

# Harding, Loevner Management Global Equity Investing

## 1994 Third Quarter Report

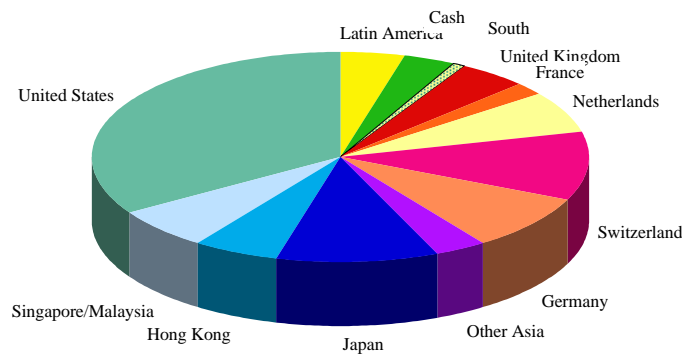
*The following material is excerpted from the 1994 third quarter report on a global portfolio managed by Harding, Loevner Management ("HLM"). The portfolio is invested worldwide in common stocks and convertible securities with the objective of preserving and increasing its capital value in US dollar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

### Portfolio Overview

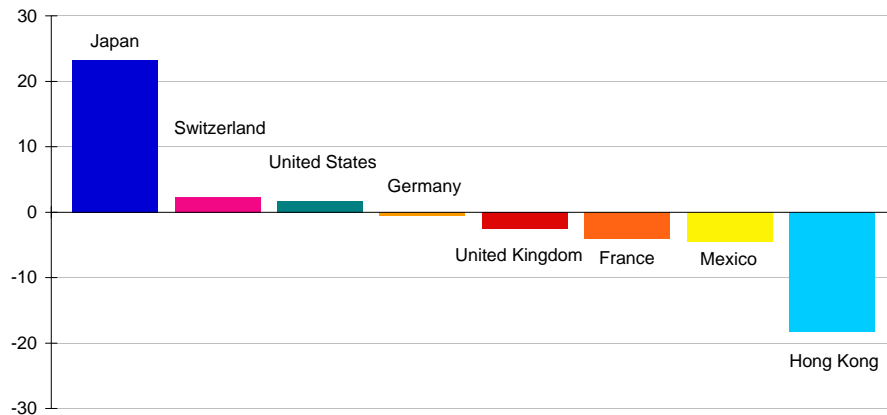
At September 30, 1994, the portfolio:

- held investments in 47 companies in 15 countries, including 17 US companies;
- was broadly diversified in terms of geographic and industry distribution;
- consisted of 96.8% stocks and warrants, the balance in cash; and
- had an annual yield, before expenses, of 2.1%.

**Portfolio Allocation by Country as of September 30, 1994**



**1994 Year to Date Performance of Major Markets**



## Performance

	1994 YTD	Average Annual Returns for periods ending 9/30/94			
		1 year	3 years	4 years	Since Inception
<b>HLM Global Equity</b>	<b>3.0</b>	<b>12.9</b>	<b>15.7</b>	<b>18.8</b>	<b>15.1</b>
Comparative Benchmarks:					
FT World Index	6.9	8.0	9.0	13.2	5.1
Global Fund Index (Lipper)	2.8	13.4	11.2	12.4	7.9
S&P 500	1.3	3.7	9.2	14.3	9.5

Note: This performance data refers to HLM's Global Equity Composite, a dollar-weighted average of *all* global equity accounts managed by HLM. Inception date 11/30/89. HLM Composite performance is presented before management fees. See attached performance summary for details and notes.

The portfolio rose in value by 3.3% in the quarter. The FT World Index also rose, by 2.1%. Financial market volatility of the first half of the year continued, but was mainly confined to weakness in bonds. Currency markets were much more stable, while equity markets began to recover early in the quarter. The continued strength of the US economy, incipient recovery in Europe, and hopes of an end to recession in Japan combined to make equity investors optimistic about corporate earnings, even as they made fixed income investors concerned that the long and favorable trend in interest rates was over.

## Portfolio Review

HLM has constructed the portfolio company by company, 'from the bottom up', by assessing companies' strengths and weaknesses and their long-term prospects, rather than by trying to forecast the direction of stockmarkets. The portfolio, however, is not a random collection of good companies. It has been carefully assembled to be well diversified by industry, by geography, and by currency. At the same time, the portfolio's holdings express certain underlying themes which reflect HLM's view of where the world is going and how its favoured companies are positioned in it. We review the portfolio from this perspective:

### What the Portfolio Owns and Doesn't Own

The portfolio doesn't own *consumer companies in mature economies*.

