

Harding, Loevner Management Global Equity Investing 1994 Year End Report

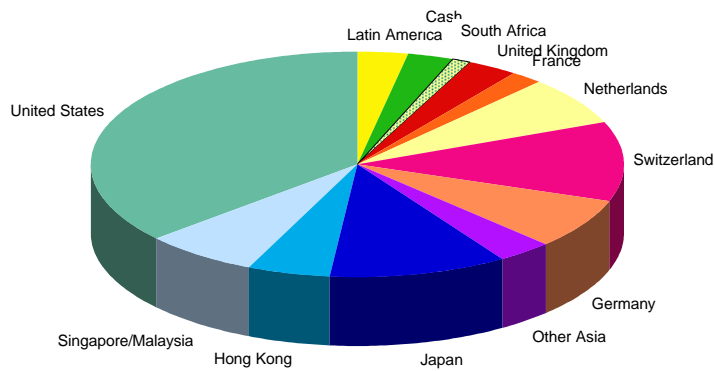
The following material is excerpted from the 1994 year-end report on a global portfolio managed by Harding, Loevner Management ("HLM"). The portfolio is invested worldwide in common stocks and convertible securities with the objective of preserving and increasing its capital value in US dollar terms.

Portfolio Overview

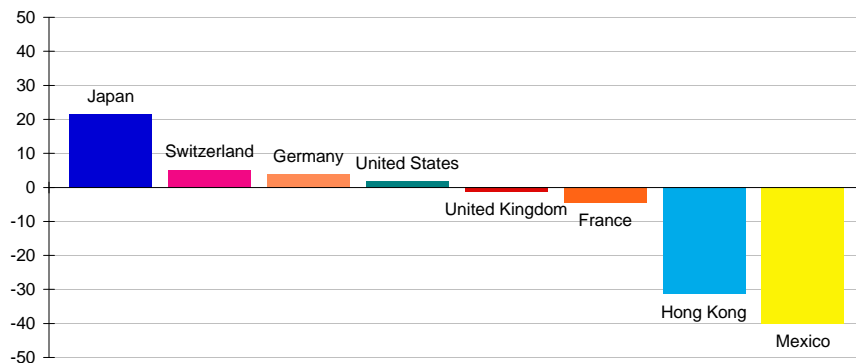
At December 31, 1994, the portfolio:

- held investments in 45 companies, including 16 US companies;
- was broadly diversified in terms of geographic distribution;
- consisted of 95% common stocks, the balance in cash, convertible bonds and warrants; and
- had an annual yield of 2.5%.

Portfolio Allocation by Country as of December 31, 1994



1994 Performance of Major Markets



Performance

	Annual Returns for periods ending 12/31/94			
	1 year	3 years	5 years	Since Inception
HLM Global Equity Portfolio	-0.1	10.6	13.0	13.6
Comparative Benchmarks:				
FT World Index	5.9	7.1	4.1	4.7
S & P 500 Index	1.3	6.3	8.7	9.0
Global Fund Index (Lipper)	-1.6	8.1	5.9	6.6

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 composite global portfolio fell in value by 3.1% in the fourth quarter. This result was substantially worse than that of the World Index (-0.9%), but somewhat better than the average global mutual fund (-4.3%). All of the damage occurred in the month of November, when most markets were down sharply, especially smaller and emerging markets in Asia, such as Hong Kong (-13.4% in the month) and Malaysia (-8.0%), in which the portfolio has significant investments. The portfolio was not significantly affected by the collapse in the Mexican currency and stock market in December.

Global Review and Stock Market Outlook

Here, at the end of an eventful year, it seems appropriate to look back and reflect on the entire year rather than on only the most recent quarter. We can say that 1994 was the year that the chickens— those hatched in the preceding half decade of low interest rates— came home to roost.

