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MOI Global *presents*

Intelligent Investing in Asia

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Adam Schwartz and Sean Huang on Investing in Asia

Shai Dardashti recently had the pleasure of sitting down for a conversation on intelligent investing in Asia with Adam Schwartz and Sean Huang. Adam and Sean are affiliated with the FM First Hong Kong Funds, First Manhattan's China investment vehicles.

Shai Dardashti, The Manual of Ideas: It's a very special honor to be sitting across the table from Adam Schwartz and Sean Huang in the offices of First Manhattan Co., learning about their unique expertise and hearing firsthand the story behind the FM First Hong Kong Funds, which are First Manhattan Co.'s China-focused investment vehicles. First Manhattan Co. was founded fifty-three years ago by Sandy Gottesman, one of the original investors in Berkshire Hathaway, and a member of Berkshire Hathaway's Board of Directors. Adam joined First Manhattan Co. in 2001 to work with Bob Gottesman, First Manhattan Co.'s CEO, and as we're going to hear more about in a few moments, Adam and Sean have been colleagues for more than a decade. Sean, please tell us how you found your way into the investment industry, and how you met Adam.

Sean Huang: Thank you for the opportunity. I'm Chinese; I was born in a small city called Beihai. I was very fortunate to be born into a business family. My father was first the assistant to the local mayor, then he did some import-export business, and finally he founded a fairly successful fruit juice company, which he later sold to a Hong Kong listed company. My dad was always my mentor. Even at a young age he walked me through a lot of his thoughts behind his business decisions. At a very young age I was exposed to the family business. Also, my dad knew the importance of having a Western education; at the age of ten my dad sent me to New York to live with my aunt. I spent the next ten years in New York.

I went to undergrad at New York University, the Stern School, where I majored in Finance and Accounting. During my sophomore year, I started reading about Warren Buffett and about value investing – which really interested me. I was very fortunate to be introduced by one of the visiting professors at NYU to Bob Gottesman and Adam Schwartz at First Manhattan Co. I was a sophomore at the time. That really changed my life, because Bob, Adam, and another partner at the company, Bernie Groveman, taught me everything I know about investing. More than that, they also taught me how to be a good person, how to work with clients, and how to build a business. I was at First Manhattan Co. for three years, and they taught me everything I know.

MOI: Adam, anything you want to add from your side?

Adam Schwartz: Sean is very humble and there is a part of the story how we met that he brushed over.

The professor who introduced us was from Omaha. Sean got the Buffett bug and wrote a letter, and asked the professor to deliver it to Buffett – because she was from Omaha, she must know Warren Buffett – which, in fact, in this small world, her family did know the Buffett's going back quite a long time. She received the letter that Sean wrote, asking if there was an opportunity to work at Berkshire, and delivered the letter to Warren. Warren was very kind and responded, saying, 'I'm sure you'd do very fine in life, but I'm looking for experienced people.'

The professor came back and said to Sean, 'You should have a back-up plan,' and Sean said, 'Great, what should my back-up plan be?' She said, 'I know a couple smart guys who invest along the same lines and style as Berkshire in First Manhattan Co.' Lo and behold, Sean ended up in our laps.

It was, from my standpoint, one of the great professional moments I've had here, because it was apparent from early on that Sean was intellectually curious and diligent. More than that, I think he had the right temperament to be a long-term value investor, which I think you can't really create; you either have it or you don't have it. When he first got here, our notion of international investments were opportunities like Nestle or Novartis. One of the exercises we did was to work together and look at filings from companies in Sweden or Japan or Hong Kong, and basically say there must be high-quality companies that write reports in English that we can get into. That was the beginning of us looking outside of our core investments.

MOI: If you could please elaborate, Adam, how the idea for the fund came about, and how the fund launched.

Schwartz: After a number of years of working with Sean, unfortunately Sean told us that, as the only son, it was the rite of passage after he got his American education he was going to have to go back to China – that's what only children do. So, Sean went back to China and got a business degree from the Guanghua School of Management at Peking University, one of China's top business programs. I think it was the summer of 2009 – Bob Gottesman and I took a trip to visit Sean, with two goals in mind: We wanted to go see our big Western holdings that had operations in China, and we also asked Sean to put together what we were calling 'The Best of China Companies.' The purpose was to compare and contrast – the year 2009 was an interesting time from the investing standpoint.

We realized a couple things that came out of this trip, which was really the kernel of the beginning of our fund. First, the Chinese and the U.S. companies were seeing the same things, but their reactions were quite different. The U.S. companies were retrenching a bit, and the Chinese companies were investing. Probably the bigger thing that we pulled out of this trip was, when we would do a meeting – whether it's here, or anywhere frankly – we would go prepared, we'd do a significant amount of work ahead of time before we met the management of the company; we'd pull all the filings, we'd read the transcripts, we'd probably call a couple of competitors, maybe an industry expert. When we showed up in front of the Chinese management teams, it became very clear that they weren't used to receiving investors and more specifically, analysts who actually knew what they were studying and were curious to learn more. What would be normally one-hour meetings with the U.S. management teams, who said 'thank you, I've got a lot to do,' – the Chinese companies, once we got to have a conversation, and they saw that we were really interested and did our work, turned into, 'Stay for an hour and a half, two hours, actually, let's have lunch.'

