

# Global Core Equity Investing

1993 Second Quarter Report

*The following material is excerpted from the 1993 second quarter report on a global portfolio managed by Harding, Loevner, McNally & Co.. 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 June 30, 1993, the portfolio:

- held investments in 41 companies, including 20 US companies;
- was broadly diversified in terms of geographic distribution;
- consisted of 90% common stocks, the balance in cash and convertible bonds and warrants; and
- had an annual yield of 2.5%.

## Performance

	1993	1992	1991	1990	<u>Since Inception (12/89)</u>	
	Year to date				Cumulative	Compound
	-----Total Returns %-----					
<b>Global Core Equity Portfolio</b>	<b>7.1</b>	<b>11.3</b>	<b>28.5</b>	<b>6.4</b>	<b>68.7</b>	<b>15.7</b>
Comparative Benchmarks:						
FT World Index	15.5	-5.1	19.7	-17.1	12.3	3.3
S & P 500	4.7	7.7	30.4	-3.1	45.9	11.1
Global Fund Index (Lipper)	10.7	-3.2	18.7	-11.2	17.4	4.6

Note: Performance of the global core equity portfolio is reported before management fees. These fees reduce returns to investors by approximately 1.0% per annum.

Returns in the second quarter (+2.2%) were more subdued than in the first. Returns from investment in stocks outside the US continue to surpass those from US stocks. The level of the global index in the second quarter was again dominated by a rise in Tokyo, where the equity index rose by 10%. For US dollar based investors, that return was amplified by a rise in the yen, so that Japanese stocks returned 18% in dollars. The converse was true in Europe, where modest falls in market indices combined with currency weakness to leave major markets lower in dollars: by 5% in Germany and by 7% in France, for example.

The portfolio now has 41% of its assets invested in US stocks, as low a proportion as it has ever had; HLM expects to continue to add to holdings of high quality companies in growing economies around the world.

## Global Review and Stock Market Outlook

The economic and political foundations of many of the world's financial markets deteriorated in the quarter:

- In the US, confidence in the economy swung wildly, from gloom—recession is returning—to glee—the economy is recovering—and back to gloom—inflation is returning.

HLM believes that the prospect of higher taxes and uncertainty about a major part of the economy, healthcare, are depressing the “animal spirits” or optimistic sentiments necessary to sustain consumption and investment growth. At the same time, stocks have remained at high levels in relation to historic valuation, supported by a continual flow of funds from maturing CD's into equity mutual funds. In this environment, stocks are highly vulnerable to earnings disappointments, to any move by the Federal Reserve to raise (very low) short-term interest rates, or to a dangerous combination of both.

*HLM has continued to reduce holdings in the United States, which now amount to some 41% of total assets.*

- The vestigial remains of European unity continues to be eroded by the Bundesbank's agonizing slowness in reducing German interest rates, in keeping with its paramount objective of low inflation, and by its remaining unperturbed by falling German output. High interest rates throughout Europe have resulted in widespread unemployment, declining corporate profits, and political pressure to break away from links to the Deutschmark. The prospect of inevitable interest rate declines has helped to stem falls in share prices, but it has also weakened the European currencies against the dollar.

*European problems are far from over; HLM has reduced holdings in Europe, but is still emphasising high-quality companies with globally-derived earnings, trading in countries where interest rates have furthest to fall, or where currencies are not under pressure. There are four holdings, for example, in Switzerland's multi-nationals.*

- In Japan, a weak economy that is the aftermath of the bursting of the financial “bubble” has helped precipitate the biggest political change since WWII. If the Liberal Democratic Party's rule is ended it will mark not only a political, but more important, a demographic shift in power: from the rural sector to the cities, from old to young, and from saver to consumer. In the long run, the shift will promote higher levels of consumption and will be positive for Japan and its trading partners. In the short run, however, an Italian-style exposure of endemic political corruption would be bound to hinder Government efforts to stimulate the economy.

*The stock market is being supported by Government-controlled investment funds, but is highly valued and therefore vulnerable to a fall. Pressure from the US for a reduction in Japan's trade surplus has begot a stronger Yen, which hurts profits of exporters. HLM has not added to the portfolio's holdings in this expensive and speculative market.*

- Stockmarkets in South East Asia have remained firm, reflecting good economic performances, despite concerns that the Chinese economy is overheating. Hong Kong is perhaps the most vulnerable to a Government-mandated slowdown in China, but the whole region would be affected should it be either severe or protracted.

