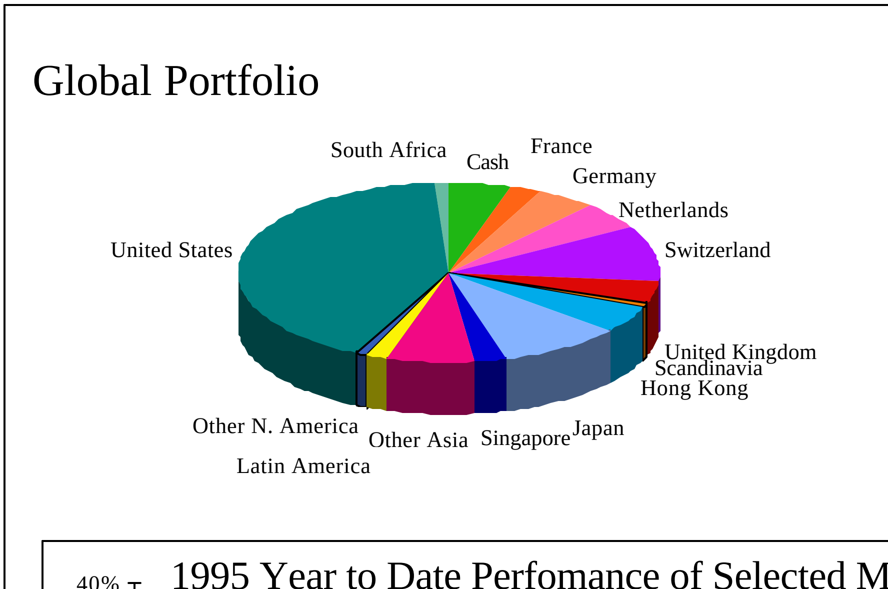
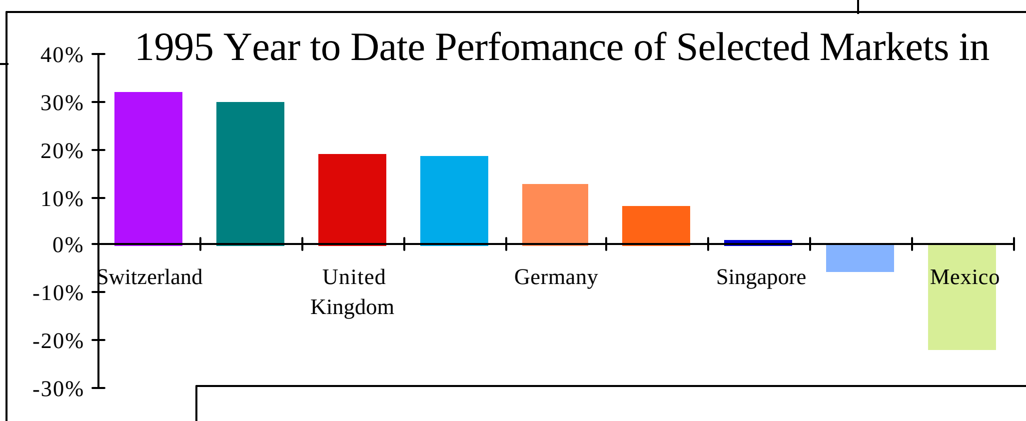
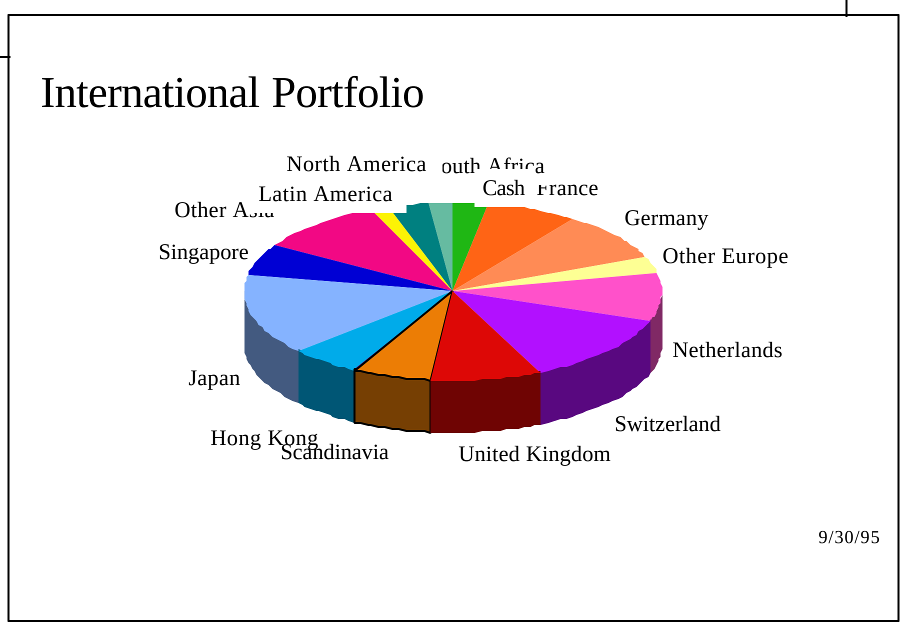
Harding, Loevner Management
Global / International
Investing