The Federal Reserve Board had sustained low short-term interest rates for a purpose: to replenish the capital of the US banking system, which had been depleted to the point of insolvency by the collapse of the real estate markets. A steeply sloping yield curve allowed banks to pay low rates on deposits and earn higher rates on their loan and bond portfolios, resulting in prodigious operating profits and, within a few years, restored financial health.

Low interest rates had unintended effects, too, however, in creating a speculative bubble, as investors sought higher returns than were available in short-term deposits, often heedless of the extra risk they were undertaking. Speculation was evident in traditional asset classes, such as bonds; cheap short-term loans were taken to finance investment in US and European long-term securities by investors ranging from small savers to banks to hedge funds. Stretching for extra yield also led institutional bond managers to more exotic foreign markets—high-yielding Mexican debt was favored by many, disregarding currency risk.

Speculative behavior also appeared in the 'new' asset classes. Vast inflows to equity mutual funds were increasingly directed at illiquid and risky 'emerging markets'. Commercial pressure for higher yields among money market funds, traditionally the most conservative of investors, became so fierce that some managers resorted to esoteric and leveraged derivative instruments. 'Inverse floaters', for example, provided small extra return at times of stable interest rates, but proved disastrous once rates turned upwards.

By early 1994, Alan Greenspan and the Fed governors felt they had fulfilled their objective of rescuing the banking system. They turned their attention to a newly emerging concern— inflation— and launched a 'preemptive strike' in the form of an interest rate increase that changed the terms of borrowing short and lending long. The result was a rush by investors for the exits, and a consequent crash in prices in traditional asset classes, where leverage had been applied— e.g., bonds— and in new asset classes where most speculation had taken place—emerging stock markets and derivatives. Orange County, Mexico, and Askin Capital (a spectacularly failed hedge fund) are but three front page examples of a single underlying dynamic that shaped financial markets in the year.

Rising real interest rates led to poor stock market performance in 1994. Internationally, most markets were down in local currencies, and up only after translation back into the US dollar, which declined in the year. Even in US dollars, world markets were flat for the year when Japan is excluded. In the US, by the end of November, nearly 60% of all stocks traded had fallen from their 1994 highs by 20% or more. The Lipper All Equity Funds Average was down by 2.3%.

How did the portfolio fare in this hazardous environment? The strong gains that were achieved in 1993 have been essentially preserved, a result with which we are satisfied. Most reassuring is that this result was achieved with the 'bottom up' investment approach that we employ— constructing portfolios company by company— notwithstanding that that approach frequently leads us to make significant investments in a number of emerging markets that performed especially poorly in 1994. In fact, we think the recent result was achieved precisely because we stuck to our knitting, and *did not* adjust the absolute standards of quality and value that we require of our portfolio investments, to accommodate the prevailing (bullish) mood of the investing public and investment industry in the period immediately preceding.

In what specific ways did our discipline enhance or detract from the performance of the portfolio in 1994? Perhaps its most striking contributions were the portfolio shifts in southeast Asia and Latin America that the bottom up approach brought about over the course of the year. At the outset of the year, the portfolio was heavily exposed to southeast Asia through a number of large, long-standing investments. Three of the most successful, **Jurong Shipyards**, **Hong Kong & China Gas**, and **East Asiatic Malaysia**, appreciated strongly, reaching valuations that made us uncomfortable. They were sold— fortuitously prior to sharp declines in their respective markets. The portfolio retained other southeast Asian investments, such as **Hutchison Whampoa**, **Nylex**

Malaysia and **Johnson Electric**, that continued to trade at reasonable prices, and their subsequent share price declines hurt the portfolio's performance. Towards the end of the year, however, valuations of many of our favorite southeast Asian companies again reached levels that we regard as attractive, with the result that we increased our commitment to the region with a new holding in Indonesian distributor **Wicaksana**, and renewed investments in two previously held companies, **Bangkok Bank** and **Nestlé Malaysia**.