It was over the course of the two-week trip that we said, 'It doesn't appear to us that anybody is doing the fundamental work that we take as commonplace at First Manhattan Co., the work we do before we make an investment. The three of us – Bob, myself, and Sean – at the end of this trip said, 'Maybe there is an opportunity: value investing First Manhattan Co. style, adopted with the nuances of the Chinese market, that could work.' I'm going to let Sean take it from there in terms of what we did with that idea.

Huang: In 2009, we had the idea of starting a very small investment vehicle. The economic motivation behind that wasn't really to gather assets and have a big asset management company; it was to take advantage of the inefficiencies of the market and to make money as long-term shareholders. We started with roughly $10 million dollars, the majority of the capital coming from the partners of First Manhattan Co., mostly from the Gottesman family, and the rest came from my family and the families of my local partners.

Let me give you a brief overview of the Hong Kong market, as a foundation towards a full picture. Hong Kong is the seventh-largest market in terms of market capitalization, but it's the biggest market in terms of the amount of money raised for IPOs. It's a relatively developed and an important international market. But Hong Kong is unique in the sense that it's an under-researched market. Of the two thousand companies that are listed on the Hong Kong stock exchange, only about 50% have any sort of coverage.

Also, what's interesting is that half of the Hong Kong listed companies are not based in Hong Kong; they are based in mainland China. Due to the capital restrictions that China has, it's very difficult for Chinese investors to invest and take part in the pricing of stocks in Hong Kong. Therefore, you have a market that is being priced by outsiders who often do not speak the language and are not in the right place to be doing the homework. I think that's unique, and that's why there are a lot of inefficiencies and information asymmetries in the Hong Kong market.

Schwartz: Said in another way, it's a value investor's dream place, because you have an inefficient market being priced by outsiders. Non-Chinese investors might have a local analyst or two who sits in Hong Kong; that would be the equivalent of having a local analyst in Toronto who is going to be responsible for covering the U.S. It's a little bit hard to do that way.

MOI: Any similarities to America in the 1950's or 1960's?

Schwartz: In my office in New York, I get to hear my septuagenarian and octogenarian partners tell stories about the early days of First Manhattan Co. They tell about the opportunities they saw, and what they thought and experienced. It strikes me that Sean and I have now worked together for ten years, and our feelings and experiences are similar to our founding partners. If we emulate our founding partners just a little bit, things should work out well.

MOI: I believe that Sean touched on the 'incubation process.' Can you elaborate?

Schwartz: We are a conservative group here at First Manhattan Co. The client comes first. We take our reputation and our name very, very seriously. We started the fund with First Manhattan Co. partner money in December of 2009. We then opened the fund to a select subset of First Manhattan Co. clients in June 2013. None of us thought that we would have in excess of $200 million of AUM by 2016.

The primary motivation, as Sean said, was to make money as investors. We thought that adapting the First Manhattan Co. methodology was a winning strategy. Do deep, fundamental research with a local team, and take advantage of market inefficiencies. What we wanted to do was to say, "if value investing, for whatever reason, doesn't work, we face the full consequences with our own partner money on the line." Essentially, after nearly four years of us getting comfortable that our style was adaptable to this market – and the team that Sean put in place felt comfortable in what they were able to do with scale – we opened the fund up first to a special subset of clients of First Manhattan Co. There are some nuances to this market that need to be made clear up front: finding the right partners and the right clients who have the stomach for China is critical because the market is going to be volatile, it's going to be a lot more volatile than the S&P.

MOI: How has the asset base helped you think and act with appropriate patience?

Schwartz: I'm going to start, but I think that Sean does a much better job. First Manhattan Co.'s client base has been built over multiple generations – we're talking clients that go back three, four decades. Once you earn their trust and you do right by them long-term, the base tends to trust you and give you the latitude to remain long-term focused. In our region of the world that's all the more important.

Huang: In terms of the base, the FM First Hong Kong Fund is currently managing roughly $200 million dollars. More than 50% of the capital is coming from the insiders of the company, meaning from the partners of First Manhattan Co. and from the partners of First Beijing. I think this structure is unique, and we can honestly say that our primary economic motivation is to do well with the fund because all of our capital is in the fund. I think this is a huge advantage because, when we look at our peers, most funds and most investors who invest in the Hong Kong market tend to be non-Chinese, that's why they are more driven by sentiment; their actions are also affected by what goes on in their home markets, and they tend to be buying at the worst time, and selling also at the worst time. I think having a knowledgeable and stable investor base affords us the luxury of being contrarian. This a big competitive advantage.

