Harding, Loevner Management
Global Equity Investing
1993 Year End Report

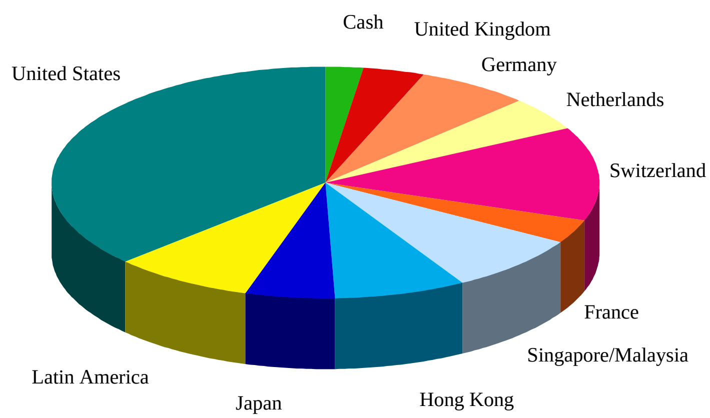
The following material is excerpted from the 1993 year end report on an global portfolio managed by Harding, Loevner Management ("HLM"). The portfolio is invested worldwide in common stocks and convertible securities with the objective of preserving and its capital value in US dollar terms.

Portfolio Overview

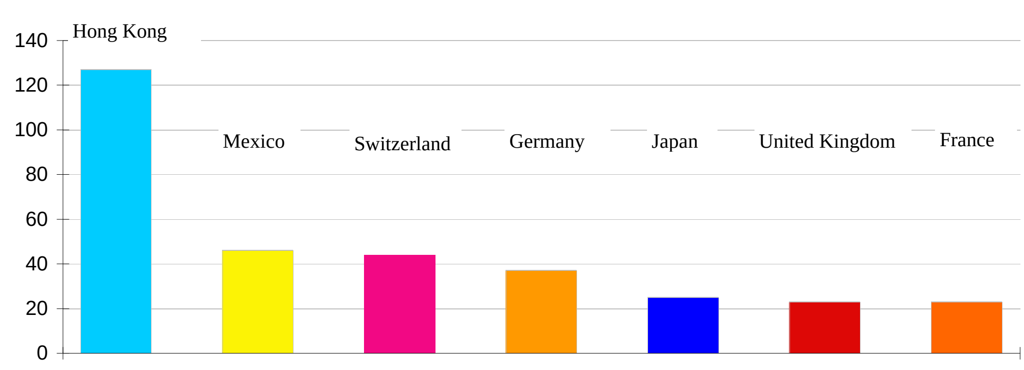
At December 31, 1993, the portfolio:

• held investments in 46 companies; including 20 US companies;
• was broadly diversified in terms of geographic and industry distribution;
• consisted of 95% stocks and 5% cash, convertible bonds and warrants; and
• had an annual yield, before expenses, of 2.2%.

Portfolio Allocation by Country as of December 31, 1993



1993 Performance of Major Markets



Performance

	1993	1992	1991	1990	Since Inception (12/89) Cumulative	Compound
	Total Returns %					
Global Core Equity Portfolio	**26.3**	**11.3**	**28.5**	**6.4**	**98.9**	**18.3**
Comparative Benchmarks:						
FT World Index	22.6	-5.1	19.7	-17.1	19.0	4.4
MSCI World Index	22.6	-5.2	18.3	-17.0	17.7	4.1
S & P 500	10.8	7.7	30.4	-3.1	53.3	11.0
Global Fund Index (Lipper)	32.7	-3.2	18.7	-11.2	40.7	8.7

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.

Global Review and Stock Market Outlook

HLM manages the global core equity portfolio “from the bottom up”, constructing (and reconstructing) the portfolio with shares of diverse, high-quality companies that trade at reasonable prices. HLM relies upon this company-by-company approach to portfolio construction, rather than upon a disembodied “world view,” as the primary basis for allocating the portfolio among various countries or industries. This is *not* to say that HLM lacks a view of the world. HLM's view of the world is gathered from the experiences and business outlook of the companies that it analyzes. It is the view from ground level, the view of *actual participants* in the global economy, not of detached observers.

The end of a successful year of investment is a good time to review those companies' experiences, how they have affected HLM's view of the world, and its expectations for the future.

