

Harding, Loevner Management

Global Equity Investing

1993 Third Quarter Report

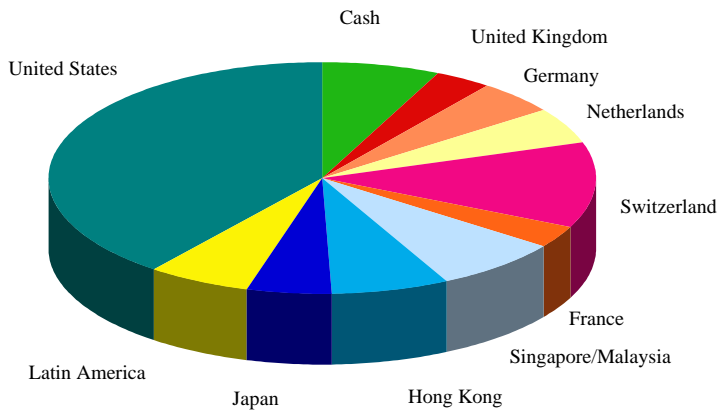
The following material is excerpted from the 1993 year end report on a global portfolio managed by Harding, Loevner Management ("HLM"). The portfolio is invested worldwide in common stocks and convertible securities with the objective of preserving and its capital value in US dollar terms.

Portfolio Overview

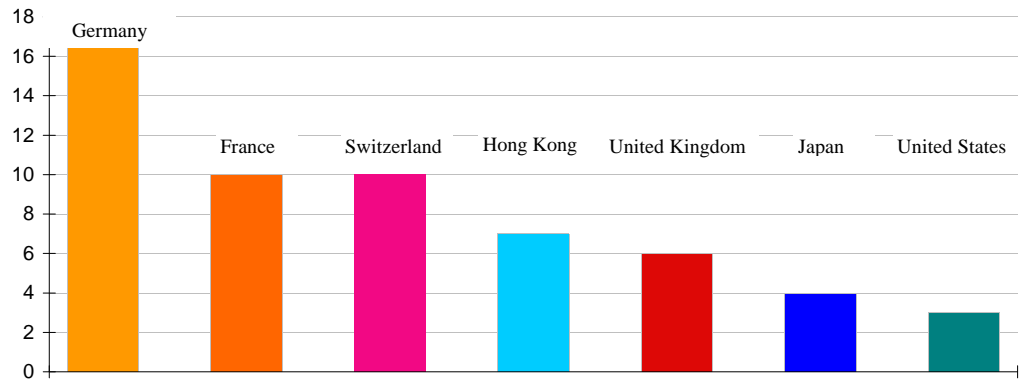
At September 30, 1993, the portfolio:

- held investments in 41 companies; including 20 US companies;
- was broadly diversified in terms of geographic and industry distribution;
- consisted of 93% stocks and 7% cash, convertible bonds and warrants; and
- had an annual yield, before expenses, of 2.3%.

Portfolio Allocation by Country as of September 30, 1993



1993 Year to Date Performance of Major Markets



Performance

	1993	1992	1991	1990	<u>Since Inception (12/89)</u>	
	Year to date				Cumulative	Compound
	-----Total Returns %-----					
Global Core Equity Portfolio	14.1	11.3	28.5	6.4	79.8	16.5

Comparative Benchmarks:

FT World Index	21.2	-5.1	19.7	-17.1	17.8	4.4
S & P 500	8.3	7.7	30.4	-3.1	49.8	11.1
Global Fund Index (Lipper)	20.2	-3.2	18.7	-11.2	27.5	6.5

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

Third quarter returns were very strong, at 6.6%. The trend whereby stock prices outside the US surpass those from US stocks is now well established. In this quarter, however, it was not Japanese and other Asian stocks which were responsible. The Japanese market, which accounts for a proportion of the world index second only to the US market, did rise—by 4.0s%—but this quarter saw a strong rise in stock prices in Europe as well. Interest rates have begun to fall. Stock markets have risen in response to lower rates and in prospect of further falls leading to economic recovery.

HLM continues to find the most attractive investment opportunities in high quality companies located outside the US; as a result the proportion of the portfolio's assets held in stocks of US companies is now 39%, as low as it has ever been. Stocks that are held in the US are high quality companies with the ability to grow earnings in a sluggish environment. In Europe, holdings are mostly of blue chips, such as **Deutsche Bank** and **Nestlé**, whose shares are attractively priced in light of the improving outlook for corporate earnings. In Asia, growth is more freely available and stocks held, such as **Hutchison Whampoa** and **Jurong Shipyard**, reflect the healthy operating environment.