Schwartz: Sean and I have said a couple of times we started this because we wanted to make money as investors, not because we wanted to make money as a fund business. We really meant that First Manhattan Co. partners who have money in the fund pay exactly the same fees and have the same terms as all outside clients. That's a very First Manhattan Co. way of doing things, in terms of aligning incentives with our clients, and putting our clients first.

MOI: Adam, I'd love to explore, in more detail, the nature of the First Manhattan Co. and First Beijing relationship.

Schwartz: Sean and I are partners, and there is something much stronger between us than just a mentor relationship. Sean is the first call I make in the morning, and he is the last one I make at night. Sean manages a team of six people on the ground all over China and he is able to punch above his firm's weight class by calling on the full intellectual and operational resources of First Manhattan Co.

On a fairly regular basis I, along with Bob, have a portfolio management call with Sean; typically, a video or telephone conference call where we go over the largest positions in the fund, what the research priorities are for his team, and what he's looking at. If Sean is looking at an industry or topic we know something about – either myself or one of First Manhattan Co.'s twelve research analysts – can pitch in and give Sean and his team a hand. For example, Sean might be looking at an industry like the cable business. Well, First Manhattan Co. has institutional knowledge via a dedicated cable-telecom analyst. We can give First Beijing perspective on questions such as: "Have you thought about how much leverage these companies can conservatively sustain?" Or, "Are the nuances of the debt capital markets very different from the U.S. marketplace, and how so?" Sean really has a force multiplier in that he is able to draw on decades of investment history and portfolio management. And it's not just at the analyst level: if he wants to speak with any First Manhattan Co. portfolio manager – that happens as well.

Conversely, when we at First Manhattan Co. are doing work on our portfolio names, and many of our businesses today have significant operations in China, there isn't a team or an opinion that I value greater than perspective from Sean and his team. A perfect example: First Manhattan Co. owned an investment in Yum! Brands. Obviously, Yum! maintained a huge China business, which they recently spun off. We were able to regularly get keen insights and deep analysis on the name. These are all unintended positive consequences of putting the First Beijing and First Manhattan Co. teams together. It's been a very nice, symbiotic relationship.

Huang: To us, it's really a perfect partnership because First Manhattan Co., with leadership from Bob and Adam, together with the back office of First Manhattan Co., take care of all of the non-investment related functions. Details like investor relations, selecting providers, handling accounting, and making certain that we have a robust infrastructure. My team and I, over in China, get to focus on what we love to do – which is research and investing. That is a luxury that most funds of our size just don't have. Normally the CIO also needs to be the CEO, and that's very time-constraining.

The First Manhattan Co. philosophy is to empower the people on the frontline, so we're very fortunate that my team and I, in China, have complete discretion of what we buy and what we sell. Adam and Bob will share with us their decades-long experience and wisdom, but in terms of actually making the investment – it's left with the team in China and it gives us the extra motivation to really work hard and get the best results.

Schwartz: It's a great partnership because my role is as a player-coach. Sean is running the team. My role – I come to China two or three times a year, and I usually bring one of my partners, either Bob or Bernie or somebody else at First Manhattan Co., to see what's going on or what's developing locally.

They call me the chief business sceptic. On a regular basis, Sean has to defend his position. Are we going to protect our capital? Have we forgotten anything? Have we looked from every angle? I find that our best investment debates are around Sean and I discussing the way a certain business or entity has operated in the U.S. historically versus what Sean is expecting in China. The discussion there is really about whether the Chinese business will develop in a similar way to the U.S. We've had some intense, but appropriate, back and forth business discussions.

MOI: It almost sounds like a Charlie-Warren occasional 'friendly disagreement.'

Schwartz: I would never hold us out to be on the same pedestal as those two, but certainly the conversations we have I can imagine Charlie and Warren having. I feel a little uncomfortable putting us in the same ballpark as them, certainly given their track record.

MOI: The alliance between First Manhattan Co. and First Beijing certainly seems to create an edge via the transfer of multi-generational, institutional knowledge.

Schwartz: When we started this, I told Sean I would not feel comfortable investing our own money, let alone outside money, if we didn't think that we were doing something that was prudent, not easily replicable, and where we actually could do something and have a true advantage. Every time I come back from China, I see more and more clearly that what we're doing in China is special and unique. It has already proven to be profitable over a long period of time, and I think it will continue to be a profitable venture.

Huang: I'd say that it's probably the best of both worlds coming together. There are two typical types of investors in Hong Kong. You have the big international institutions; they have lots of money, they have great infrastructure, but the portfolio managers tend to be people who are not based in China – not locals, typically sitting in places like New York, Boston, London. Whereas on the other side of the spectrum there are many retail investors; they are nimble, they may have great relationships with one or two companies, but their capital is very unstable in the sense that they require much higher returns, which makes them take on excessive risk. They don't have the infrastructure.