1995 Third Quarter Report

The following material is excerpted from reports to equity clients of Harding, Loevner Management.







Overview of Portfolios

Harding, Loevner Management offers clients a choice of equity programs: *global equity*, which includes US-based companies, and *international equity*, which excludes US-based companies. Within each equity program, carefully selected companies are combined in portfolios that are broadly diversified by industry and by geography. The following table provides a 'snapshot' at September 30, 1995, of two representative portfolios:

portfolio characteristics	**HLM Global Portfolio**	**HLM International Portfolio**
Number of companies	46	45
Number of countries	16	18
current yield	2.3%	2.0%
geographic allocation (%)		
US	42	--
Europe	27	55
Japan	9	15
South East Asia	14	21
Other	3	6
Cash (US$)	5	3
	100	100

Performance

HLM's global portfolios returned 1.7%, on average, in the third quarter, which compares with a rise of 5.7% from the FT World Index and 5.6% from the Lipper Global Fund Index. International portfolios returned 0.7%, versus 4.2% for the FT World ex-US Index and 5.4% for the Lipper International Index. For the year to date, the global portfolios have returned 15.7% and the international, 7.7%.

		Compound Annual Returns (%) for periods ending 9/30/95			
	1995 YTD	1 year	3 years	5 years	Since Inception
HLM Global Equity Portfolio	**15.7**	**12.1**	**13.7**	**17.5**	**14.6**
FT World Index	14.2	13.1	14.0	13.2	6.4
S & P 500 Index	29.8	29.7	15.0	17.2	12.8
Global Fund Index (Lipper)	13.3	8.4	14.4	13.2	9.2
HLM International Equity Portfolio	**7.7**	**3.8**	**17.9**	**16.9**	**12.2**
FT World ex-US Index	6.0	4.4	13.5	10.7	3.2
MSCI World ex-US Index	7.3	6.1	13.9	10.8	3.7
International Fund Index (Lipper)	8.1	3.3	13.8	11.0	6.9

Note: The HLM performance data refer to its global and international equity composites, which are dollar-weighted averages of *all* HLM-managed global and international equity accounts, respectively. Inception date for global composite, 11/30/89; international composite, 9/30/89. HLM composite performance is presented before management and custody fees. See attached composite performance summaries for details.

Returns from foreign markets in the third quarter were strongly influenced by movements in foreign exchange rates. The reversal of the long-term decline in the value of the US dollar was particularly evident relative to the Japanese yen. The yen fell by 15% against the dollar, turning a large (20.8%) gain in local stock prices to a more modest gain of 4.0% in US dollars.

