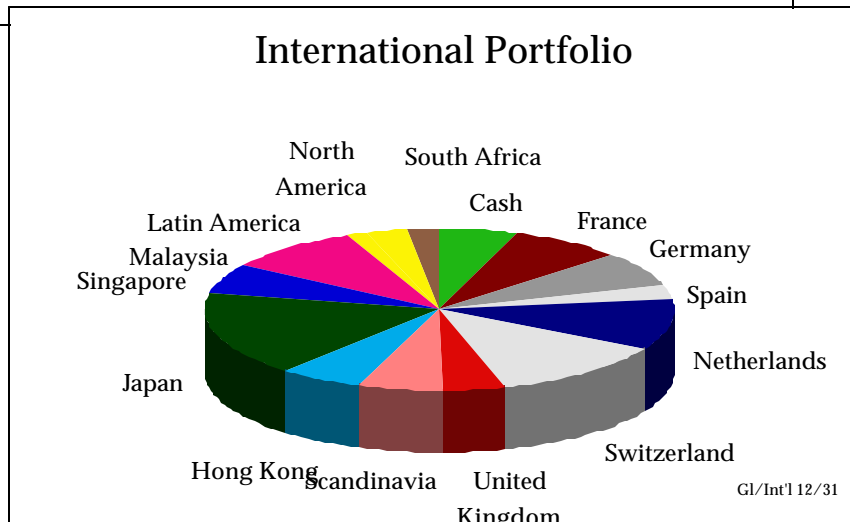
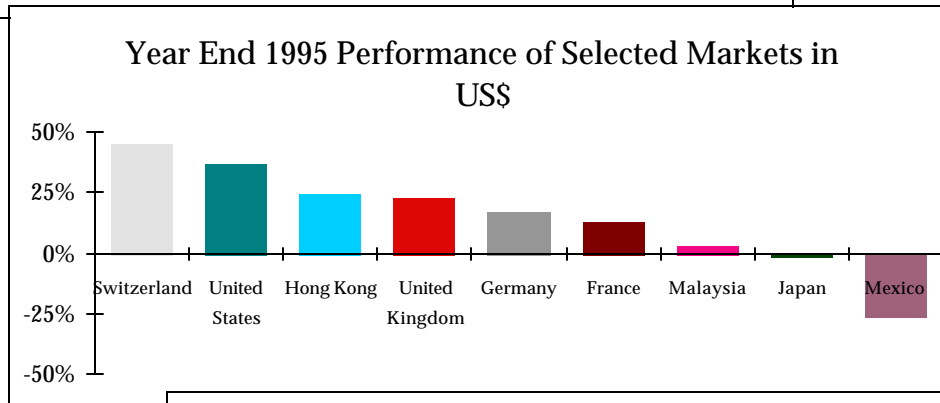
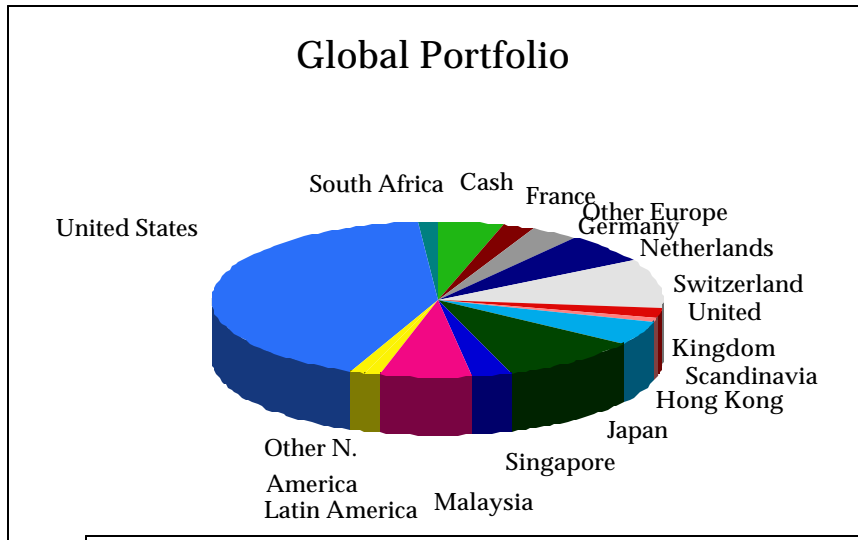


