

Harding, Loevner Management Global Equity Investing

1994 First Quarter Report

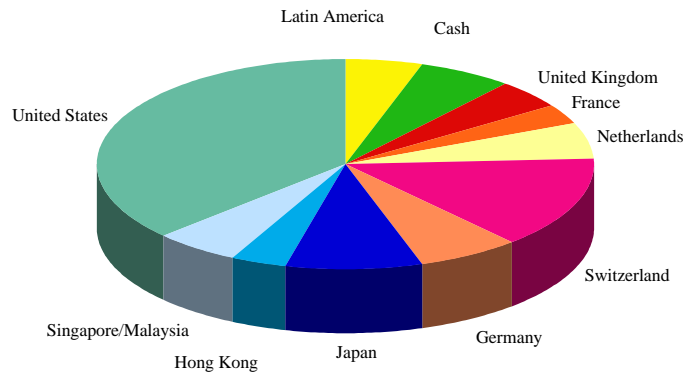
The following material is excerpted from the 1994 first quarter report on a global portfolio managed by Harding, Loevner Management ("HLM"). The portfolio is invested worldwide in common stocks and convertible securities with the objective of preserving and increasing its capital value in US dollar terms.

Portfolio Overview

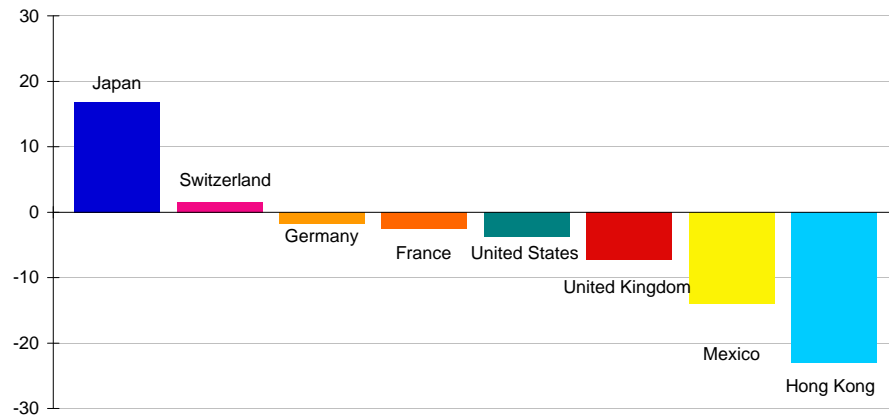
At March 31, 1994, the portfolio:

- held investments in 45 companies, including 19 US companies;
- was broadly diversified in terms of geographic and industry distribution;
- consisted of 94% stocks and warrants, the balance in cash; and
- had an annual yield, before expenses, of 2.2%.

Portfolio Allocation by Country as of March 31, 1994



1994 Year to Date Performance of Major Markets



Performance

	1994	1993	1992	1991	1990	<u>Since Inception (11/30/89)</u>	
	3 months					Cumulative	Annual
	-----Total Returns %-----						
HLM Global Equity	-2.4	24.2	9.1	31.6	3.6	86.7	15.5
Comparative Benchmarks:							
FT World Index	1.1	22.6	-5.1	19.7	-17.1	20.4	4.4
MSCI World Index	0.7	22.6	-5.2	18.3	-17.0	18.5	4.0
S & P 500	-3.9	10.0	7.7	30.4	-3.1	47.4	9.4
Global Fund Index (Lipper)	-2.1	32.7	-3.2	18.7	-11.2	37.7	7.7

Note: This performance data refers to HLM's Global Equity Composite, a dollar-weighted average of *all* global equity accounts managed by HLM. Performance of the composite is reported before management fees. These fees reduce returns to investors by approximately 1.0% per annum.