HLM believes that companies selling to American and Western European consumers have limited ability to grow earnings through raising prices. Consumers in the developed world have become more price conscious *and* are no longer reliant upon a famous brand (at a premium price) to assure premium quality. As a result, in order to

grow, producers and retailers must fight for market share— they must introduce new products and formats, or extend old ones. But this growth path is limited, and even the best of the developed world’s consumer companies are constrained by the absence of growth in overall demand in their domestic market. Volumes will be static and prices will remain under pressure so long as unfavorable trends in demographics, household debt and real wages prevent a sustained resumption of growth in consumer demand.

The portfolio does own ‘*emerging*’ consumers—17% of the portfolio

In developing economies, however, branded goods from the West are still in demand, offering both status and an assurance of quality to those who can afford to buy them. The number of those people, of course, is growing quickly as rapid economic growth trickles down to the masses, providing hitherto unseen buying power. Companies that benefit will be companies with global vision and presence in developing markets, and local distributors selling imported goods.

The portfolio contains examples of both. **Nestlé** of all the major consumer products companies, has the most exposure to developing economies. Nestlé’s local subsidiary in Malaysia, **Nestlé Malaysia**, combines its parent’s marketing and technological strength with local manufacturing presence. **Wicaksana** is Indonesia’s second largest distribution company, selling household and personal products on behalf of companies such as Procter and Gamble and Bristol Meyers Squibb to an increasingly wealthy population of 180 million. In Latin America, **Quilmes** is the dominant brewer in Argentina, Uruguay and Paraguay, expanding into Chile, while **PanAmerican Beverages** is a leading bottler in Mexico, Brazil and Colombia for the world’s most valuable brand, Coca Cola. Nestlé Malaysia, Wicaksana, and Quilmes were all purchased in the last quarter.

**Krones**, in Germany, is the world’s leading producer of equipment that fills, cleans, caps and labels bottles for beverage manufacturers. Its factories are full of work in progress destined for the developing world, from Mexico, to South Korea, to Romania. In a similar business, packaging powerhouse **Crown, Cork and Seal** has grown through acquisition and, more recently, through creative redeployment of its assets, releasing older but still serviceable existing plant and equipment to establish low-cost capacity overseas, most recently in China and Argentina.

It owns *global capital goods producers*—21% of the portfolio

Providing the infrastructure for the needs of consumers in the emerging world, rebuilding Eastern Europe, and remedying decades of under investment in the West are major tasks for the 1990s. This promises favorable conditions for producers of capital goods. Of those that possess the necessary expertise, the successful companies will be those that already operate on a global basis. **Brown Boveri**, Swiss producer of heavy equipment, invented the maxim ‘think global, act local’. Its power generation equipment sales in Asia and Eastern Europe are growing rapidly. Construction and related companies, such as German **Hochtief** and Swiss **Sika**, have order books bulging

with projects in the developing world at a time when the European economies themselves are only beginning to emerge from recession. **AMP**, the world's leading producer of electrical connectors, enjoys growth driven by high levels of investment in productivity-enhancing computer equipment.

It doesn't own: *'Recovery Plays'*

As Europe recovers, investors have been attracted to hitherto poorly performing industrial companies whose earnings are dependent upon strong economic growth. HLM has avoided such deeply cyclical companies, such as those in the steel or automobile industries, believing that buying (and selling) their shares successfully is tantamount to 'timing the markets' and that the odds are against being able to do so consistently. A number of the portfolio's holdings are in companies whose prospects will improve with higher levels of economic activity, but they are companies where earnings will grow from cycle to cycle as well. Dutch temporary employment agency **Randstad** is a good example: its business is directly tied to levels of economic activity in the short-term, but demographic change, labor deregulation and customer requirements are all resulting in secular growth in the longer term.

It also doesn't own:

*Property stocks*

HLM believes that property companies are 'for buying and selling, not for owning' and prefers to be a long-term owner of growing businesses. As a result, the portfolio has no property companies, anywhere in the world, although they comprise significant parts of many market indices.

*Regulated utilities*

The portfolio owns no companies where government regulates their level of profitability. Regulation and protection form a two-edged sword—helpful when politicians or bureaucrats are favorably disposed, but threatening when they are not. Moreover, much of the world now accepts the principle that competition enhances efficiency and that free markets are better at setting prices than governments. Remaining bastions of regulation—the US electric utility industry, national telecommunications businesses, many Japanese industries—are facing attack. The winners will include consumers, for certain, and some nimble producers— but not very many of those companies that prospered under the old régime.

