

# Global Core Equity Investing

## 1992 Year-end Report

The following material is excerpted from the 1992 year-end 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.

### Description

The global core equity portfolio invests worldwide in common stocks and convertible securities with the objective of preserving and increasing investors' capital in US dollar terms.

### Portfolio Overview

At December 31, 1992, the portfolio:

- held investments in 40 large companies, including 19 US companies;
- was broadly diversified in terms of geographic distribution;
- consisted of 96% common stocks, the balance in cash and currency options; and
- had an annual yield of 2.5%.

### Performance

	1992	1991	1990	<u>Since Inception (12/89)</u>	
				Cumulative	Compound
	-----Total Returns %-----				
<b>Global Core Equity Portfolio</b>	<b>11.3</b>	<b>28.5</b>	<b>6.4</b>	<b>57.5</b>	<b>15.9</b>
Comparative Benchmarks:					
FT World Index	-5.1	19.7	-17.1	-2.8	-0.9
S & P 500	7.7	30.4	-3.1	39.3	11.4
Global Fund Index (Lipper)	-3.2	18.7	n/a	n/a	n/a

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.

The global core equity portfolio's 1992 results were good in absolute terms, and excellent in light of the poor conditions prevailing throughout the year in most major stockmarkets. The portfolio's good performance was attributable to our investment approach:

- Our focus on the very best companies meant that remarkably few of its holdings suffered earnings disappointment, despite soft business conditions worldwide.
- Our bias towards growing companies resulted in large performance contributions from selected holdings in S.E. Asia (e.g., **Bangkok Bank, Hong Kong Gas**).
- Our emphasis on financial strength and earnings quality resulted in *high* exposure to Switzerland (**Nestlé, Sandoz**) and the US (**AIG, Fannie Mae**), two of only a handful of markets to rise in the year; and *low* exposure to such disastrous markets as Spain and Japan.

*The portfolio's company-oriented, "bottom-up" approach led to favorable stock selection, country allocation and investment performance.*

## **Global Review**

- 1992 was a year of unusual turmoil in many places:
  - Succumbing to sustained high interest rates, Western Europe, including Germany, slipped deeper into recession, resulting in collapse of the European currency system and heightened socio-political instability.
  - The Japanese financial system teetered on the edge of violent contraction, belayed by only by government promises of future cash injections.
  - Eastern Europe struggled to find new equilibrium in the aftermath of Soviet hegemony; civil war raged on the borders of the European Community.
- Of 29 major stock markets worldwide, only five rose in the year, in US dollars:
  - The US, which stood out as an oasis of relative calm despite concerns about lingering recession and the change in political leadership;
  - Hong Kong, where euphoria over the boom in Southern China was subsequently punctured by political bickering;
  - Malaysia, which was quiet all year, but soared as interest rates fell in the fourth quarter;
  - Mexico, which recovered after a precipitous first-half fall; and
  - Switzerland, which was a steady performer during the year despite voter rejection of the rest of the European continent.

## Stock Market Outlook

- European stocks are cheap, but the outlook for corporate earnings is poor.
  - Interest rates in Germany are still the key: when the Bundesbank acknowledges that *recession*, no longer *inflation*, is the enemy, stock prices will recover.
- US stocks are expensive, but the outlook for earnings is good.
  - Rising earnings may carry stock prices higher, though earnings multiples are unlikely to rise.
  - While the Fed is on the side of relaxation, valuations are sustainable.
- The Japanese market is still expensive and growth is hard to find— the least favorable combination of factors for investment.
- Stocks in the rest of Asia are reasonably priced and earnings are growing rapidly— the most favorable combination of factors.

## Portfolio Activity in the Fourth Quarter

Stocks sold in the quarter were:

- **Telefonica**, the Spanish telephone company, in reaction to disappointing interim results and confusing accounting changes.
- **Canon**, an important portfolio holding since 1989. Its share price had withstood the Japanese market's decline based on strong growth of its laser printers and color copiers. A recent company visit, however, convinced us that weakness in camera and camcorder sales to Japanese consumers, and the absence of exciting new products threatens future growth.

Stocks purchased in the quarter were:

- **Kimberly Clark de Mexico**, the Mexican subsidiary of the US Kimberly Clark, which manufactures disposable diapers, bathroom tissue, notebooks, and business papers. Kimberly is poised to benefit from rapid growth of Mexican consumer's disposable income and spending.
- **Generale des Eaux**, France's largest water utility and municipal waste services company. Generale has the business strength and defensive characteristics to continue growing during the current period of French recession.