The portfolio declined over 2% in the first quarter of 1994. The World Index, in contrast, provided a small positive return, but this mild result masks the turbulent underlying reality. The World Index is hugely influenced by the action of the Japanese stockmarket and the yen, both of which appreciated strongly in the first quarter. Most other major stockmarkets declined in the quarter: the World Index *excluding* the Japanese market fell by 4.3%. Even that figure does not reveal the extent of damage done to many markets, and investment portfolios, in the quarter. The Asia/Pacific Index, again excluding Japan, fell by 17.0%! Some of the strongest markets of 1993 have been the weakest thus far in 1994. In the quarter, the Hong Kong market fell by 23%, Malaysian by 25%, and Mexican by 14%.

“Emerging markets” became popular last year both among the public and with professional investors. Their attraction was based partly on their exposure to fast economic growth, but also on the thesis, widely promoted, that adding a diversified clutch of emerging markets equities to a portfolio was a means to *reduce* its overall “risk”, or volatility. The thesis rested on the observation, historically accurate, that movements of individual emerging markets have been largely uncorrelated with one another and with movements of markets in the developed countries.

The thesis has not held good. Recent falls in developed markets have been magnified in the emerging markets, which have proven highly correlated, not only with developed markets, but also with each other. This is because emerging markets no longer dance to the tune of their local investors, so much as to that of overseas investors, ‘allocating’ to what they have decreed a distinct asset class. Now, a relatively small number of huge institutional investors are, at the margin, the most influential investors in each and every one of the emerging markets. Insofar as they tend to act in the same direction in them all, the markets themselves now all tend to move in the same direction.

The portfolio has made, and continues to make, significant investments in companies in emerging markets. In every case, the investment rationale concerns the fundamental quality and growth potential of the individual company and the value of its shares. Each such investment stands on its own merits. HLM does not invest in “markets”, per se, whether developed or emerging. As noted in the year end report, the portfolio’s returns of last year were exceptional and owed, in no small part, to large gains in several emerging market company investments. HLM is pleased that these gains have been preserved in a period of extreme turmoil in many markets around the world.

Global Review and Stock Market Outlook

- It is widely believed in the United States that higher short-term interest rates— Mr. Greenspan’s ‘preemptive strike’ on inflation— were the cause of the weakness in equity markets and the steep fall in bond prices, in the US and in Europe. HLM agrees that higher short-term interest rates have cut the legs from under some speculative investors—so-called ‘hedge funds’, in particular—which were borrowing money at low short-term interest rates, and buying long-term financial assets in the expectation of lower bond yields, higher prices and profits magnified by leverage. Hedge funds tend to base investment decisions on market momentum, so, at the first signs of reversal in direction, all rush for the door at the same time. Incentive to be the first out, of course, is there aplenty, given the enormous financial leverage that many such funds undertake.

Although the rise in short rates has led to lower bond prices because of the unwinding of speculative positions, it does not herald any sustained or significant rise in the rate of inflation. Rather, short rates are now responding to a higher level of demand for credit as the US economic expansion gathers steam and the European and Japanese economies stop contracting. The rise in commodity prices, in response to which Mr Greenspan launched his strike, does not herald a return to higher consumer prices or an inflationary ‘spiral’; unemployment (and the fear thereof) is still high in the developed economies, global competition among goods manufacturers is fierce and growing, and the US consumer is still indebted and cautious about spending.

By taking this action at this stage of the economic cycle, Mr Greenspan has not only extended the length of the cycle, but also reaffirmed the commitment of the US monetary authorities to sound money. He makes it clear that he will not countenance a return to the era in which wealth was transferred from investors— those with savings—to those who consumed—or on whose behalf the Government consumed—via inflation.

*The global core equity portfolio has 37% of its assets invested in US stocks. The selected stocks are concentrated in ‘growth cyclicals’, companies able to grow in periods of low price inflation and modest economic growth, such as **Crown Cork, Union Pacific and Lubrizol**, or high quality financials, such as **JP Morgan and Fannie Mae**. Although the*

former, in particular, have performed satisfactorily this year, the overall level of exposure to US companies remains low in relation to the past.