Events of 1993

What Did Not Go Wrong

A year ago, 1993 appeared to be fraught with risk. About to be inaugurated was a new US President, one whose election resulted from dissatisfaction with prior leadership and from pessimism about the future for America, rather than the traditional optimism. The US recession had spread to Europe where it was being made worse by the fiscal problems facing Germany in paying the escalating costs of re-unification. The widespread hopes that had been ignited by the tearing down of the Iron Curtain had been doused by economic slump. Recovery was not visible on the horizon and its eventual arrival was threatened by currency strains and a rising belief that protectionism was a viable way to defend individual economies from further unemployment.

In the Near East, Russian disintegration appeared an unfathomable threat to Europe's stability. In the Far East, China was embarked on a massive and unsustainable boom. In

Japan, the fragile banking system, its assets deflated by falling property and equity prices at the end of the "bubble" era, appeared in danger of collapse.

In the event, some of these risks faded and others failed to worsen. Remarkably, none of them did serious damage to financial markets— though some yet may. Most importantly, the world's commitment to free trade was reinforced, by the signing of a new GATT accord, and by US Congressional approval of the North American Free Trade Agreement. The *intellectual* argument for free trade had been won previously, but it took great *political* courage for the Clinton Administration to commit itself so fully to it.

Other potential flash points were precarious, though survived the year: Russia's elections passed quietly, though with disturbing gains for ultra nationalists. In China, boom gave way to slowdown, but not to bust. There are signs that the boom may have started again, however, so an eventual bust cannot be ruled out.

The Japanese banking system survived, but only barely. The sources of its ills, however, did also lead to the dramatic end of nearly fifty years of one-party rule and new leaders genuinely committed to overturning the political rot and financial corruption of the past.

The Economies

The world's major economies are out of sync. At the end of last year, most appeared to be moving together, and moving down. Today, however, the US economy is growing, while those of Europe and Japan are not. Recent visits to European companies, however, have convinced HLM that the general slide there has been arrested. European companies report increased demand from US customers and stabilizing demand locally. The former is no surprise, but it is still not evident in macroeconomic data that European recovery is in sight.

Of the OECD countries, only Japan continues its downward slide. Japan must restructure much of its industrial base, which was predicated on cheap capital and ever-growing export demand. It must restructure its consumer distribution and selling systems, which were devised to suppress consumer demand. And it must restructure its labor markets, which demanded limitless personal sacrifice, assumed a high degree of mutual loyalty and attached minimal value to women workers. These processes will inevitably be prolonged and difficult. Real action by Japanese companies on these challenges is only just beginning to replace rhetoric. That is not surprising insofar as the changes required at the company level represent not merely responses to cyclical slowdown, but are bound up in larger changes in the Japanese political, economic and social structure that, taken together, constitute a revolution as dramatic as that which is unfolding in Eastern Europe.

Lessons from 1993

Capitalism has triumphed.

The evidence for this unremarkable assertion is not just the end of the Cold War and the tearing down of the Iron Curtain. It is seen in the now ubiquitous belief that investment capital is a solution to, not a cause of, economic ills.

To reconstruct or to build an industrial base, developing countries need to invest and to invest heavily. In the past the most successful economies have been those with savings rates high enough to fund such investment—the countries of the Pacific Rim being the most prominent recent examples. The gap between local savings and local investment needs in developing countries, however, is increasingly being met by the excess savings of the rest of the world, in the form of international flows of investment capital. Savers in the mature economies of the West (and Japan) are increasingly attracted to investment opportunities in countries at an earlier stage of economic development. Those countries are attracting capital by providing the elements necessary for sustainable economic growth and high returns for investors. Those elements include a commitment to a market economy, to private ownership, and to protection for investors, in its broadest sense.

The triumph of capitalism is seen all over the world, from China to Mexico to the Czech Republic, countries where foreign investment is funding rapid development. The holdouts to this process of opening to foreign capital are not those with an ideological problem, but those with no need for others' capital—South Korea and Taiwan are examples. Ideological disputes are few now: Communist Vietnam is embarking on free market reforms and the University of Havana is offering courses in capitalism! In South Africa, the end of apartheid has been rapidly followed by the African National Congress's repudiation of its prior commitment to state ownership of industry.

Inflation has been controlled.

Commitment to market economies has resulted in enhanced mobility of capital: it provides companies with opportunities to cut costs through investment wherever it will be most effective. It is one aspect of a decline in inflationary pressures that is now widely recognised. Free trade, global competition and mobility of capital all combine to reduce prices to the consumer.