# Harding, Loevner Management

## Global and International Equity Investing

### 1995 Year End 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 December 31, 1995, of two representative portfolios:

<b>portfolio characteristics</b>	<b>HLM Global Portfolio</b>	<b>HLM International Portfolio</b>
Number of companies	45	42
Number of countries	16	18
current yield	2.2%	2.1%
<b>geographic allocation (%)</b>		
US	42	--
Europe	25	50
Japan	10	17
South East Asia	15	21
Other	3	7
Cash (US\$)	<u>5</u>	<u>5</u>
	100	100

## Performance

HLM's global and international equity portfolios finished the year on a strong note. On average, global portfolios returned 2.9%, before fees, in the fourth quarter. This compares with a rise of 4.7% for the FT World Index, and 0.6% for the Lipper Global Index. For the full year, global portfolios returned 19.0%; the indices 19.6% and 14.0%, respectively. During the year, the globally-oriented blue-chip companies that dominate the portfolio performed well, as did the defensive European growth stocks. Returns from US holdings, despite their larger size and higher quality, were only a little less than those from the soaring market. The best returns in the US were from holdings in the capital goods and financial sectors. In emerging markets, our policy of only buying the best was handsomely rewarded: absolute returns were strong, despite an 11.0% fall in the MSCI Emerging Market Index.

	Compound Annual Returns (%) for periods ending 12/31/95			
	1 year	3 years	5 years	Since Inception
<b>HLM Global Equity Portfolio</b>	<b>19.0</b>	<b>13.9</b>	<b>16.2</b>	<b>14.5</b>
FT World Index	19.6	15.7	12.0	7.0
S & P 500 Index	37.5	15.3	16.6	13.3
Global Fund Index (Lipper)	14.0	14.0	12.3	8.9
<b>HLM International Equity Portfolio</b>	<b>13.2</b>	<b>19.3</b>	<b>17.9</b>	<b>12.5</b>
FT World ex-US Index	10.4	16.5	9.3	3.7
MSCI World ex-US Index	11.8	16.9	9.6	4.2
International Fund Index (Lipper)	9.3	14.7	10.3	6.8

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.

International equity portfolios returned 5.0% in the fourth quarter, against a rise of 4.2% for the FT World ex-US Index, and 1.1% for the Lipper International Index. For the full year, the international portfolios returned 13.2%; the indices 10.4% and 9.3%, respectively.

Once again, good portfolio returns were associated with stable currency markets. As in the second quarter, in the calm following the market trauma of a plunging dollar, so in the fourth, following summer's soaring dollar, the portfolios did well. Valuation of multi-national companies becomes problematic during periods of extreme currency volatility, as near-term translation effects come to dominate long-term business prospects. As we suggested in our last report might be the case, investors were willing to pay more for the dollar-based earnings streams of the globally-oriented, blue-chip companies that characterize the portfolios once the period of extreme currency volatility had passed.

## **Review and Outlook**

### ***The background***

We wrote two years ago, at the end of 1993, that this seemed 'the best of all possible worlds'. Worldwide economic growth was steady, yet inflation was continuing to fall. The tangible benefits of technology were diffusing to an increasing number of industries as their workers' productivity was boosted by increased use of cheap computing power. With the principle of free trade gaining increasing acceptance, productivity gains were further spurred by falling trade barriers, which forced companies to concentrate on cutting costs, becoming more efficient, and expanding their customer base beyond national boundaries. Finally, and importantly, there was the near-universal acceptance by governments, and (somewhat less universally) by voters, of economic orthodoxy, particularly the acceptance of price stability as the highest goal of monetary policy, and the unsustainability of large fiscal deficits (as enshrined, for example, in the US balanced budget debate and the Maastricht convergence criteria for European Monetary Union — 'EMU').