- In Europe, economic recovery is still not evident in aggregate data. At the company level, however, there are mounting indications that order books have stopped shrinking and that the worst is over. Whether it be through restructuring, through seeking new markets, or through increased attention to areas where demand is strongest—notably Asia—European corporate profits have bottomed. That this recovery is at a time of depressed consumer demand and historically high levels of unemployment suggests that long-term interest rates will resume their fall, once the speculative excesses referred to are unwound, and that the combination of lower long rates and recovering profits is a winning one for equity investors.

*HLM has increased the portfolio's holdings in Europe, now accounting for 34% of the portfolio. Holdings are concentrated in companies where there is exposure to the near-term recovery as well as to longer-term trends. Above all, the portfolio's companies are generating revenue growth through seeking new markets for products that are mature in the companies' traditional trading areas. **Brown Boveri** is a prime example—its engineering business is inherently cyclical, but it has restructured its operations, relocating to areas such as Eastern Europe where wage costs are lower, and focused its marketing on areas such as Asia where demand is still in a secular growth phase. Other portfolio companies, such as **Krones**, **Surveillance**, and even the giant **Nestlé**, have been following this general strategy for years, and are now reporting good 1993 results and optimistic assessments for 1994.*

- In Japan, a sharp recovery in equity prices has been driven by foreigners, who have long neglected the market in favour of higher growth opportunities in the rest of Asia. The economy, however, shows few signs of recovering, despite low interest rates and huge amounts of fiscal stimulus by the Government.

There are signs of change: new alliances in the food industry are cutting out inefficient and costly layers of distribution, manufacturers are laying plans to move production to cheaper areas offshore and the liberalisation of the rice market was controversial but a token of the new Japan which is emerging. The rate of change will be slow, however. A recent visit to Japan has convinced HLM that change is necessary, but that only a few companies will overcome cultural inhibitions towards restructuring and accompanying layoffs that must take place.

*The portfolio's investments are concentrated in companies that have long been at the forefront of global diversification and are widely admired for their management quality and responsiveness, such as **Nippon Denso**, or in companies at the leading edge of change, such as **Senshukai** and **Mr Max**, that are changing the way consumers consume (and lowering the prices they pay!). The portfolio's exposure has been increased in the recent past, and HLM expects to increase it further. In particular, HLM believes that companies that sell the means to improve productivity in the service sector will enjoy buoyant demand in coming years, and is working to identify one which meets its quality criteria.*

- While, in Japan, the economy has been terrible but the stockmarket good, in Southeast Asia, the reverse has been true. Economic growth continues apace, but stockmarkets have collapsed. Partly, this is a case of a fear of higher interest rates in local currencies, most of which are linked, explicitly or implicitly, to the US dollar. This fear is warranted, for example, in Thailand, where credit demand has been strong, the balance of payments has deteriorated and there are signs of accelerating inflation.

Partly, though, it is a case of pure speculative excess in financial assets, led by overseas investors, being violently unwound. A general problem for these markets is that they are both 'emerging' and (until recently) had positive 'momentum'. Around the world for the previous few years growth has been a rare commodity. Where in abundance, in Southeast Asia, too much money chased stocks in illiquid and small markets—they went up too much, too fast. The short-term oriented investors who drove prices to such heights at the end of last year and early this are leaving in droves now that 'momentum' has turned negative. The exits are narrow, so this process takes time and produces wide price swings, but once they are gone, stocks will again be attractive.

For example, in Singapore, a favorite of foreign investors until recently, there is no reasonable basis to fear higher interest rates: inflation remains under control, money supply is stable and the economy is growing strongly. The stock market has, nonetheless, fallen by 17%, so that it is now, despite the rosy fundamentals, at a valuation level below its historical norm.

Overall portfolio exposure to Southeast Asia is currently 9%, against 16% at year end. Sales made were all of very good companies whose business prospects remain outstanding. Prices simply rose too far in advance of reality.