The US market, underpinned by lower long-term interest rates and generally strong corporate earnings, continued its remarkable rise, gaining 8.1% in the quarter. Technology stocks, in particular, remained in favor as ‘momentum’ investors turned aggressively to this sector, driving share prices higher. In other sectors of the market, however, the fragility of sentiment was exposed by numerous examples of companies that announced modest earnings downgrades, only to see stock prices fall sharply.

Our policy is that we seldom hedge the foreign exchange value of stocks held in portfolios. Hedging is expensive, and some currency diversification in a portfolio is desirable. Moreover, the companies we own tend to be multi-national in their activities, owning assets and earning revenues in a variety of currencies, and thus enjoying some degree of natural hedge against currency fluctuations. In the recent period of dollar strength, this policy of not hedging has hurt performance. Share prices of multi-national companies are slow to adjust to reflect changes in the value of their overseas assets and earnings. The rise in the dollar is as yet short-lived, and a sharp reversal towards the end of the quarter reminded investors that its strength is fragile and, perhaps, temporary. They will pay more for dollar-earning stocks when an assumption of sustained dollar strength gives rise to higher earnings forecasts.

Returns from South East Asian companies in the portfolio were modest, reflecting concerns, not about growth, but about the inflationary pressures that have been building over an extended period of rapid growth and rising capacity utilization, and the interest rate increases that might follow in turn. Returns were hurt by poor performance from several of the smaller European companies held in the portfolio. This neglected asset class has provided us with numerous successful investments in the past. Global competitive pressures that we have discussed previously, and to which we will return again this quarter, proved too much to bear for some of our favoured companies.

Review and Outlook

The US market’s spectacular gain since the turn of the year occasions more than a little nervousness among investors. Yet, at least with benefit of hindsight, the forces underlying this performance are clear: the flow of funds into equities has been strong, especially via mutual funds, and the twin pillars of equity valuation— interest rates and corporate earnings— have both been trending in a favorable direction. The result is that, today, share prices, though 30% higher than nine months ago, are still within the (imprecise) bounds of fair fundamental value. While that observation does not negate the possibility of a significant market correction based on changes in animal spirits alone, it suggests that a complete retracing of the years’ gains will not occur unless there is some major disruption of the underlying forces. How likely is that?

Not very likely in the near term, we think. Funds flows into equities are variable month to month, but in the bigger picture are closely linked to US demographic trends. American workers are becoming older and wiser: older, in that they are entering their prime earning years (and leaving their prime consuming years), and wiser in that they grow more cynical about the commitment of government to return their involuntary savings to support their retirement. These trends, which have a powerful impact on household savings behavior, are set to accelerate. Interest rates, too, are capricious in the short term, but again the long-term picture is very positive. Rates remain high in real terms, i.e. compared with inflation, and inflation itself seems ever more remote a threat in a world where, in many places, prices are *declining*. Indeed, recent strengthening of the dollar helps to import into the US from Japan and Europe some of their deflationary tendency.

If there is a potentially weak pillar, it is corporate earnings. Their rapid growth in the recent past has owed as much to cyclical recovery as to fundamental improvement in profitability. The stronger dollar will take the wind from the sails of US multi-nationals, such as the branded consumer products makers, whose earnings growth has been enhanced by translation gains, and will renew the pressure of competitive imports on domestic manufacturers, such as the auto makers. The market is already beginning to act uncharitably toward the shares of companies that miss their earnings forecasts, even by just a little, and there may be a message in this for the future. It will be much more important to own the right companies, i.e., those whose earnings growth does not disappoint, in the coming year than it had been in the past one.

In this heady equity environment, US investors have become enthralled with ‘technology’. Interest has focused not only on the producers of high-tech electronic goods and components—among them such portfolio companies as **Motorola**, **AMP**, and **Thermo Electron**— but also on the long-term benefits that accrue to US companies and the US economy generally by virtue of their leadership in the dissemination and usage of computers. We agree that these benefits—which boil down to an increase in productivity and international competitiveness—are taking place, but disagree that they are confined to US companies. Our investments, both here and abroad, are directed to companies that we believe employ ‘best practice’ in the conduct of their businesses, and that includes, importantly, generous investment in productivity-enhancing technology.