Global Review and Stock Market Outlook

- The wild swings in confidence about the US economy now appear to have settled down and it is widely accepted that the economic recovery is sustainable but will only unfold at a modest pace. The consequence has been a lowering of inflation expectations and a further fall in the yields on long-term US dollar bonds. This new consensus is in accord with HLM's long-held views about modest growth and the lack of inflationary pressure. It means that US stock prices are supported not primarily by the prospect of strong earnings growth, but by the prospect of sustained low interest rates.

With no expectations of either accelerating earnings growth or further significant declines in nominal interest rates, HLM expects only modest returns from the US stock market as a whole.

*HLM has concentrated its holdings in the US to “growth cyclicals”—companies, such as **Crown Cork & Seal, Dover** and **Union Pacific**, that it expects will show significant underlying growth notwithstanding a lacklustre economic environment.*

Another result is that HLM has continued to reduce the portfolio's investment in US companies, in favour of companies in countries where growth prospects are better, or where there is significant scope for lower domestic interest rates and higher economic growth.

- European stocks enjoyed a strong and widespread rise in the past quarter. The European Rate Mechanism (“ERM”), with the Deutschemerk as its anchor, has been under intense pressure as a result of the divergent monetary needs of its participants. Fast money growth and strong inflation pressures in Germany have demanded high Deutschemerk interest rates. Rising unemployment and recession elsewhere have demanded lower interest rates—a dichotomy incompatible with fixed exchange rates.

Governments were strong in resisting political pressure to devalue and reduce rates, but ultimately could not withstand the huge, largely speculative, flows which now dominate currency markets. The French Government in particular succumbed to foreign exchange market pressure which forced the widening of the range within which its currency is allowed to float. The resulting prospect, not yet a reality, of sharply lower interest rates led to a sharp rise in the prices of French stocks. Even in Germany, inflationary pressures are peaking, the currency is fundamentally strong, yet short-term rates are *four times* the level in Japan. They have farther to fall.

The portfolio has 28% of its assets invested in European companies, concentrated in high quality companies with globally diversified earnings. In the quarter, HLM made little change to the holdings. The currency exposure of the portfolio's holdings is partially hedged via a holding of warrants to sell Deutschemarks at a fixed exchange rate.

- July marked a watershed in Japan's modern political and economic history. The new coalition Government represents the end of the Liberal Democratic Party's domination of government since WWII. For investors, it marks the beginning of a new era in economic policy. For decades, Japan's economy has been dominated by saving, not consumption; by investment in manufacturing capacity for export, not in domestic infrastructure; and by protection and regulation, not by markets that Westerners could regard as “free”. While Japan's manufacturers have become the most productive in the world, its consumers have not benefitted from the free availability of cheap goods which would be expected. Rather, prices have been kept high, to stifle consumption and to protect manufacturing industry. It is now recognised that in an era of a strong yen and rising protectionist fervour around the world, Japan *has* to begin to spend some of the wealth it has accumulated.

HLM believes that the new Government will attempt to stimulate economic recovery through a program of tax cuts and deregulation to benefit the consumer. The resulting transfer of wealth to consumers will, for the first time, enable consumers rather than producers to lead the way to restored economic growth. As

elsewhere, Japanese consumers respond to lower prices and higher disposable incomes by consuming more. They are changing their habits: spending their money more often in the new discount stores beginning to appear and on imported goods previously only available at high prices.

*HLM has added to holdings in Japan, by buying warrants in two Japanese consumer companies, **Mr Max** and **Senshukai**. Mr Max is a small, but rapidly growing discount retailer; while Senshukai is Japan's second largest mail order company. Both companies will grow rapidly as a result of the secular changes in consumption patterns outlined above.*

- South East Asian stock markets continued their strong performance. In Hong Kong, prices were held back by concerns about the direction of the Chinese economy and by little sign of agreement between the Chinese and British Governments about the level of democratic process to be introduced to the colony in the runup to the transfer of power in 1997. HLM expects some resolution of the disagreement early in the fourth quarter.

