Harding, Loevner, McNally & Co.

Global Core Equity Investing

Description

The following material is excerpted from the 1992 third 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 September 30, 1992, the portfolio:

- held investments in 38 large companies, including 17 US companies;
- was broadly diversified in terms of geographic distribution (as illustrated);
- consisted of 94% common stocks, the balance in cash and currency options; and
- had an annual yield of 3.5%.

Overview

The portfolio had a positive return in the quarter, despite the volatility in markets, rising in value by 1.8%. Although markets outside the US were generally weaker, stronger currencies enabled returns in dollars to be positive. In the year to date, the value of units in the portfolio has risen by nearly 8%.

The FT Index of world stocks rose by 2.1% in dollars, reducing the fall in the year to date to 5.2%. Declines in European markets were offset by a dramatic rise in Tokyo from mid-August as the Japanese Government was temporarily able to stem the collapse in share prices with a massive program of economic stimulation. By mid-September, the benefits of this program were unable to prevent renewed selling.

The past quarter has seen a series of shocks to equity exchanges and massive, even historic, dislocations in currency markets. In Europe, dreams of currency unification and economic convergence died, leaving equity markets much lower. Values are attractive—many high quality industrial companies trade at less than half the cash flow multiples of their US counterparts, for example—but growth is rare and the medium-term direction of equity prices will still be in the hands of the Bundesbank. To date, that institution has remained committed to German monetary stringency, even at the expense of other European economies.

Stock markets have been volatile in Europe and full of pitfalls. The US market has also been full of pitfalls, but these have been company specific—any company which has disappointed in its earnings or which has been subject to a Wall Street downgrade (even for the most short-term of reasons) has seen its stock price suffer badly. In Europe, the damage has been more widespread and whole markets and sectors have been under severe pressure. Spain, for example fell by 21% in dollars, Italy by 26% and Sweden by 15%. Best performance has been from companies with stable rates of earnings growth, but stocks of cyclical and small companies were significantly lower. The portfolio owns a lot of the former and few of the latter.

HLM’s approach has served the portfolio well. A globally diversified portfolio of high quality companies has provided positive returns to holders. Importantly, investors have not suffered the volatility seen in broad market indices. HLM’s investment style is conservative and fundamentally based. Its policy of investing in excellent companies with good businesses, good management and good balance sheets has meant that the portfolio has avoided many of the pitfalls into which many global investors have fallen. The portfolio is inherently conservative and has shown outstanding stability in the past three years.

Portfolio Activities

The holdings in **CGIP**, in France, and **Unilever**, in the Netherlands, were sold. Economic growth in Europe, as in the US, will at best be sluggish. Unilever’s share price, however, has performed exceptionally well and now discounts a growth rate that is unlikely to be achieved. A good profit was realised. CGIP is cheap in relation to the company’s asset base of holdings in French industrial companies, but the discount is unlikely to narrow in the current environment. One of CGIP’s main investments is in **Cap Gemini**, the computer services company. HLM had previously sold a direct holding in Cap Gemini, so a sale of the parent was also appropriate. A loss was realised.

The final sale was a reduction in the holding in **Bangkok Bank**. The outstanding performance of this share had led to it becoming a large position. Although the outlook for the company is still sound, its shares are beginning to become fairly valued and a large profit was taken on part of the holding.

HLM added to positions that had been initiated earlier in the year. Additional shares were bought in **Makita**, the power tool company which will benefit from the secular growth in Japanese housing construction; in **Lubrizol**, where the share price dipped out of proportion to a Wall Street analyst’s minor revision to his quarterly earnings forecasts. Such overreactions provide buying opportunities for investors who look beyond quarterly earnings to the long-term record and outlook. The final addition was to the **Siam Portfolio**, a high quality investment portfolio whose assets are Thai blue chip companies. The share price performance has been strong recently, but still stands at a considerable discount to its net asset backing, despite the fact that that asset value will be realisable in January when the fund converts to being open-ended.

HLM added two new names to the portfolio. In the US, they bought shares in **Crown, Cork and Seal**. CCK is the leading US maker of crowns and closures for bottles and containers as well as being one of the largest can manufacturers. Its domination of the US market means that growth will be from increasing efficiencies, combined with further international expansion. The company has a superb and consistent record, a reputation for outstanding management, and a sound balance sheet.

In Europe, HLM bought shares in **Société Générale de Surveillance.** SGS provides testing, control and loss adjustment services to a variety of private companies in agriculture, natural resources, industrial and consumer goods, insurance, finance and transportation. It also offers services to governments in the area of export and import control. SGS's balance sheet remains strong, with large holdings of cash in Swiss Francs, and its business continues to progress well, with growth seen in particular in its loss adjustment and laboratory testing businesses. Dividend and earnings were up in 1991 and the registered shares, which split 5 for 1, were opened up to foreign investors. The Portfolio now has holdings in four Swiss companies. All are characterised by high quality and by the global spread of their businesses.