Elsewhere, the main theme of the quarter has been the fall of the Japanese yen, in response, above all, to coordinated intervention in foreign exchange markets. The world’s central banks acted out of grave concern for Japan’s financial health. The strength of the yen over the past decade, combined with the bursting of the speculative bubble in financial and property assets, has had a profoundly depressive impact on the Japanese economy. Falling values, in yen terms, of domestic and overseas assets have left Japanese banks, and the entire financial system, dangerously short of capital. The banks cannot repair themselves through earnings because there is no loan demand. Japanese industry, still flush with capital raised during the bubble, has stopped investing in new domestic capacity: products made in Japan have become unprofitable to export as a result of yen strength, and difficult to sell at home as rising unemployment and a collapsed real estate market have rattled the confidence of Japanese households and quenched their desire to consume.

Another visible result has been the ‘hollowing out’ of Japan’s industrial base. Currency appreciation has forced Japan’s manufacturers to reduce costs. At first they could do so by improving productivity, through investment and better training—the ‘miracle’ of the Japanese economy in the 1970s and 1980s. Now, however, their only recourse is to hire lower cost workers and utilise cheaper factory space abroad. The rise in levels of Japanese investment in low cost areas, such as the UK, and, above all, in South East Asia has been a significant factor in those regions’ recent economic success, even while it has progressively dampened economic activity at home.

Buying of dollars by central banks, or tinkering with financial regulations as the Japanese did in July, will not solve the central problem behind yen strength: that Japan saves too much and its principal trading partner, the US, saves too little. Until this imbalance is removed, trade imbalance, yen strength, and Japanese deflation will persist. There is some evidence that both sides of the problem are, at least, being addressed. The aforementioned demographic trends in the US are now combined with a radical Congress determined to reduce the level of participation in the economy, and associated dis-savings, by Government. In Japan, the same is true of the population, the reverse of the Government. At the end of the quarter, a fiscal stimulus package was announced that will inject some $80 billion in new demand into the economy. Equally important, the US now has goods that Japanese consumers want to buy, while the tearing down of trade barriers and deregulation of the distribution system are making them more readily available. In the last two years alone US makers of computer software and hardware, for example, have established leading positions in this rapidly growing markets, at the expense of the tired, unattractive products previously offered by their Japanese competitors.

In the long run, deregulation and a lower yen will favour the efficient allocation of resources between the export sector and the ‘subsidised’ producers of domestic goods and services. In the short run, however, unleashed competitive pressures will lead to the painful restructuring of the domestic economy that has already been seen in the export sector.

There is a parallel between what has happened in Japan, and what is happening today in the hard core of the European monetary system—above all, in Europe's manufacturing powerhouse, Germany. The long-term rise in the Deutschemark was previously met, as in Japan, by strong gains in productivity, and, hence, international competitiveness, that result from high levels of investment: from putting massive amounts of new equipment at the disposal of a well-trained and motivated work force. As in Japan, the ability to make further progress in that way is limited. Since the liberation of central Europe from Russian domination, that region could be to the Germans what South East Asia is to Japan: a source of inexpensive land, and skilled, motivated and, not least, cheap labour.

Until recently, the German manufacturing sector had resisted pressure to invest abroad. Currencies in Europe were interlinked (albeit not as tightly as industrialists would have liked), and pressure from Japanese imports was lessened by protectionist agreements, as in the case of the motor car business, and by petty customs regulations, as in the case of consumer electronics.

The Deutschemark has been at the heart of the European Currency system, a role hoisted on it by the Bundesbank's independence from political pressures, and single-minded objective of maintaining its domestic value, i.e., of fighting inflation. That determination has resulted in the Deutschemark being viewed, internationally, as a store of value. Resulting long-term currency strength has forced German industry, like that in Japan, to invest in productivity-enhancing equipment to overcome the loss of competitive edge. Social rigidities, legislation, and powerful unions have prevented German manufacturers from reducing costs by reducing wages.