First Manhattan Co., being the big brother, so to speak, affords us the infrastructure and the patience and smart investor base, but we are given the power to make decisions based on the information that we get with a local team. We can also be nimble and we can also understand the local businesses and build conviction better than the international firms, so it's really the best of both worlds.

Schwartz: It would be an absolute disaster for decisions to be made on China coming out of New York, or London, or anywhere else. I know that a lot of places say that, 'We have our Portfolio Managers sitting in Hong Kong,' but that's just not the same – and this is a very important point - that's just not the same as having people, and a deep network - in Beijing, Shanghai, Shenzhen who are actually living and breathing these services every day. Then in China, Sean and our local team are empowered to decide, "Do I buy or do I sell or do I hold?" The local knowledge is critical in determining what the values of the businesses are and how best to size the portfolio positions. It's been enormously powerful to the investing process.

MOI: Let's please unpack this in more detail. Sean, why don't we elaborate on what's been happening locally, and expand on the team that you're building?

Huang: We have a couple of founding members / directors of the company that are focused on the research. Let me mention two:

Victor Liang is a co-founder of First Beijing and has a very similar background to mine; he was educated in Canada, then worked at Mercedes-Benz in Canada. He and I met in Beijing University and he is passionate about investing. Aside from being a very good auto analyst, his father is also a successful real estate developer in China, so through his father's networks and relationships we were able to learn a lot about real estate, which led to some fairly successful investments and the development of research processes, which have allowed us to become smart shareholders in a couple of the fund's real estate holdings.

Bill Wu joined First Beijing roughly two years ago. He has fifteen years of experience in multinational companies such as Coca-Cola, and as head of Guangdong Province for Novartis. He and I met on a due diligence trip, and we really just hit it off.

I think what is most unique about our team is the Talents Program. It's an internship program that Victor built with Peking University about four years ago. Every semester about fifty of the top undergrads or graduate students are applying to our internship program. Out of the fifty we choose about five to eight, who sign up for a two-year commitment. We teach these interns, we train them, and then they get assigned to specific industries based on their interests. We will only hire full-time analysts from this program; we do not hire anywhere outside of the firm because I find it impossible to get to know somebody with only one or two interviews. The three full-time analysts we have now in First Beijing are all products of this internship program. A valuable side benefit of the internship program is the alumni base. The alumni who do not join us are now working in a diverse range of industries and companies throughout China. This network is valuable – if we call on our alumni with specific research questions, they are usually able and willing to provide keen insights.

MOI: When you're hiring the interns, what are you looking for? How do you separate the five you hire from the fifty who begin?

Huang: Clearly, the applicants are all very intelligent. Our applicants come from the top five universities in China. Some of our colleagues have ranked within the top 10 out of half a million people in their province on their college entrance exams, so there's no question about their intellect. But people have different career paths, different interests. We want people who are genuinely interested in research and investing. They make huge sacrifices – they can probably go work for a big multinational company and make five or ten times more than what they would make at First Beijing – so, it's really their pure passion for investing that we look for. All of those who have stayed believe that investing is what they will do for the rest of their lives – and this is something First Beijing can provide.

MOI: In the back of your mind how big might the team get, one day?

Huang: We don't have any plans. We don't always hire somebody. It's very opportunistically-driven, and it's all very individually-based. It's all based on whether we like this person and whether this person likes us, because it is a huge commitment on both sides. They would be giving up much higher-paying jobs to work for a company that is relatively small, and paying a low base salary. It would be a big commitment from their point of view.

Schwartz: As the older brother here, I look at the First Beijing analyst intern program in awe and amazement. I'm confident in the quality and thoroughness of the program, as they have made just three full-time hires since its inception nearly five years ago.

I regularly interface with the First Beijing analysts: they're exceptional, they're very motivated, they're intelligent, and they're curious – which is probably the most important thing.

The force multiplier effect, again, was another unintended positive consequence. We now have forty highly intelligent, well-placed alumni from the First Beijing internship program who look back at their time with Sean and Victor and the team very positively. When the First Beijing team is doing research on an industry, a company, or region, we have this group of individuals who are more than happy to help, and who know the kinds of qualities that we look for in long-term investments. It's really been a great enhancement of the research process.

Another thing that's important to distinguish – when Sean spoke about his partners and their family backgrounds in business, it's quite different than me saying, 'My family was in the education business and I happened to go into the investment business.' In China, much business is done via relationships, and that's not just how the country is, but also in terms of how people open up and are willing to talk to you. The First Hong Kong Fund has really benefitted. Sean's father built a very successful agriculture business. The other partner, Victor, comes from a family that has been successful in real estate development. Another partner's family was in logistics, airlines, and transportation. We were able to draw on these family networks that enable deep industry knowledge. It also has saved us – several times. Because we know these industries from these families, we also know the shenanigans that some of the bad players do in this business.