HLM has taken the unusual step of hedging part of the portfolio's exposure to European currencies. This has been done through the purchase of options to sell Deutschmarks at 1.40 to the US dollar. HLM prefers this route to the more normal foreign exchange transaction, whereby the portfolio would sell a foreign currency forward, because it limits the amount of exposure to the amount of premium paid. This means that, if the dollar continues to decline, the portfolio will benefit from the appreciation in non-dollar stocks, the amount of the benefit being reduced only by the amount of premium paid. If the dollar does rise in value, however, so will the value of the option, offsetting the depreciation in non-dollar stocks.

Companies

By sector, the worst performances were seen in cyclical stocks. Amongst those companies most exposed to basic industry, **Alcoa** was down 13%, **Lubrizol** 15%, a sharp reaction to quarterly estimate revision and to its previously strong price rise, and **Metallgesellschaft**, which is directly exposed to metal prices, 18%, even in US dollars. Strong currencies rather than share prices meant that **Nippon Denso** and **Bayer** were more defensive, falling by 1% and 2% respectively. **Union Pacific** has growing earnings, trades at discount to the market, has strongly incentivised management and exposure to natural gas as a bonus. The stock price rose by 9%.

Other stocks of companies more directly exposed to rising gas prices also improved. **Baker Hughes** stood out, rising by 15% and continuing the recovery begun in the previous quarter, but all prices were generally firm.

Stocks in companies where earnings are driven by the consumer spending cycle were weak. **Bandag** fell by 12%—on an analyst's short-term revision to earnings estimates. **Singapore International Airlines** sufferred from fears of over capacity, even in a region where demand is growing rapidly These fears were compounded by technical factors which led foreign-registered shares significantly to under-perform local ones. The premium at which foreign shares are usually priced has now fallen dramatically.

South China Morning Post posted good earnings results, but the share price fell, in line with the correction in the Hong Kong market. They dropped by 7%, unwinding a part of the good gains seen last quarter. The shares are still very attractive, with a price-earnings ratio of 11.6 and a dividend yield of 7.3%, in, effectively, US dollars. The portfolio's other holding in that market, **Hong Kong and China Gas** was resilient despite good previous performance. Utility shares traditionally outperform a falling market in Hong Kong, while Gas has the growth characteristics which enable it to do well when the market is rising.

Stable growth companies and those which HLM classifies as "credit sensitive" form a significant part of the portfolio and were responsible for the positive returns in the quarter. **Abbott Labs** and **Merck** were the exception, as the US healthcare industry potentially faces a more hostile administration under Clinton. Healthcare stocks have been hitting lows for the year, but HLM believes they are attractively priced. The superficial assessment that earnings will be under pressure in the short-term does not take account of the long-term trends in demand for drugs and other health-related products.

The Swiss market has been seen as a safe haven in the current turmoil, while gains were augmented by a firm currency—reverting also to its traditional safe haven status. There were good gains from **Nestlé**, up 13% in dollars and **Sandoz**, up 3%, holding on to its gains in the first half.

Gains in the "credit sensitives" were very strong. The exceptions were the European stocks, **Telefonica** and **S.G.Warburg**, where currency devaluations hit US dollar prices. In the US, **AIG** and **Exel** were huge beneficiaries of the rethinking of the cyclical outlok for the insurance industry in the wake of Hurricane Andrew. The revelation by the Prudential that it faced losses of up to $1.6bln from the disaster led investors to believe that insurance rates may finally have bottomed after several years of cyclical weakness. Both stock prices rose by 20%.

In Thailand, elections came and went smoothly and the market responded well. When HLM bought shares in the **Bangkok Bank**, its price earnings ratio was about 5.6 times, *lower* than its dividend yield of 7%! That has now reversed as the share price has soared. In the quarter alone it rose by 24%. The shares are valued at around 11 times this year's earnings and the dividend yield is just 3%. These are still attractive numbers for a company capable of 18% growth in earnings over the medium term. The **Siam Fund** is also still attractively priced, even after its 24% rise in the quarter, given investors' ability to realise full net asset value in January 1993.

Investment Performance

Total Returns %

	Year to date	1991	1990	Since Inception (12/89) Cumulative	Compound
Global Core Equity	**7.7**	**28.5**	**6.4**	**52.5**	**16.1**
Comparative Benchmarks:					
FT World Index	-5.2	19.7	-17.1	-2.9	-1.0
S & P 500	2.5	30.4	-3.1	32.6	10.5
Global Fund Index (Lipper)	-3.7	18.7	n/a	n/a	n/a

Note: In response to repeated requests from investors for performance information of greater comparability, performance of Global Core Equity portfolio is now being reported before management and trustee fees. These fees amount to approximately 1.5% per annum.