The ability to become more competitive in export markets is now limited; German manufacturers can no longer rely on domestic production for manufacture of export goods. A recent visit to Germany has convinced us that the best German companies have embarked on a period of overseas investment, especially in Eastern Europe. The main beneficiaries will not, surprisingly, include the former East Germany (promises to raise wages to the levels of those in the West will inhibit that), but Poland, the Czech Republic, and, perhaps, eventually, Russia.

We are looking for companies able to cope with this changing world; that have globally acceptable products and services; and, above all, a global outlook that enables them to exploit the opportunities presented by freer trade, whilst responding successfully to the competitive threats it poses.

Portfolio Policy

Our stock selection has been shaped by a strong conviction that we live in a world where the rate of inflation is in secular decline. Increased levels of global competition, and the breaking down of trade barriers, combined with the alertness to monetary pressures on price levels, have made it difficult for companies to raise profits by raising prices. Consequently, high rates of earnings growth are scarce, and increasingly valuable.

The portfolio comprises numerous companies that, notwithstanding the difficulties, have been able to grow earnings rapidly— whether through increasing market share for existing products, introduction of new products, improvements in productivity, or increasing involvement in high growth geographical regions or business sectors. The portfolio is thus concentrated in highly-valued European and South East Asian growth stocks. We added to holdings of these growth companies, and four such additions—**Rentokil**, **Astra**, **Canon** and **Wolters Kluwer—** as well as older holdings **B Sky B** and **Randstad**, produced outstanding returns in the third quarter.

While this policy of emphasizing companies with growing earnings has been successful, it carries risk. These companies' shares are expensive; if growth falters, their prices can fall far. In the third quarter, that befell several of our companies, all smaller companies, in niche businesses in Europe. The high margins previously enjoyed by **Coflexip**, a French company that has led the world in the manufacturing of flexible undersea piping for the oil industry, attracted new competitors to their niche. In the case of **Krones**, a German manufacturer of beverage bottling machinery, management failed to respond in timely fashion to the cost pressures exerted on them by a strong currency in their domestic production base. Even industry-dominating companies, such as **Crown, Cork and Seal**, are finding they can no longer pass on increased costs of raw materials.

We are responding by selling companies, such as **Krones**, where management is not taking firm action, even if it means taking losses. We are also taking some profits in holdings where growth has been sustained, but high stock prices do not adequately reflect the risks attendant with that growth. Examples are the aforementioned **Randstad** and **Nestlé Malaysia**, the local arm of the world's largest food company.

Companies operating in a strong currency environment have the opportunity to restructure and remain competitive, and will do so if they posses strong, flexible management and a global outlook. US companies faced similar challenges in the mid-1980s. The best, such as Caterpillar, globalised, restructured, cut costs—and were thus very well positioned to prosper in any currency environment. Lesser companies, such as International Harvester, were unable to face reality, and disappeared. European multi-national **ASEA Brown Boveri** is perhaps the best example of a company that saw both necessity and opportunity, and launched a twin attack on costs, through investment in Eastern Europe, and on new markets, in the Far East. The vision of its management in implementing this strategy is now widely recognised. Our job is to identify other such winners in a tough world and to avoid the losers.

Transactions

During the quarter, we sold all of our shares in two foreign and two US companies, reduced our position in another four, and bought four new holdings.

The sales included:

- **Generale des Eaux**, a French conglomerate whose business is based upon water supply and treatment, waste management, telecommunications and property, has proven too close to corrupt French politics. Senior management was ensnared in the current corruption investigations, and replaced. The arrival of a new and determined CEO led to a recovery in the share price. His abilities, however, will not be enough to overcome the secular difficulties in the French economy that Generale des Eaux faces.

- **Nestlé Malaysia** is a fine company operating in a growing market. The stock price has advanced to a level where foreseeable growth is discounted, but not so the foreseeable risks, such as higher commodity prices and cyclical risks to the Malaysian economy. We sold part of the position.