So much of being successful in China is avoiding the minefield that exists for investors. There's no shortage of frauds, and really being able to focus on what to avoid, and how to make sense of it within the context of the entire industry, is really very helpful.

MOI: If I heard correctly, is it also hiring that's very local, on a region-by-region basis?

Schwartz: We have people in major cities in China, so that we are able to do the research. But we don't tie people to specific regions - usually it's where they come out of university or where they happen to be located.

MOI: Taking a big picture perspective, help me understand the opportunity you're seeing in China. It's a very broad question, where do we start?

Huang: Why don't I start. First you have the second-largest economy in the world, so that's a good opportunity, a good place to start.

Schwartz: Soon to be first.

Huang: You have GDP per capita that is maybe one-fourth of the U.S., and one third of neighboring countries like South Korea and Japan, with very similar cultures and work ethics. If you look at the long run, GDP per capita is probably the most important factor that we focus on. I have no reason to believe that a Chinese person will be only half as productive as a Korean person or a Japanese person, so that's the long-term opportunity, or that's the long-term direction.

If you look at what the government has done – yes, the government has its issues, but if you look at what Deng Xiaoping has done, he is probably a better compounder than even the great Warren Buffett. He compounded the Chinese economy, a much larger economic entity, at roughly 18% for the past thirty years, under his leadership, under his vision. I think you really have a government that is very good in many, many ways.

As a value investor, you always look at what you're paying, and if you compare the Hong Kong market valuation versus all other valuations of the major economies, Hong Kong's valuation is the lowest, with a relatively high return on equity. All these very interesting conditions that I just mentioned create lots of information asymmetry, lots of frauds, lots of inefficiencies. If you combine everything together it's fertile ground for the investors who do the work.

Schwartz: Let's say there are approximately two thousand publicly–traded companies on the Hong Kong market today. About 40% or 50% of those are not covered by any sort of sell-side research, whatsoever – and even if there is research on those names it's often not high quality. There is this huge subsector of companies that are underfollowed or not followed properly, so we can start there.

Within that underfollowed universe, there is a wide range of companies – but our sweet spot has tended to be one to five billion in market cap. That's where we've found the biggest value anomalies. There exists a market where people from the outside who don't use these goods and services are incorrectly valuing these companies, based on an enormous information gap.

Most of the time people look at the Hong Kong or China equity market and say, 'I only want to go there for 20%+ growth.' If you're, instead, going there to find companies that are going to 'only' grow more modestly, say 12% to 15%, and you can get them while they are paying dividend yields in the mid-single digits, 4%, 5%, 6%, and you can buy those companies for seven, eight, or nine times earnings, you need only to make very modest assumptions and you generally will do fine over the long term.

When we look at China, we don't make heroic assumptions; there are clearly issues, issues that not only China but the whole world is grappling with. We make the following three assumptions in this market: one, the middle class will be larger and stronger in the future than what it is today; two, there will be social stability, there's not going to be huge insurrection or anything that's going to derail China; and three, reforms that President Xi and the Party are making are going to be more helpful than hurtful to the Chinese economy. If you are willing to take that view over a long period of time, and buy the kinds of companies we're buying at the values we are buying them at, where investors really aren't doing the work, this is a reasonable way to earn outsized returns.

MOI: The word 'landmines' came up earlier – how do you navigate the minefield?

Schwartz: Well, you don't do it from New York.

Huang: It's by being local, and staying within your circle of competence. One requirement we have – before we even think about whether a listed company has the potential to become an investee company, is [the question] 'Can we independently verify the key numbers published by these companies?' I think it's very important to be able to do so and most funds just don't think this way. I've met many Western analysts who will talk about business models and run analysis for the next three to five years – based on numbers that are completely fraudulent.

You really have to learn to walk before you run. You really have to be able to have a high degree of certainty that the companies, or the numbers that are being put forth by these companies, are indeed accurate. There are various ways; there's lots of public information if you know where to look, and there are proprietary ways that we have developed and have honed over the years that provide the ability to verify key numbers of certain industries. We tend to focus our investments only in these industries.

Schwartz: This might surprise the Western investor; it surprised me when I was getting to know China: if you don't physically go to semi-annual company meetings for the results – companies in America report quarterly, in Hong Kong it's semi-annually – if you're not physically in the room, there's usually no transcription of the event, so you have to have somebody there to get the information. Secondly, to be allowed to be in the room, you need to be a shareholder. Meaning, if you're looking at a company – oftentimes they don't let non-shareholders in the room. You must own a token share simply to get access to the information.