The portfolio sidestepped December's disaster in Mexico by selling its holdings there, **Kimberly Clark de Mexico** and Pepsi bottler **Gemex**, in the middle of the year. Though we had no prescience of the coming collapse of the Mexican peso and stock market, we acted on the perception that speculative interest had driven the prices of the portfolio's Mexican investments too high. We redeployed proceeds further south, where better value was perceived, in Argentina's leading brewer **Quilmes**. Mexican Coca Cola bottler, **Pan American Beverages**, was retained because its business spans Brazil and Columbia as well as Mexico. These holdings have declined in price, amidst the regional anxiety stemming from Mexico.

In other emerging markets, being sensitive to value and quality and insensitive to prevailing opinion, helped to enhance 1994 returns. Shares of industrial conglomerate **Liberty Life Strategic Investments** appreciated as confidence in that country's political and economic stability increased over the year.

US holdings represent a balanced group of high quality companies. At around 35%, the portfolio's US weighting remained low in relation to its past history and the World Index throughout the year. US holdings are predominantly cyclical companies whose earnings should rise strongly as the US economy expands: oil and oil service companies; capital goods producers such as **AMP** and elevator maker **Dover**; and specialty industrial products producers such as **Lubrizol** (oil additives) and **Corning** (fiber optic cable). Dislike of more deeply cyclical companies with mediocre secular growth prospects kept the portfolio away from such poorly performing groups as auto makers, steel makers and commodity chemical companies. Of note, though, is the addition of **Cummins Engine** in September. We believe that its growing exposure to the electrical generation and light truck markets has reduced the company's cyclicity and enhanced its long-term growth rate. On the other hand, our reluctance to invest in companies whose businesses we do not understand well led to a near-absence of technology stocks. Except for **Apple Computer**, which was sold in October, the portfolio was not helped by the strong performance of this sector.

The portfolio's performance was hurt by its complement of US financial companies: **J. P. Morgan**, **First Fidelity Bank**, **Fannie Mae** and specialist insurer **EXEL**, each a superbly managed, strongly capitalized company with a leading market position and good growth prospects—paragons of the type of company in which we seek to invest. Despite share prices that reflect PE multiples half those of the broad market, financial

stocks moved steadily downward behind the bond market. A better outlook for bonds will improve their prospects.

According to our long-standing prejudice, European investments remained concentrated in the 'sound money' countries— Germany, Switzerland, and the Netherlands— and absent from countries of the 'Qué será, será' school of economic management, such as Italy and Sweden. This bias, per se, did not enhance 1994 performance, as the least austere group actually performed slightly better for the entire year in both local currency and US dollar terms (though with great volatility). Concentration in the DM bloc did, however, give us the confidence to carry these investments without fully hedging the currency, a posture that greatly helped returns in a year of US dollar depreciation. Among the companies owned are many whose prospects are tied to rising capital spending in a recovering Europe, East and West, and in the developing world: **Hochtief** (construction), **Deutsche Bank**, **Sika** (concrete additives), **Krones** (bottling machines), and **Brown Boveri** (power plants).

The UK and France— the waffler and the wannabee, where sound money is concerned— were lightly represented by holdings in **Hanson**, **Blenheim Exhibitions** and **Générale des Eaux**.

The absolute standards of quality and value which we try to apply consistently across markets have prevented all but a handful of potential investments in Japan, notwithstanding its large size and prominence in the World Indices. The Japanese market, for reasons relating to the unique arrangements among industry, government and financial institutions, and its inward looking public, is characterized by unreasonably high valuations accorded to slow-growing companies. Thus, the portfolio's performance benefited to only a small degree from early 1994's strong rise in the Japanese market, amplified by a rising Yen. Japanese companies owned by the portfolio, personal computer dealer **Canon Sales**, **Mitsubishi Heavy Industries**, and auto component maker **Nippon Denso**, were positive contributors to performance. Exceptions were retailers **Mr. Max** and **Senshukai**, victims of increased competition in the retail sector, and power tool maker **Makita**, whose global competitive position was eroded by the appreciation of the yen.