- Similar logic applies to **Randstad**, the Dutch temporary employment agency, where consensus is now that this is a growth company. Whilst we agree that outsourcing of labour is a business that will grow over cycles, earnings remain vulnerable to an economic slowdown. After substantial appreciation, we reduced our position.

- US holding **Corning** has been a disappointment. Well publicised problems with the legal wrangling over breast implant litigation have masked the underlying problem, that, in all business segments, higher volumes must compensate for lower prices. Mounting evidence that management is failing to cope with these pressures led us to sell.

- US mid-Atlantic regional bank **First Fidelity** was taken over in one of a series of mergers in the rapidly consolidating banking industry. We sold for cash, realising a large gain, as the market price moved close to the value of the offer.

In global portfolios only, we also sold our positions in **Sika**, a Swiss specialty chemicals company, and **Nylex Malaysia,** the local plastics subsidiary of UK-based industrial giant, BTR. Warrants in **Senshukai**, the Japanese mail order company, expired without being exercised.

New purchases were:

- **Sime Darby** is the largest listed conglomerate in Malaysia with extensive interests in plantations, manufacturing, banking, infrastructure development, services and trading. The company, which is conservatively managed, focuses on well-defined businesses where it commands major market shares. Its activities span the entire Asia-Pacific region including Singapore, Hong Kong, the Philippines and Australia. Sime's recent acquisition of a major Malaysian banking group provides greater diversity and stability to its earnings.

- **Kyocera**'s core business and main profit source is the production of ceramic capacitors and the mounting of silicon chips in ceramic packages. The company also produces advanced electronic components, telecommunication equipment, optical devices and cameras. Kyocera's listed affiliate, DDI (22% owned), is a mobile phone operator and long distance common carrier in Japan, ranking #2 behind NTT. DDI accounts for nearly 25% of Kyocera's net asset value. As Kyocera benefits primarily from the volume of chips it mounts for its customers, two secular trends underpin its long term growth: the growing sophistication of computer chips (most of which require ceramic bonding in their manufacture) and the explosion of chips in a wide variety of products, not just computers.

- **Primagaz** is the leading distributor of liquefied petroleum gas (LPG) in Europe. Primagaz represents a rare combination of steady cash earnings from its core Western European markets with the prospect of high unit volume growth from newer markets in Eastern Europe. Management is achieving profit growth even in mature Western markets through cost reductions and productivity-enhancing capital investment.

- **Colgate-Palmolive** is a leading global consumer products company, marketing its products in 194 countries and territories under such internationally recognized brand names as Colgate, Palmolive, Mennen, Ajax, Fab, Soupline / Suavitel and Hills' Pet Products. A hiccup in Colgate's earnings, stemming from the Mexican devaluation and a soft European market, provided a favorable entry into the company that ranks among the top emerging market consumer plays. The combination of globally recognised brands with dominant market shares in international growth markets should enable Colgate to deliver steady, mid-teens earnings growth over the long term.

We also added positions in French holding company **Gaz et Eaux** and Dutch technical publisher **Wolters Kluwer** to global portfolios, and increased our holdings in **Ito Yokado**, the Japanese retailing giant.

HARDING, LOEVNER MANAGEMENT
Global Equity Performance Summary 09/30/95

	Calendar Year Returns					
	1995 9 mos.	1994	1993	1992	1991	1990
HLM Global Equity Composite	**15.7**	**-0.1**	**24.2**	**9.1**	**31.6**	**3.6**
Financial Times World Index	*14.2*	*5.9*	*22.6*	*-5.1*	*19.6*	*-17.0*
Morgan Stanley Capital International World Index	*15.7*	*5.6*	*23.1*	*-4.7*	*18.7*	*-16.4*
S&P 500	*29.8*	*1.3*	*10.1*	*7.7*	*30.2*	*-3.1*
Lipper Global Fund Index	*13.3*	*-2.2*	*32.8*	*0.1*	*20.3*	*-9.1*