Another thing we've come across: presentations that companies present online, on their official investor relations websites, are oftentimes different than the presentations delivered in person, when you go and do company visits. The concept of Regulation FD, as we know in the West, just doesn't exist in this market. That, again, is why you need to have analysts on the ground, ferreting this out, doing independent analysis. Sean earlier made the point that we won't touch something if we can't independently verify every significant number or claim that the management makes. I'd like to say that, when I look at a 10-K or a 10-Q and the balance sheet says that there is $100 million dollars in the bank, I take that, if it's a reputable auditor, as sacrosanct. That's not the case with the team in China; assume that everyone is lying to you, and that you're the patsy, and then search for the starting point, and check everything independently.

MOI: Just for a sense of magnitude, how many annual meetings do you go to, how many people do you talk with per year?

Huang: It's a labor-intensive process. Of the two thousand companies that are listed on the Hong Kong Stock Exchange, only a third – roughly six hundred companies – are what we consider to be within our investment universe. Of the six hundred companies, we talk to about four to five hundred of them. We personally go see from one hundred to one hundred and fifty of them. My team and I are on the road maybe 50% of the time.

Schwartz: Sean himself is a hands-on guy; he's on 95% of those touchpoints with the companies. It's just the way he likes to do the work.

Huang: A big part of investing is about building convictions, and the best way to build convictions is by getting the information first-hand rather than having your colleagues give the information to you.

MOI: Very early in the conversation the cable industry came up, in passing. I'm curious if there are industries you try to avoid, or perhaps industries in which you have particular expertise?

Huang: Different industries will have different characteristics. Certain industries will be much easier for the incumbent or the leading players to grow and expand their edge. Financial services, banks, etc., tend to get bigger and bigger. As they get bigger, their cost of capital becomes lower and they are able to lend more money, to borrow more easily, and further expand. So, it's a good virtuous cycle. This is also the case in the internet space. There are specific industries that tend to produce compounders over time and these are industries that we focus on.

There are also industries that are more cyclical in nature, more capital-intensive, but there can, occasionally, be opportunities there too. While we spend a lot of time on the industries that tend to produce compounders – and try to develop more networks and more understanding in this area – we are also opportunistic and will look at companies and industries that don't have the absolute best economics.

Schwartz: Having said that, you are very unlikely to see metal-benders, or large manufacturers in industries which have tremendous overcapacity issues. Those are things that are unlikely to end up in the portfolio for obvious reasons.

MOI: I think that it's so amazing that there is a knowledge transfer from First Manhattan Co. to First Beijing, and a virtuous cycle in return. I'm curious if any historical observation that worked in America and you thought might work in China – you looked at and deliberately decided not to pursue.

Huang: Yes. One would be in the fast-moving consumer goods sector. Historically, a lot of wealth has been amassed from buying leading consumer brands like Coca-Cola and P&G. Many investment firms tried to apply that same mindset to China. It was the perfect investment storm: a growing middle class with very dominant brands growing at 10%, 15% for the next twenty, thirty years.

It was also easy to underestimate the dynamism that exists in China and how – due to the rapid increases in disposable income – people's consumption habits change very quickly. Looking at the top fast-moving consumer goods, the best-selling and most profitable products have also tended to be the unhealthiest products. It all worked well for the first ten, twenty years because mass consumers weren't especially health-conscious. What you've seen over the past two to three years is that the local consumer taste changed very rapidly, which led to a complete rejection of some of the most profitable product lines. Performance over the past few years of fast-moving consumer goods companies that are publicly traded in China has been terrible.

Schwartz: They've been high priced, too.

Huang: It's almost like you were buying something at thirty times earnings at the peak, and then earnings dropped by 50% to 80%, so it was very painful. We have always been very valuation-conscious, because many consumer preferences in China are rapidly changing; you can't pay for goods or services that look dominant now but could quickly change.

MOI: Is First Beijing long-short or long only? Relatedly, how do you approach position sizing?

Huang: We have the mandate to invest on both the long and short side. We haven't shorted.

The cost of borrowing in Hong Kong is extremely high. In most cases, it is prohibitively difficult to find shares to borrow, or alternatively the borrow cost is 10%, or 20%. It's practically impossible to make money from shorts. I think it's just a way to justify charging much higher fees. Most of our peers that do short either short the index or they short knowing they won't make money. It's not something that we're looking to do.

If there's very compelling opportunities, it's something we will look into – but for the past seven years we haven't shorted.

MOI: China could also ban shorting, at times. Is that correct?

Huang: Yes, that's on the A-share market. That's on the domestic stock market. Now most of the funds' investments are on the Hong Kong Stock Exchange, which tends to be more market driven. But, yes, market regulators don't like it when you short. When it comes to longs, when you go above 5% you have to make a filing, but for shorts any time you go above 1% you have to make yourself known. There are many ways, both on and under the table, that the management and the local government can apply pressure on you when it's known that you have shorted a company stock.

Schwartz: There's plenty to do in this market just as an astute long investor. We see frauds all the time, and avoiding them is half of the game. Our goal is to earn our reputation as being successful long-term investors along the lines of how First Manhattan Co. has made its name.

