions of dollars of other people's money to finance your project if your presentation sounds right.

So these days, if someone comes to see me who has got the right university degrees and attire and speaks like my kind of language and tells what I want to hear, I am actually very suspicious. I'm not relaxed at all. I now have a history of preferring people who are pretty rough and ready, and look like they just came out of the shop floor. That is my kind of person now.

I mentioned earlier about abundant hard skills, not much soft skills, and here is the other thing about our industry. Because of the incredible growth and abundance of wealth created so suddenly in just 20 years by the financial industry in East and Southeast Asia, everybody wants to join in. Even people who are not the least bit interested in finance. This is very unhealthy. It has created a phenomenon that I call the money disease, where people join because they think they will make a lot of money not because they are interested in our profession.

At Value Partners, we usually have an induction class that within the first 3 months, I will personally give you a talk where I try to explain to you that your name is your brand. If your name is John Smith, then John Smith is your brand. It stands for how people will see you in the years and the decades to come, and you can very

easily spoil it by becoming a victim of the money disease, putting money in front of everything else, whereas money in fact should be a byproduct of professional excellence.

If you are very good in what you do, money will find you, you don't have to find money. It reminds me of Sash Spencer.

Okay, I jumped the slide a little bit. So, your name is your brand. Now, the next thing we want to do is that we think that the disease of fund management is ego. People who have had some success being money managers, they are very vulnerable to the ego disease. They think they are God and we try to discourage that. For example, we have this Master Big Theory of how you see yourself. If you see yourself as smart, you are likely to do stupid things. If you see yourself as stupid, you are likely to do smart things.

“ You can very easily spoil [your personal brand] by becoming a victim of the money disease, putting money in front of everything else, whereas money in fact should be a byproduct of professional excellence. ”

So, we try to tell each other, let us see each other as stupid people. It is better to assume we are stupid. And we also find, at least for our team, people tend to overreact to almost everything. It is that kind of office: we are nervous, we are jumpy, there is a very high energy level. The average age in my office is about 30 to 35 years old, lots of surplus energy.

So, I had to train people before you even decide what to do, decide how much you are willing to invest emotionally, and as a reaction, to any situation. Once you have decided it should be no reaction, some reaction or a lot of reaction, then decide the contents of your reaction; what exactly and how you want to react. And of course, be a contrarian, as always.

I want to show you how all these years of fighting and being hurt and trying to be the best is possible. My own signature is “Learn.” I changed my signature when I was about 25 years old from my name to “Learn,” so that I can remind myself every day when I sign my name to be humble and

learn new things, because I think the commitment of learning is one of the major characteristics of a civilized and responsible human being, whether you are a fund manager or you are not a fund manager. But if you are a fund manager, even more so.

So, timing is good. I'm on track.

I just want to end the formal presentations and invite your questions by summarizing some slogans you will see on the walls at Value Partners, my office in Hong Kong.

We try to be small enough to be effective, big enough to be strong.

This is probably the subject of another speech, but essentially, even though we have grown to up to 100 people, I have been trying the various concepts and theories to divide the theme into small boutiques, so that each person working in Value Partners would not have a big company disease.

He or she is actually working for a small group of only 5 people, and they have to think like a boutique and perform like a boutique. I am still facing some difficulties in executing this concept... That's for the next speech.

Also, I think I told this earlier that we try to create a company where we depend on ordinary people and try to turn them into extraordinary performers.

Because I think it is not sustainable for a business model to depend on the constant inflow of geniuses to join you, and even if they do, they may not stay for very long.

Finally, I started these formal remarks or discussion by saying that I don't have much to say about theory, but we have gained a lot of insights into the practice of value investing. In fact, I would end by saying that how you see yourself is very important, and very often I find that I am my own worst enemy.

My own error rate is about one third – about one third of everything I do. With hindsight, I wish I had not done it, but it is done, it is too late. So, the way I see myself and the way my young people who are working with me see themselves is that we think of ourselves first and foremost as soldiers. You know, we don't wear a uniform, we don't carry a gun, but we act very much like real soldiers, very disciplined, very committed.

We don't have any breaks, and we know that we are engaged in a war that never stops, the war for performance, and these things are not very theoretical for us because we actually mean what we say.

Thank you so much.