To some extent, the decline in global inflation is a cyclical phenomenon. Rising unemployment in the West has led to falling consumer demand and to companies' inability to make price rises stick. It is, however, also a secular phenomenon. Costs are falling as more effective uses of technology reduce the need to hold inventory, as production techniques improve and as distribution of goods is made more efficient. Competition is rising directly from the global commitment to free markets.

Companies can no longer rely on the power of brand names alone to sell products at premium prices. One of the lessons of "Marlboro Friday" in the US was that even the strongest brand names can no longer command superior prices, because they no longer assure superior quality. Manufacturing technology is now so readily disseminated that nearly all producers can provide goods of high quality, and Madison Avenue is unable to sustain the fiction that it is otherwise. Companies are scrambling to improve productivity through investment and through relocation of producton facilities to low cost areas.

Look East!

......is the watchword of the world's best companies. **Brown Boveri** is lowering costs by a shift in employment from Western Europe to Eastern Europe, taking advantage of the low costs and high skill levels of Czech and Polish engineers. It needs new capacity to meet the growing demand for power generation in Eastern Europe and, even more markedly, in the Far East. **Nestlé** is the world's largest food company. Its brands have lost pricing power in the developed world, but still command premium prices in the East, especially in Asia, where economic growth is providing the wealth that makes them affordable. That wealth is also leading to the emergence of intra-regional trade. Asia in itself has become an important and rapidly-growing consumer market.

The Best of All Possible Worlds?

Greater economic freedom, greater competition, more productive use of cheap computing power, and mobility of capital all imply low rates of inflation. In turn, they imply low nominal interest rates. Alan Greenspan is now the first Chairman of the Federal Reserve Board in memory to preside over an inflation rate lower than the rate of economic growth. In such circumstances, the earnings of the *best* companies can grow, notwithstanding limits on their pricing power.

The dangers to the stability of financial markets are not economic. Real interest rates are still high. In the absence of inflationary pressure, nominal interest rates can continue to decline, supporting equity prices and stimulating growth in corporate earnings. The dangers are political: Russia and its former satellites remain unstable, Europe lacks strong or cohesive leadership, and North Korea's economic disaster may lead to desperate gambits. Even in Japan, a *policy* solution to the country's problems exists, *political* gridlock may yet abort it.

The Portfolio

The global core equity portfolio is a low risk portfolio. This is true in the technical sense—volatility has been low relative to market indices and to comparable global funds—and in the qualitative sense—the companies it owns have strong business franchises and are of excellent financial quality. The portfolio's very high return this year must be regarded as exceptional. As is often the case in dissecting portfolio results, much of the exceptional return can be traced to a small number of companies that were the beneficiaries of a sudden shift in investor perception.

Hong Kong companies have long offered fast growth of corporate profits but with much perceived risk. In 1993 the consensus shifted, with international investors reducing their estimates of the political risk and thereby recognizing that share prices were too low in relation to the rate of profits growth. Despite the rising discord between Hong Kong's present rulers, the British, and its future ones, the Chinese, China has long been in effective control. HLM has held that view consistently, and this year the portfolio was well rewarded for it. Holdings in **Hutchison Whampoa**, **Jardine Strategic Holdings**, **South China Morning Post** and **Hong Kong Gas** all performed well.

In Singapore growth, not risk, was at issue. Political stability and financial strength have never been in doubt, but only recently, and belatedly, has the investment world recognised that those qualities have been augmented by a governmental commitment to growth, through encouragement to the private sector and entrepreneurialism in particular (the triumph of capitalism again!). Holdings in shipbuilders **Keppel** and **Jurong** responded to revitalised local demand for equity and to heightened international interest.

Mexican assets were also revalued as President Clinton took on personal responsibility for seeing NAFTA pass through Congress. HLM was attracted in mid year to excellent business franchises and high financial quality at very cheap prices—**Kimberly Clark de Mexico** and **Grupo Embotellador**. Both provided splendid returns, and immediate gratification, by more than doubling since purchase.

Changed perceptions of growth and risk were responsible for the rises in Hong Kong, Singapore and Mexico. In Switzerland and Germany, investors are under no illusions about the modest short-term outlook for growth, but have been attracted by high quality equity assets in a period of declining interest rates. Returns from the likes of **Deutsche Bank** (28%), global engineering company **Brown Boveri** (43%), and Swiss pharmaceutical company **Sandoz** (32%) have not been as spectacular as those in Southeast Asia, but have nonetheless exceeded world markets as a whole.