HLM believes that a slowdown is almost certainly already underway, but that the “genie” of economic development is out of the bottle and cannot be forced back in. Moreover, shares in Hong Kong companies whose prices had soared as a result of “China fever” have already corrected sharply.

*HLM has added slightly to the portfolio's holdings in Asia, through purchases in Malaysia and Singapore. Its concerns about excessive speculation in the Hong Kong market have proven justified, but the portfolio's holdings are in more conservative companies not relying solely on China for growth.*

- Latin American markets have been volatile and have produced mixed results. The Mexican market has been weak as concerns have mounted over US Congressional (and environmental) opposition to the North American Free Trade agreement and an Administration increasingly short of political capital with which to overcome it.

*HLM believes that NAFTA will be enacted, further enhancing the good investment opportunities that Mexico offers. HLM has added to the Fund's Mexican holdings in the quarter, by buying shares in GEMEX, the PepsiCola bottling company in the Mexico City area. It has also bought the portfolio's first holding in South America through participating in the privatisation of Argentina's oil and gas company, YPF.*

## **Second Quarter Portfolio Activity**

HLM took profits on four stocks in the quarter:

- Part of the holding in **Fannie Mae** was sold for a large gain. Also, among US financial companies, HLM sold the portfolio's holding in **AIG**, which has simply become fully priced.
- During the three years **L'Oréal** has been held by the portfolio, the company's earnings have grown rapidly, while the stock market's valuation of those earnings has also increased. A takeover offer for the Certificats d'Investissement led to a closing of the discount at which these securities trade relative to the ordinary shares. These three factors had together led to a three-fold increase in the price of the security, making it fully valued.
- Shares in **Singapore International Airlines** were sold after a strong run-up in price had left the foreign shares which the portfolio owns trading at a huge premium to the local shares. Such a phenomenon has proven unsustainable in the past.

HLM sold two other issues:

- Partly to offset the substantial gains realised in the above four stocks, HLM took a tax loss by selling **Apple Computer**. The company's share price has come under pressure recently, along with those of other computer manufacturers. Apple's products are superior and its financial strength is greater, but its ability to charge premium prices has been eroded.
- Finally, the sale of **Henkel**, the German household products company, realised a small loss. The company was held as a growth company with a defensive business mix, but it has now disappointed by showing declining earnings and no dividend growth for two years in a row.

The proceeds of these sales were almost entirely reinvested outside the US, with the emphasis on Latin America and Asia:

- The one, US, exception was an addition to **Union Pacific**. This excellently-managed company offers exposure both to rising natural gas prices and to a recovery in the railroad industry. To date, investors have focussed on cost-cutting and productivity improvements by the railroads. HLM believes they will also gain market share from trucking companies and be more correctly perceived as able to grow even in a sluggish economy.
- Other additions to existing holdings were, in Asia, to **Makita** of Japan and **East Asiatic (Malaysia)**, in Mexico, to **Kimberly Clark** and, in Europe to **Hochtief** of Germany.

There were three new holdings:

- **Grupo Embottelador** is the Pepsi Cola bottling company for Mexico City and the surrounding areas. It is the largest Pepsi bottler outside the US, financially strong, modestly priced, and well placed to benefit from increasing consumption of US-branded goods in Mexico.
- **YPF**, an integrated oil and gas company, is Argentina's largest company. Its offering of Government-owned shares and listing of ADRs on the NYSE represents the latest stage in the country's program of privatising state-owned assets.
- **Keppel** is a diversified Singaporean company, with main interests in shipping, ship repair and ship building. Keppel is widely recognised as the best-managed industrial concern in Singapore, a country noted for good management. It is at the forefront of the Government's attempts to restore Singapore's entrepreneurialism and to use its corporate sector's financial strength to take advantage of the regional opportunities which abound.
- Finally, HLM bought some newly-issued, NYSE-listed, warrants, which enable the holders to sell Deutschmarks for US dollars at a fixed exchange rate at any time

over the next two years. In the expected event of German interest rates falling, it is likely that equity prices will rise, but that those gains would be offset by a decline in the German currency. Holding these warrants helps to provide a hedge against that outcome.