Elsewhere, returns were stronger. In Singapore, the Government's commitment to a thriving equity market has become apparent to all. Buoyant stock prices are a necessary background for the partial privatisation of Singapore Telecom and of several other publicly-owned assets in coming years. By easing restrictions on the investment of private savings, the Government has assured that that positive background will be present.

*Holdings in the region were reduced slightly, in aggregate, as a result of the sale of shares in **South China Morning Post**, Hong Kong's leading English daily newspaper, following an unexpected change in management control that reduced HLM's confidence in its future direction.*

- A main issue for investors in Latin America has been the prospects for passage in Congress of the North American Free Trade Agreement. Despite publicity accorded the vested interests and rabble rousers in opposition to this ground breaking commitment to free markets, HLM believes that Mr Clinton's Administration is fully committed to it and ready to spend the political capital necessary to see it pass. With or without NAFTA, Mexican companies offer outstanding opportunities for growth. Investors in the Mexican market have been uneasily confident about a favourable outcome, pushing up prices by 10% in the quarter.

Elsewhere in the region, the portfolio's holding in **YPF**, the recently privatised Argentinean oil company performed well while oil prices fell and then recovered. As HLM expected, analysts' estimates of YPF's earnings are beginning to be raised as they recognise the cost savings that can be made now that political influence is diminished.

HLM has invested a significant portion (6%) of the portfolio's assets in Latin and South America, through holdings in YPF and two high quality Mexican consumer growth

companies: **Kimberly Clark de Mexico** and **Grupo Embotellador**, a Pepsi bottler. HLM continues to emphasise financial quality and consistent growth prospects in this market.

Third Quarter Portfolio Activity

HLM took profits in four stocks during the quarter:

- **Deere's** stock price has risen strongly this year (up 55%), along with many other capital goods companies. The company has responded by raising large amounts of new equity capital. HLM regarded this action as abusive of existing shareholders.
- **Merck's** share price has been weak for the last year and more as concerns mounted about the outlook even for the premier drug companies in light of the Clinton family's proposals to revolutionise the American healthcare system. Merck has responded to the uncertainties by announcing the \$6 billion acquisition of Medco, the nation's largest distributor of pharmaceuticals. HLM sold the portfolio's holding in light of the increased uncertainty created by this desperate action.
- **Warburg** has enjoyed a remarkable run, in terms of its business and its stock price. Earnings of any investment bank, however, are subject to the vagaries of the market places in which it operates and are volatile. Warburg's stock price now, however, implies that those earnings are sustainable, and such sanguinity cannot persist.
- Control of **South China Morning Post** passed from Rupert Murdoch to Robert Kwok. With that change may come a different business strategy and, importantly, a different dividend policy. With so much uncertainty, HLM decided to take a profit on the portfolio's holding.

The final sale was of part of the holding in **Makita**, the Japanese manufacturer of power tools.

Proceeds from these sales were reinvested, in the US, Europe and Japan. HLM increased holdings in **Hochtief**, **Nippon Denso**, **Keppel**, **Crown Cork** and **Abbott Labs** and bought shares in five new companies:

- **Mr Max** and **Shensukai** are companies at the forefront of the revolution in Japanese consumption patterns. Mr Max operates 19 low-cost, "no frills" discount stores in the fast growing Kyushu region, while Senshukai is the country's second largest mail order company. Both companies are well capitalised and have excellent growth prospects.
- **Blenheim Exhibitions** is the world's largest organiser and "owner" of trade fairs and exhibitions. It also has a publishing/information business based on those events. The company has grown rapidly in recent years but has fallen out of favour as a result of poor investor communications and its mishandling a rights

offering earlier in this year. A recent visit with senior management in London convinced HLM that the company is misperceived by the market, but its business remains sound.

- **Hutchison Whampoa** is one of Hong Kong's largest and oldest conglomerates, with interests spanning container terminals, property, telecommunications, oil and gas, and an electric utility. As such it is perfectly positioned to benefit from the growth in economic activity in China that HLM expects in coming years. Unjustified concerns about Husky Oil, its Canadian resource arm, weakened the price of Hutch's shares and created a buying opportunity.
- **J.P. Morgan** is the last of the United States' triple A-rated banks. Its stock provides financial strength, management quality, high returns, and dividend growth, at a large discount to the market which is sceptical of the sustainability of J.P. Morgan's proprietary securities trading profits. HLM believes the weight of evidence favours their sustainability and therefore regards the stock as deeply underpriced.