MOI: It's a very high-class problem but still an issue worth discussing: how do you approach large position sizes, winners, and trimming?

Huang: I don't think that we have been particularly good at it. I think it's a process. It's very difficult for us to hold something that we think is no longer cheap. One of the best pieces of advice I've received from people who have been in this industry for much longer than we have is to really think twice before you sell to try to capture your profit, especially if the business can grow five, ten times bigger than where it is now. Really think of the problem as like an upside, downside ratio. Yes, if you capture profit now, maybe you can avoid a 10%, 15% correction, but if this is a company that is a real potential compounder then you should really be careful about selling.

Schwartz: This is a topic that Sean and I, along with Bob, regularly discuss: What is the optimal size of a position? And if we have our risk manager hat on, are we taking an undue risk by having the position get to this size, what is the risk reward? This is probably, in terms of portfolio management, one of the topics that should get a significant amount of attention from us.

Huang: We like to be quite concentrated. I come to New York once a year, and people here, the elder statesmen, they tell me to concentrate the fund's capital in the top names. I think this is really the investment philosophy of many legendary Western investors and many investors at First Manhattan Co. We have a 20% position size restriction per name, at cost. The top five positions in the fund cannot be more than 50% of the portfolio, at cost. Today our top ten holdings make up roughly 80% of the portfolio, by value. We run a pretty concentrated portfolio.

MOI: How do you define the word 'alignment?'

Schwartz: One of the greatest benefits of being at First Manhattan Co. is moral clarity. It takes people, generally speaking, a long time in business to understand what it means to put your clients first. That directive was ingrained in the culture from the first day I got here, and was one of the great attractions of the firm. In terms of how we practice that, it really means doing right by your client, and so on a very basic level, all of our portfolio managers, all my partners here at First Manhattan Co., have nearly identical portfolios to what their clients have. If it's good enough for our clients it's good enough for me. There aren't two different portfolios. On a very basic level, alignment means that I feel the pain should the stocks go down, and I also reap the rewards if the stocks go up, and that I'm going to make money as a co-investor, more so than I would taking a fee.

We've applied that in terms of how we've aligned ourselves with our investors. If you look at our fund structure, as I said, the First Manhattan Co. partners that are invested in the fund pay the same fees as the outside clients. The other way we're aligned is that we have a 5% hard hurdle rate on the fund, which is annual. I don't know too many funds that have that kind of incentive structure, but it's something that we thought was fair and the right way to set up the fund. We really have to do something to earn an incentive allocation.

MOI: Larger asset bases become a headwind for performance. Is there a point where you stop gathering assets, altogether?

Schwartz: Again, in typical First Manhattan Co. style we were very deliberate, some would say slow, about how we did this. As we said in the beginning, we wanted to test this out on ourselves for a period of nearly four years to see if our thesis that value investing would work in this market before we unleashed this on our clients. We think that with our strategy, we could do what we're doing up until between $750 million and $1 billion. The fund is at about $200 million, and we're thinking of a soft close around $750 million.

But more important than getting to that number, is getting the right investor base. When Sean and I meet with investors, we are focused on making sure they share our long-term orientation. Up to this point, we have met mostly high net worth individuals, but we've recently been speaking with endowments and pension funds. We want a handful of partners who philosophically think about investing the way we do. They must think in terms of arbitraging time, and they must share our vision of value investing in Chinese companies.

MOI: If I understand correctly, you have three strategies: compounders, undervalued, and special situations?

Schwartz: I wouldn't call those strategies so much as opportunity sets, because it's the same strategy – which is being opportunistic and looking for value.

Huang: We borrowed the idea from Warren Buffett; in his early partnership letters, he broke his investments down into those three opportunity sets. He had the very good companies (or compounders), the Coca-Colas, the American Expresses; he also had the very cheap companies. Then he had a category for opportunities that were based on corporate actions.

Here is how we think about compounders: As the companies grow, their competitive advantage will get bigger, and they will grow. We can pay up a little bit more, but we try not to pay up too much for buying compounders. Then you have these very cheap companies. These are companies trading at a fraction of tangible book value, and are very cheap relative to their cash flow and dividend yields. We like to buy things that have some catalysts, maybe management change, maybe thoughts about divesting certain money-losing businesses, or some other potential events. Then you have the special situations. These are opportunities where the company has already made public its intention to undertake some sort of corporate action, either to privatize the company or to have some sort of tender, or to do mergers and acquisitions, or to pursue a spin-off. We look for a fixed time and a definitive action that would likely have a positive impact on the stock price.

MOI: I'd love to understand how you navigate between the buckets. Is it reactive, where you respond to unique opportunity sets; it is proactive, where you want to be in higher quality companies in certain environments?

Schwartz: Yes, all of the above.