***Professor Bruce Greenwald:***

All right, we'll go ahead and take questions. Can we turn the lights up a little so we can see the audience? I mean, I would be happy to take questions from the audience if there are ones out there, since – Ah. Yes.

***Speaker #1:***

Thank you very much. Thank you for your kind remarks. Two questions really. You mentioned that you are finally finding a fair amount of quality companies with enduring franchises in Asia. Right? Quality enduring franchises. Two-part question. When we look at the non-SOEs in China, the non-SOEs, how many do you think will be allowed flourish over a number of years? I mean, I see they are confiscating BYD's land; there was an article in Bloomberg last week about a private auto company being forced to merge with an SOE for political reasons – that is part 1. Maybe an easier question is, since about 90% of the SOEs' CEOs are appointed by the communist party, what is their principal objective? Is it really to maximize shareholder value or to promote the communist party's agenda regarding China?

***Mr. Cheah Cheng Hye:***

Actually this is a fundamentally credible question, because the economic and political system of the People's Republic of China is not capitalism in the American sense. It is a form of authoritarian state capitalism. So, your question reflects the reality of what this actually means. The SOEs are there to carry out the concept that the party remains in control, although at the working level we have a system of material incentives and backup forces to promote an efficient economy. Now, having said that, I am not allowed to show you for compliance reasons my performance, but I can tell you verbally without giving you numbers because of the restrictions, that we have flourished essentially by focusing on private chips.

Private chips is the jargon used by the industry to describe non-state enterprises. From the 1990s onwards, I figured that these big gigantic state-owned enterprises were not my cup of tea. So, I went on my way to cultivate a small number of

private entrepreneurs who were allowed to flourish, and we took big stakes in them. Some of them let me down; they are some of my worst losses, but those that you make money. You make 10 beggars, you make 20 beggars, and they are still your friends till this day.

So, the whole Value Partners fund was in fact a kind of antimagnetic fund in the sense that the main game about China is the state-owned enterprises, but we went the other way. We focused on the small number non-state enterprises, and the answer to your question, by the way, is that forced mergers between private enterprises and state-owned enterprises, as far as I know, are not a major issue in China. It gets reported by the media like Bloomberg, partly because the Western media, of which I used to be a representative myself, is very ideological. They tend to pick on those stories and highlight it, but this is not the main landscape. This is only part of the landscape that interests a Western audience.

Rest assured that most private enterprises in China are left to their own devices for better or for worse, but the real body is not a level playing field. If you are the private enterprise you don't get access to bank lending, bank loans; you don't get access to privileged locations, and you have to wait a lot longer for licenses and other things. So, the playing field is very unfair if you are not a state-owned enterprise. And the way to get around that is to be corrupt – yes!

So, there is a saying that may be less true, I'm trying to figure out what are the right words to use... I'm not good at discounting, is that you have got to be friends with the government officials. But every now and then, the government officials turn against you and then they pick up your file and say, you did XYZ corrupting back in 1985. Sorry boys, you know, you're in jail.

See, it's a very messy system. Yeah, a lot of heartbreaks.

***Professor Bruce Greenwald:***

Okay, yes, go ahead.

***Speaker #2:***

(Inaudible)

***Professor Bruce Greenwald:***

Okay, for people who didn't hear that question, the question was: as the fund has gotten bigger and has had almost of necessity to move into larger cap stocks, how has that changed the investment process?

***Mr. Cheah Cheng Hye:***

The investment process actually has not changed for us in response to size constraints or size considerations, I should say. It has changed in response to my intellectual frustration, with the notion that both in the Western world and the Eastern world, that successful, glamorous hedge funds depend on star managers or mysterious black boxes. I think I tried to describe how I tried to change it into a process of very ordinary manufacturing process, but the answer to your question is on several levels.

First of all, I think at some point, firms of Value Partners will come out against the constraints of capacity. Yeah, I think that's the right word, capacity, yeah. We, in fact, briefly closed our funds several times in the past because we ran out of ideas. The way I have tried to do the job is that I know that at some point I won't be able to take on any more money.

My self-interest is performance rather than size, because I earn performance fees, which are more important to me than the small annual fee I get for size, and I have responded.