*Japanese Financials*

Local banks and other financial institutions form a very large part of the Japanese equity market, and hence of the traditional benchmarks for global investors. HLM believes they are too risky—balance sheets are stretched, protection is being removed, and stock valuations are sky high.

## Outlook

Companies around the world are having to cope with a new kind of business cycle—one where they cannot raise prices at the first signs of renewed demand, and where a rebound in demand in traditional market places will be limited. They will have to seek growth where it is available, and that means a focus on unfamiliar places—Eastern Europe, the Near and Far East, and Latin America. Only those companies with the strongest management, best products and adequate financial resources will be able to prosper in such an environment. As always, HLM will be paying close attention to developments in these places and making regular visits—to test new investment ideas and to ensure that the outlook for long-held investments remains sound.

At a time when the vulnerability of equity markets to rising interest rates is being tested, HLM takes comfort from the fact that the portfolio is broadly diversified and that its holdings are in companies of very high financial quality whose earnings are growing.

## Portfolio Transactions

HLM bought six new stocks in the quarter and sold three:

- **Johnson Electric** is one of the world's leading independent manufacturers of small precision electric motors, used in a wide range of consumer products including automobiles and household appliances. Johnson has a consistent record of success since its listing in 1984. Its technological leadership, strong management and global vision have resulted in a deservedly high rating by the stock market. In the long-term, increased use of micro motors will fuel growth in demand. In the short-term, recoveries in Western economies and in the automobile industry in particular will provide further growth in 1994 and 1995.
- **Linde** is the European market leader in materials handling, with products ranging from fork lifts to pallet stackers and automated guided vehicles. In industrial gases, Linde ranks number two in Europe. The company has a healthy balance sheet, no net debt, and a promising strategic focus. Management is diversifying the business toward the fairly cyclically-resistant and expanding industrial gas market, and at the same time improving the product mix. There is scope for strong growth in materials handling products, while industrial gas demand will also benefit from an industrial recovery in Europe.
- **Nestlé Malaysia** is engaged in the manufacturing and marketing of various food products such as coffee, fortified drinks, condensed milk, milk powders, infant formulae and cereals, instant noodles and other foods. The company is 51% owned by Nestlé of Switzerland. Its balance sheet strength, corporate backing, quality brand names, and exposure to rising personal expenditure in Malaysia justify a high market valuation.

- **Quilmes** is the leading beer producer in Argentina, Paraguay and Uruguay and the second largest brewer in Chile. The company is also the leading producer of soft drinks in Paraguay where it holds the Coca-Cola license. Quilmes has first class management, a sound balance sheet and strong cash flow with which to fund its aggressive investment plans. HLM expects Quilmes to continue to benefit from the improving economic environment in Argentina and from emerging opportunities elsewhere in the Latin American region.
- **Bangkok Bank** is Thailand's largest and strongest bank, commanding a 27% share of the market in terms of total assets, deposits and loans. It is a leader in trade finance and has become increasingly active in offshore dollar-based lending. The Bank also has important interests in a number of other financial service companies. It is well capitalized, conservatively managed, and among the largest non-Japanese banks in Asia in terms of assets and earnings.
- **Wicaksana** is the second largest distributor of consumer goods in Indonesia. Procter and Gamble, Bristol-Myers, British American Tobacco and others supply Wicaksana with a wide assortment of fast-moving goods ranging from instant noodles and snacks to pharmaceuticals and baby foods. The Indonesian consumer sector represents a population of over 180m, over half of which is under the age of 20 years and where the average daily wage is US\$2. Consumer spending should continue to rise strongly in volume and value terms.

The three stocks sold were:

- **EAC (Malaysia)**, a distributor of consumer products in Malaysia, underperformed the stock market last year, but became caught up in speculative frenzy during the past quarter. The stock price rose by more than 50% amid conjecture concerning a sale of plantation assets, to a level that exceeded HLM's estimate of the underlying value of the business.
- Changes in **Sandoz's** top management, and the recent acquisition of Gerber, are evidence of an increased focus away from the core pharmaceutical business. Since the future direction of the company is unclear, HLM sold. The shares have performed well and erased much of the previous undervaluation.
- **Mikuni Coca Cola** was sold because HLM concluded it had overestimated the strength of the Coca Cola franchise in Japan. Price competition among established beverage brands is as fierce in Tokyo as in the US, and generic brands have arrived on the scene years sooner than HLM expected. Despite the company's financial strength, growth will be very hard to achieve.