Looking ahead to the coming year, what can we expect? Worldwide economic growth seems set to continue, though high real interest rates should cause growth rates to slow and interest rates themselves to stabilize. Inflation remains a much talked about fear, but not a credible danger. To be sure, securities markets are vulnerable to further unwinding of speculative investments— to the sale of long-term assets in favor of shorter-term interest bearing securities. In particular, there is a danger that the US mutual fund industry will see a reversal, not just a slowdown, in the vast flows it has seen in the last few years.

The internationalization of US savings is a trend that will continue, but a pause would severely test liquidity in many emerging markets, revealing the over dependence of many emerging economies on other peoples' savings and, in some cases, breaking the

virtuous circle of capital inflow, low domestic interest rates, growth, rising internal and external confidence, leading to more capital inflow that has characterized most emerging markets in the past half decade. Mexico is the first but is unlikely to be the last such example.

Against such a background of continued earnings growth and moderating interest rates, and despite the prevailing mood of bearishness, valuations of stocks across the world are quite reasonable.

We continue to find a wide range of companies whose business prospects are excellent and whose shares trade at reasonable prices. Accordingly, the portfolio remains fully invested. Careful attention to quality and value should continue to help us to avoid situations that present speculative dangers and uncompensated risk.

Portfolio

We have attached to this report a list of a sample global portfolio's holdings and their value, in place of the usual 'Top Ten Holdings' list. More details of any or all of the companies held are available upon request.

Transactions

In the fourth quarter, we bought shares in three new companies and sold five. The new companies are:

- **Ito Yokado** is Japan's leading retail company, owning a department store chain, fast food restaurants, Japan's Seven-Eleven business, and others, including Southland in this country. As well as being the biggest in the industry, it is the best, by most measures of profitability and of financial stability.
- **Cummins Engine** is a leading worldwide designer and manufacturer of fuel-efficient diesel engines, components and power systems for trucks and industrial equipment. Its shares are modestly valued after a long period of heavy capital spending to produce more fuel efficient engines to meet stringent new environmental regulations. Rapidly growing sales of power generation equipment in Asia provide a new area of growth. The company has recently doubled the quarterly dividend and started a share repurchase program.
- **Unocal** is an integrated oil company with a superior U.S. natural gas production profile, profitable operations in the Far East, and strong sensitivity to both oil and natural gas prices. Unocal's revenues are highly sensitive to the prices of both oil and gas, with the bulk of earnings coming from production from its extensive reserves. In the last few years, the company has become more sensitive to the need to create shareholder value, and has cut costs, restructured and made significant overseas investments. In particular, it has acquired the rights to develop, by the end of this decade, several potentially huge gas fields in South East Asia.

We also added to holdings in Swiss inspection and measurement company **Surveillance**; to **Fannie Mae**; and to **Sabine Royalty Trust**.

The five sales were:

- **Mr. Max**, a Japanese discount retailer. Competition has grown for Mr Max as it has expanded out of its home area and margins have been under pressure. The changes we expected in Japanese retailing have come about more quickly than we expected. The winners will be the large diversified companies, such as Ito Yokado, into which proceeds were reinvested.
- **Apple Computer**'s shares rose strongly, partly in response to a successful new product introduction, but partly on takeover speculation. We took a profit.
- In the UK, we have owned **Trafalgar House** throughout a difficult period of restructuring under the control of the Jardine Matheson empire. Just as recovery was in sight, led, as we expected, by the synergies with Jardine's own Asian operations, the company announced a takeover bid for an English electricity distribution company. Whatever the merits in the financial engineering sense (and the bid has been very cleverly financed and structured), this is a regulated industry without the long-term growth characteristics we had expected in the rest of Trafalgar's operations.
- We realised a tax loss in **Burlington Resources**, switching proceeds of sale to **Unocal**, as described above.
- Finally, we sold **YPF**, the leading Argentinean oil company, reinvesting the proceeds into **Unocal**, in whose shares we perceived equivalent oil sector value without emerging market risk.