If you look at my website from last year with my strategic partner, the Ping An Insurance Company of China, I launched an ETF division: Exchange-Traded Fund division. Three or four years ago, almost by accident I read the CFA journal, a professor from New York, but it is kind of unfair, I forgot his name. He was writing about the concept of fundamental indexing. He took the S&P 500, he picked the 25 cheapest stocks in terms of fundamental value, at least the lowest PE, if I am not mistaken, and it worked, he outperformed. I had simply copied his idea.

Okay, having succeeded with that, it was an astonishing example. I think I'll blow my trumpet a little bit here, of a local Hong Kong Chinese firm being able to penetrate into a space dominated by

2 western multinationals; BlackRock and I think StateStreet.

We are not supposed to get in there. We got in there only because we came out of a differentiated product.

Now that we are successful, we are conceptually, and I will choose my words, because for regulatory reasons I cannot kind of say too much, but we are coming out with similar fundamental indexing products for other asset classes and markets across the Asian continent.

This will be my avenue for growth in future because of the limitations of the actively managed star.

***Professor Bruce Greenwald:***

In the back.

***Speaker #3:***

How does your research effort cover small and medium-sized companies in Asia, which are not covered by the institutional research community? To give you an example, IDS, which Li & Fung acquired a couple of weeks ago; it didn't have any institutional research coverage on it at all, yeah. And if you just looked at it, you know that Victor and William Fung would support the company, and as part of that, when you have got somebody reputable like the Fung Brothers behind the company, do you give it a higher valuation, if you will, in terms of an asset allocation?

***Professor Bruce Greenwald:***

Oh, oh, there are two questions. The first is, how do you go about doing research on companies if there is no published research on those companies, except I assume the financials are available, so that's the first question. The second question is, how important is the reputation for integrity and the quality of the people back in the companies, and how far does that affect your decision on the amount of money you'll allocate to funds?

**Mr. Cheah Cheng Hye:**

Thank you for these questions. We are – you are talking with the right guy at this time because we are the pioneers of small-cap research and also China B-share research. The lack of published research is a huge advantage. You don't really want someone else competing with you and researching the company. You want to be the first ambulance on the scene, you know, so I estimate that in my universe there are approximately 1000 to 1300 companies with market capitalization below US\$1 billion.

I classify them as small cap stocks, and we have an army of people there researching them and confidently buying them, usually through structured deals; and these people are, frankly speaking, desperate. They don't have a brand; they don't have a major institutional investor as their shareholder, so we squeeze them. We usually ask, in one particular case I can still recall last year, we asked for the maximum discount of 19.9% to the quoted price in the stock market... And the guy said yes. Actually, I was astonished, but anyway I took it, you know.

So anyway, so no research is a good idea because it means you are really, really in the promised land, what I call Category #1. Remember I told you about Category 1, 2, 3? Yeah. Now, the real trouble with some of these guys are actually value traps. You could be in Category 1 forever. You never make any money out of it, you know? It refuses to move down the conveyor belt to category 2.5, when you are supposed to sell it, right? So, after you get in, it is fairly useful to try to encourage the management

to do more IR and talk to the media and come out with this and that.

But, for your information, contrary to what some people in our audience may think today, in general, the accounting standards for Hong Kong listed companies is very high; it is world class. It is typically done by a Big-4 auditor.

We actually have the head of E&Y here, he used to work in Hong Kong for many years.

Anyhow, and the regulators are incredibly strict; they have a habit of jailing anyone who violates the securities regulations, so published accounts are not an issue, it is not some Mickey Mouse play at all.

Your second question is about integrity issues. This one is a tough one for me, too. I have been in the market – I am now 56 years old. I was a newspaperman from the age of 17 to 36, and from then on I was in the financial industry as a head of research, and then a money manager, and to this day I get fooled. I was fooled as recently as just a year ago by this guy who ran a company called Peace Mark who, however, was anything but peaceful.

He ran a chain of watch shops selling fancy European watches, and he disappeared after I had put in about Hong Kong \$40 million into his company. We are still chasing him, and this guy is like the, I can't remember the term now. I think it is something like the great grand wizard of the Freemason's chapter of Hong Kong, a pillar of the community, the son of one of the most established colonial families, etcetera. So what do you do? That is why I told you, right? You have to be diversified, do a lot of background checks, and pray for the best.

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