The growth component of the portfolio was strongly geared to the consumer in emerging economies: the two Mexican companies are good examples, as is trading company **EAC Malaysia**. Less obviously, **Nestlé**, and the other global Swiss companies, **Brown Boveri** and **SGS**, are growing strongly in Asia, while German bottling machine maker **Krones** has a full order book from selling its bottling machines to drinks companies in growing economies all over the world. In a startling illustration of HLM's "one world" thesis, one of the first crates HLM saw on a recent visit to Krones' factory in Neutrabling was addressed to **Grupo Embotellador** in Mexico City!

There were a few disappointments in 1993, concentrated among the portfolio's US holdings. **Corning** continued to suffer from the breast implant controversy and earnings also proved less recession resistant than hoped. **Apple Computer** suffered from pricing problems, the flip side of the disinflation which has helped financial markets so much this year. More generally, the year saw the US emerge from recession. Stocks of companies geared to cyclical recovery left those with financial quality and defensive earnings strength—those favoured by HLM— in the dust.

The Year to Come

1993 will be a hard act to follow. There are few markets today in which share prices are at odds with fair value. HLM will be devoting greater research time in several where potential bargains may still be found—South Korea, South Africa, Indonesia, Eastern Europe and Japan. Of these, the most fertile is likely to be Japan.

The Japanese market is broad and has long offered many high quality companies, but in recent years their share prices have usually been beyond even the most optimistic of valuations. The signs are that this is changing. Structural difficulties in Japan in the aftermath of the "bubble era" have led companies to relocate capacity in lower cost areas, such as Southeast Asia. Only now is the payoff to corporate profitability at hand as excess domestic labour is laid off. This marks a revolutionary change in attitude: a spreading belief that shareholders' interests should be put above those of employees and even those of Government, whose popularity has always been linked to maintenance of full employment. The ousting of the LDP represents the destruction of the unholy alliance between politicians, the bureaucracy, and the manufacturing and construction sectors. The system has been one in which corporations and politicians benefit at the expense of the consumer. The Hosakawa government recognises that, this time, investment cannot lead to economic recovery, but consumption can—and therefore must. Stimulation of consumption requires fundamental changes in retailing, distribution, the service sector and the tax system, with consequences, positive as well as negative, for the business prospects of individual companies.

Perhaps the most important influence on international markets will be the behaviour of US investors. American portfolios are dramatically under-represented in global equity markets, despite huge recent flows.

Fourth Quarter Portfolio Activity

HLM bought shares in four new companies in the quarter:

- **Nylex Malaysia** is a well-managed and well-capitalised company which is the Asian arm of a successful Anglo-Australian conglomerate, BTR. Nylex has been chosen by BTR to expand into the polymer and electrical engineering sectors in Asia. Its shares have not participated in the Malaysian bull market as a result of concerns about rising competition in the polymer business following tariff reductions in Malaysia. Little attention has been paid to Nylex's engineering business which has boomed, along with the country's electricity generating needs. Earnings are depressed at the moment, but will recover in 1994. This is a cyclical business in an economy where the cycle is firmly on the uptrend.
- **Sika** is a small, family-controlled Swiss company which operates globally. Its two core businesses are concrete additives and industrial adhesives/sealants. The company operates through more than 50 subsidiaries worldwide, with two thirds of sales made in Europe. It has maintained profitability throughout the recession in Europe through the global breadth of its business and because it sells specialty chemicals, not bulk products. Growth in future will be where infrastructure development proceeds apace: Eastern Europe and Asia.
- **Mikuni Coca Cola**'s main business is the production and marketing of Coca-Cola products, other soft drinks and imported alcoholic drinks. It has grown steadily over the past few years, has a good balance sheet, and is an example of a high quality Japanese consumer company whose share price is no longer divorced from reality.
- **AMP** is the world's leading manufacturer of electrical connectors used in consumer and industrial electronic products. AMP is the leader in a highly fragmented market, operating 165 facilities in 31 countries. The company's sales and earnings have stagnated in the sluggish economic environment of the past three years, but are poised to recover quickly as the global economy picks up. Connectors are still a growth market in which AMP is the dominant player in terms of market share, technology, financial strength, and global breadth.

HLM also added to holdings in trade show organiser **Blenheim Exhibitions**, in the UK and, in France to conglomerate **Generale des Eaux**, the latter through a rights offering of new shares at a discount to market price.

HLM reduced two holdings where price appreciation had led to the holding becoming very large. They were **Hong Kong Gas** and **Jurong Shipyard**.