In particular, the portfolio has reduced its exposure to Hong Kong. HLM has consistently believed that the futures of Hong Kong and of China are inextricably linked, as of now, not from the date of transfer of sovereignty by the British. HLM has also believed that the future was very bright. That is still HLM's view, but it became consensus in 1993 and stock prices reflected only optimism, not the risks involved as China's rapid development proceeds.

- It was a turbulent quarter for Latin American stocks and, above all for those in Mexico, a big beneficiary of the chase for emerging markets by US investors. Although the Mexican market is a long established target for institutional investment from the US, 85% of investment has been in just fifteen large companies. Even a slight change in sentiment will clearly have an extreme effect on prices of these issues.

At the end of the quarter, real world events upstaged financial market turbulence with the murder of the ruling party's candidate for the Presidential elections. It is a mark of the progress made by Mexico's financial system and of its increased political maturity that no widespread panic followed this tragic event.

HLM sold one Mexican stock during the quarter, **Grupo Embotellador**, so that remaining holdings in Latin America are **Kimberly Clark de Mexico** and Argentinean oil giant, **YPF**.

First Quarter Portfolio Activity

After the sharp rise in many stocks last year, prices had moved to levels of extreme overvaluation in many markets. HLM is prepared to pay premium prices for premium quality companies, but not to own stocks which are clearly overvalued. As a result, the following sales were undertaken in the quarter:

- **Hong Kong and China Gas** has long been an HLM favourite, in the belief that a company of this quality, with a steadily growing earnings stream, in, effectively, US dollars should be accorded a very high valuation. In early January, HLM's best hopes for the company were realised when its shares achieved a price-earnings multiple of 30. The entire position was sold.
- **Jurong Shipyard** is a high quality company in a cyclical industry. When the market began to place a high multiple on *peak* earnings for Jurong, HLM sold. All the good news learned from HLM's visit last year—particularly the planned dry dock expansion—was adequately reflected in the price.
- **East Asiatic** did not enjoy a surge in price during last year's bull market in Malaysian stocks—it was considered too dull! This year, however, the company announced good earnings, the stock attracted attention for the first time and its price rose sharply. HLM sold part of the position on an upwards spike in price shortly after the results announcement.
- **Grupo Embotellador** is a growth company in a growth business, providing soft drinks to an increasingly wealthy and brand conscious population in Mexico. Again, however, the stock price has risen dramatically to a level in excess of private market transactions for comparable companies. The announcement of a complicated and confusing restructuring of the share capital had its good side, in facilitating a listing on the NYSE, but also provided a pretext for the controlling family to sell shares at generous prices. HLM followed suit.
- Unlike the above sales, that of **Baker Hughes** was made at a loss. The company has done a good job in restructuring over the last few years, but seems destined to play second fiddle to the industry leader, **Schlumberger**. Proceeds of sale were used to expand the portfolio's position in Schlumberger.

The exposure of the portfolio to companies that benefit from cyclical recovery has increased steadily over the last few quarters. In the first quarter of 1994, that continued with the addition of three new holdings:

- **Randstad** is a temporary employment agency: earnings have been depressed by lack of growth in the overall employment market, but its strong balance sheet has enabled it to grow through acquisition during that period. The business is in a secular uptrend as companies increasingly seek efficiency in their use of labour in the same way as 'just in time' inventory management has revolutionised use of raw materials.
- **Mitsubishi Heavy Industries** is Japan's leading supplier of defence equipment, of pollution control systems, and of power generation equipment. MHI's earnings have been cyclical, but its businesses are in a long-term upswing in Asia. MHI's strong balance sheet and enormous backlog of business will enable earnings to grow rapidly in the next few years.
- **Trafalgar House** is a conglomerate in a number of deeply cyclical and unattractive industries as well as in engineering, now its core business. Since Hong Kong Land assumed control of the company, however, its introduction to new management, long familiar to HLM, will enable it to focus attention on the businesses where it can compete globally, notably engineering, and will gain it access to regions, such as Asia, where growth is more assured, and its famous brand names (Cunard, Ritz) may command premium prices.