- Holdings in **Singapore Airlines, Bandag, Crown Cork & Seal, and Dover** were increased.
- The portfolio hedged part of its European currency exposure by purchasing Swiss francs and D-mark put options.

## Ten Largest Holdings at December 31, 1992

Weighting	Company Name	Stock Performance	Company Business
4.6%	<i>Hong Kong &amp; China Gas</i>	+72%	<i>Unregulated gas utility</i>
<p>A leading growth stock in the strong Hong Kong market, HK Gas again delivered its customary 20%+ growth in earnings and dividends. The shares are no longer “cheap” but still represent good value based on continued 20% growth.</p>			
4.5%	<i>Nestlé</i>	+28%	<i>World's largest food company</i>
<p>1992 was a good year for Nestlé in a difficult European environment. Increased earnings and dividends, a successful acquisition of Perrier, a 10 for 1 stock split, and better corporate disclosure in preparation for a NYSE listing in 1993, attracted attention to Nestlé's strengths. The shares remain undervalued against other global food companies offering comparable growth.</p>			
4.3%	<i>Federal National Mortgage Association (“Fannie Mae”)</i>	+12%	<i>US quasi-governmental mortgage company</i>
<p>The year saw 17% earnings growth and a 33% dividend increase, without reduction in credit quality or significant change in regulation. Fannie Mae continues to benefit from the weaknesses of the savings &amp; loan industry and is only modestly exposed to potential interest rate increases. The shares are still excellent value at only 11 times 1993 earnings.</p>			
4.0%	<i>Sandoz</i>	+26%	<i>Swiss drug company</i>
<p>Swiss and global investors began to think of Sandoz more as a growing, worldwide pharmaceutical business and less as a Swiss chemical company, as highlighted by the company’s shift to international accounting standards. As a result, Sandoz shares are more highly valued, though they still sell at a large discount to better known but comparable drug companies.</p>			
4.0%	<i>L'Oreal</i>	+46%	<i>French cosmetics company</i>
<p>L'Oreal demonstrated the strength of its consumer brands by nearly achieving its 15% earnings growth goal in the face of European and US recession— a rare achievement for French companies in 1992. Dividends were increased the customary 15%. The portfolio holds non-voting shares that still sell at a large discount to the ordinary shares even after three years of dramatic outperformance.</p>			

3.8% *Royal Dutch Petroleum* +1% *International oil company*

It was a bad year for most large oil companies reflecting weak oil demand, poor refining margins and cyclically-depressed results from chemical divisions. RD's modest increase in earnings and a dividends were again superior to the industry average. RD remains the paragon of the industry in terms of financial quality, proven reserves, and growth prospects; its shares, at an average industry valuation, are attractive.

3.8% *Bangkok Bank* +135% *Largest bank in Thailand*

1992 was an extremely favorable business environment for Thai banks, resulting in a year of strong earnings, an 18% dividend increase, a 10 for 1 stock split and an extraordinary rise in the share price for Bangkok Bank, the largest and best of the group. At their current price Bangkok Bank shares may not adequately reflect the risks of the emerging Thai market and are therefore candidates for sale.

3.3% *American International Group* +19% *Insurance*

Unlike most of the insurance industry, AIG will report earnings increases this year because its AAA balance sheet is liquid, it owns little junk bonds or real estate, its large Asian businesses are booming, and its new airplane leasing and other financial businesses are growing rapidly. AIG's management owns lots of stock, which provides strong comfort that loss reserves are adequate.

2.9% *Abbott Labs* -11% *Hospital products & health care*

Like clockwork, Abbott delivered its customary 15%+ annual growth in earnings and dividends— without recourse to price increases. New drugs and diagnostics offset weakness in nutritional and hospital supply products. Reliable 15% growth is attractive in an environment of low inflation and low interest rates even at the current valuation of 20 times 1993 earnings. Nonetheless, the shares declined last year, in line with the sector, due to health care reform anxiety

2.8% *Apple Computer* +4% *Computer manufacturer*

1992 was a modest year for Apple shares despite an excellent year for its business including successful introduction of new products and large gains in sales and earnings. Last year Apple sold more than 2.5 million Macintosh computers, a 20% increase. Apple gets little respect from investors, who incorrectly value the company as a cyclical commodity producer at only 13 times current earnings.

Note: "Stock Performance" refers to the *internal rate of return to the portfolio* in 1992 on its investment in the indicated stock. It is dependent on the timing of purchases and sales of the stock by the portfolio during the year, and in general does not correspond to the simple price appreciation of the stock during 1992.