Huang: It is all of the above, but it's also more opportunistic. You have to be opportunistic. I think every day you just have to keep your mind open, because the Hong Kong market is very volatile. You just don't know what the market will serve up. We are open-minded. Sometimes we get it right, sometimes we don't. We aim to be more right than wrong, in aggregate.

We do have a view on the macro-economy, and I think the next few years are going to be tough for almost every country in the world. Whereas in the past we tended to be overly focused on buying the cheapest companies, we now are willing to pay a little bit more for companies that are much better in terms of quality.

MOI: If there is inefficiency in the $1 to $5 billion market capitalization range of publicly traded equities, might it be reasonable to guess, particularly regarding special situations, that there's even more inefficiency in warrants, option markets, and other derivative instruments?

Huang: Maybe with a few exceptions of options on mega-cap names like Tencent, there's no options market for most of the Hong Kong exchange.

Schwartz: It really speaks to the maturity, or lack thereof, of this market – which is mainly why we're seeing the opportunities that we're seeing. What Western investors tend to forget is that it's a different stage in development, so these tools just don't exist in this market today, so you have to work with what's there – which is common stocks.

MOI: Honing into this $1 to $5 billion sweet spot, is that based on liquidity dynamics, or based on business maturity, perhaps a required level of operating scale?

Schwartz: Again, it's opportunistically-driven. We're not market-cap bound, we're not going fishing only in this pool, but it's where we found the most information arbitrage, if you will, or our ability to basically capitalize between real value and what is perceived value in the marketplace. The ability for people to actually go out and speak with the managements and do their homework.

Huang: Yes, it's also important to mention that I think the liquidity is a significant factor. $1 to $5 billion may sound much bigger than it really is. Chinese-based companies that are listed in Hong Kong tend to have one or two very large shareholders, and they would have 30%, 50%, sometimes even 70% of the entire shares outstanding. What you're left with is only a quarter or a half of the outstanding shares that are truly free-floating. The actual size of the float is much smaller than the market cap. We are at $200 million now, I don't think that we could do what we are doing with maybe $5 or $10 billion – it's just not possible.

MOI: What have you learned, or what do you more deeply appreciate, after having gone through the initial incubation process?

Schwartz: We're very grateful that we had the incubation period with our own money. It made us better investors and frankly more credible. You're just much more careful, diligent and credible when writing letters to partners when your own money is a significant part of what's in the fund. I don't think we were ever careless, but having started with the discipline of investing our own money and thinking about it that way rather than saying, 'Let's go make a business go of it' made us start off on the right foot.

Huang: The biggest thing I've learned is the need to be more local. And not to go in with any preconceived notions. When we first started, it was, "Yes, we were Chinese…" but we really adhered to the Western view that you can only invest in privately-owned companies – and by privately owned I mean publicly-listed companies that are owned by a private family. In other words – not state-owned enterprises. This is true to a certain extent; private families tend to be more driven, more shareholder-friendly – but that's not always the case. Also, there are lots of trade-offs. Private families tend to run listed companies as if they are still private companies, they still own 100%; they have no desire to try to unlock value, there are no checks and balances, and they're more likely to be frauds. If the family gets into trouble with the government, the company gets more negatively impacted than if it were an SOE. What is most important: we must understand that in a country like China private companies, more often than not, are less well-endowed in the sense that there won't be favorable policies or favorable regulations which can help to protect a moat.

State-owned enterprises are given a lot of advantages. In areas where there are many state-owned enterprises, incumbent players tend to be more protected. State-owned enterprises tend to be more heavily regulated where the incumbent can enjoy earning a much higher return on investment capital, so it's important to recognize that. Also, it is important to recognize that there are many state-owned enterprises that are managed very well; being able to tell the difference between the well-run SOEs and the poorly-run SOEs has been one of our biggest lessons.

MOI: How could people reach out to you with any questions or to learn more?

Schwartz: They can call First Manhattan Co., they can look at our website. My phone number is +1.212.756.3388. My email address is aschwartz@firstmanhattan.com

We're always happy to talk to people about China and investing in China, because we learn – some of the best ideas and conversations we've had have been from other people along the way. What surprised me the most since I've been going to China for the past eight years to visit companies is the growing domestic investor class. It's not so much that we're seeing very sophisticated international hedge funds and analysts there, but it's the local guys who have read different letters and Buffett and are starting to really understand value investing. The people we run up against are local guys who are often investing their own money, their family's money, who are very shrewd on some of the names that we're seeing. I get excited by that.

MOI: The website for First Hong Kong, if I could ask?

Schwartz: It is firstmanhattan.com, and then you can search for Adam Schwartz.

Huang: As I said, First Manhattan Co. handles all of the non-investment elements.

Schwartz: It's also a benefit of flying below the radar, which is the way we like to do it.

MOI: With that said, Adam and Sean, thank you for letting me into your office and sharing so much of your time and wisdom with our community. It's an honor to learn from you and I'm very grateful for this conversation, thank you

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