	Average Annual Returns for periods ending 09/30/95			
	1 year	3 years	5 years	Since Inception*
HLM Global Equity Composite	**12.1**	**13.9**	**16.2**	**14.5**
Financial Times World Index	*13.1*	*15.7*	*12.0*	*7.0*
Morgan Stanley Capital International World Index	*15.0*	*16.4*	*12.3*	*7.4*
S&P 500	*29.7*	*15.3*	*16.6*	*13.3*
Lipper Global Fund Index	*8.4*	*14.0*	*12.3*	*8.9*

* Inception date: 11/30/89

Notes:

1. Returns shown are time-weighted total returns, and include reinvestment of dividends.
2. Returns from all cash reserve and equivalents, bonds and/or convertible securities used in place of equities are included in performance calculations.
3. Composite calculations have been weighted by account size.
4. Figures include all global equity accounts under discretionary management from their inception dates, including accounts no longer in existence.
5. No alterations of composites as presented here have occurred due to changes in personnel or other reasons at any time.
6. No selective periods of performance have been utilized.
7. Results are presented after brokerage commissions but before management and custodial fees. Management fees are described in our Form ADV Part II. Inclusion of standard management fees would reduce annual returns for global composite by approximately 1%.
8. Lipper Index performance is after fees and expenses.

Account summary information:

1. Number of accounts included in composite: 1989: 1; 1990: 4; 1991: 7; 1992: 14; 1993: 17; 1994: 17; 1995: (3Q) 12.
2. Total market value at year-end of accounts included in composite ('000): 1989: $1,564; 1990: $15,311; 1991: $36,637; 1992: $64,513; 1993: $93,197; 1994: $112,683; 1995: (3Q0 $151,679.

HARDING, LOEVNER MANAGEMENT
International (Non-US) Equity Performance Summary 09/30/95

	Calendar Year Returns					
	1995 9 mos.	1994	1993	1992	1991	1990
HLM International (non-US) Equity Composite	**7.7**	**2.5**	**46.3**	**9.9**	**21.9**	**-12.9**
Financial Times World ex.-US Index	*6.0*	*8.4*	*32.1*	*-13.1*	*13.3*	*-23.1*
Morgan Stanley Capital International World Ex-US Index	*7.3*	*7.6*	*32.6*	*-11.9*	*12.4*	*-22.8*
Lipper International Fund Index	*8.1*	*-0.9*	*39.2*	*-4.3*	*13.2*	*-12.4*

	Average Annual Returns for periods ending 09/30/95			
	1 year	3 years	5 years	Since Inception*
HLM International (non-US) Equity Composite	**3.8**	**17.9**	**16.9**	**12.2**
Financial Times World ex.-US Index	*4.4*	*13.5*	*10.7*	*3.2*
Morgan Stanley Capital International World Ex-US Index	*6.1*	*13.9*	*10.8*	*3.7*
Lipper International Fund Index	*3.3*	*13.8*	*11.0*	*6.9*

* Inception date: 9/30/89

Notes:

1. Returns shown are time-weighted total returns, and include reinvestment of dividends.
2. Returns from all cash reserve and equivalents, bonds and/or convertible securities used in place of equities are included in performance calculations.
3. Composite calculations have been weighted by account size.
4. Figures include all international equity accounts under discretionary management from their inception dates, including accounts no longer in existence.
5. No alterations of composites as presented here have occurred due to changes in personnel or other reasons at any time.
6. No selective periods of performance have been utilized.
7. Results are presented after brokerage commissions but before management and custodial fees. Management fees are described in our Form ADV Part II. Inclusion of standard management fees would reduce annual returns for international composite by approximately 1%.
8. Lipper Index performance is after fees and expenses.

Account summary information:

1. Number of accounts included in composite: 1989: 1; 1990: 2; 1991: 3; 1992: 4; 1993: 5; 1994: 14; 1995: (3Q) 25.
2. Total market value at year-end of accounts included in composite ('000): 1989: $10,899; 1990: $10,599; 1991: $6,770; 1992: $12,061; 1993: $23,003; 1994: $110,370; 1995: (3Q) $307,396.