All that has proven accurate, and roughly describes the economic background to financial markets today. Financial markets, however, sometimes lead reality, and sometimes they lag it. Sometimes they accentuate the positive, and minimize the negative. It now seems to us that investors in the US market have perceived the remarkably healthy long-term state of the world economy. Focusing on the positives, such as the low inflation/high employment nexus and the prospects of a balanced budget, US investors have, in classic bull market style, revalued financial assets with exuberance. Investors in other world markets are lagging in their reappraisal. It is true that major non-US markets have risen, but only in line with recovering earnings; there has been little or no revaluation of those earnings.

Despite its record breaking rise in 1995, the US market still does not appear to have reached the level of excessive valuation that characterizes cyclical stockmarket tops, or the level of speculative excess that portends a significant decline. It is not dramatically overpriced by simple measures of value against historical benchmarks, such as the price-to-book-value or price-to-earnings ratios, and is actually quite reasonably priced under a discounted cash flow valuation approach in the current environment of low inflation, low interest rates, and high corporate profitability. Only in terms of its dividend yield relative to historical benchmarks *does* the market look expensive, and this measure fails to take into account the substantial pseudo-dividends paid out by companies in buying back their own shares.

More important than the absence of extreme overvaluation is the observation that the market's rise is underpinned by powerful structural changes that have taken place in the US industrial sector, and in financial markets. In industry itself, a decade of restructuring, capital investment and, less happily, dollar devaluation, have left corporate America in the best competitive shape since the 1940s. The result has been an outstanding level of profitability; the return on equity for the S&P 500 is now above 20%, nearly double the return one might expect in an economy with nominal GDP growth of less than 5%.

Just as corporate competitiveness is beginning to solve the first of the triple deficits that plagued financial markets in the 1970s and 1980s—that on the trade account—other secular trends are at least addressing the other deficits, in the budgets of the Government and the private sector, caused by an excess of public spending and a dearth of private savings. The former can only be solved by politicians, so, despite current optimism, success can never be forecast with confidence. It is, however, more comfortable to forecast that, as the baby boom generation ages, it will save more than it does now— not just in absolute terms as it reaches peak earnings power, but also in relative terms, i.e., a higher percentage of its income. That will be not simply the result of the conservatism that comes with age, but also of a deep-seated distrust of the Government's ability to fulfill its promises to the middle class in respect of its provision for retirement.

The duration of today's exceptionally favorable combination of low interest rates and high corporate profitability will determine the ultimate peak and length of this 'bull market'. We remain confident of low inflation and, therefore, low interest rates, but are less confident about continued high corporate profitability, which might be undone by a host of factors ranging from the recessionary impact of continued political gridlock to a rebound in the dollar.

The US holdings in the global portfolios remain well balanced between modestly-valued cyclical companies such as **Cummins Engine**, **Dover**, and **Union Pacific** and global growth companies, such as **AMP**, **Colgate Palmolive**, and **FlightSafety**. Expected returns from the US equity market are lower than they have been in many years, but so are investors' return targets, as determined by expected inflation and dollar interest rates. In such an environment, we expect that 1996 will be a year that rewards careful stock selection.

Returns from international holdings in 1995 were in line with expected long-term returns, and with the growth of underlying earnings and dividends; in that sense, they were satisfactory. They only appear lackluster relative to returns in the US stockmarket. Among international markets, returns varied widely, and no single, overriding theme can be invoked to explain the variation. Switzerland, for example, returned 42.9% in US dollars, while Japan fell by 1.3%. Moreover, the aggregate return figures do not reveal the many pitfalls into which the international investor could have fallen. Entire asset classes, such as European small companies, were disappointing. While a handful of emerging markets, such as South Africa (+14.4%), provided decent returns, the great majority provided poor returns; some, notably Mexico (-26.9%), Taiwan (-30.1%), and India (-31.5%), were disastrous. Currency volatility presented another particularly nasty potential pitfall: one could have undertaken a costly program to hedge non-dollar exposure while the dollar collapsed, but abandoned it just as the dollar began its recovery.

The reasons for this wide variation in market returns are specific to each region. In Latin America, the 'tequila effect' in the aftermath of the Mexican debacle has detracted from the steadily improving economic conditions elsewhere in the region, in, for example, Chile and Argentina. Other emerging markets, in South East Asia, have suffered from exaggerated concern with cyclical overheating, and from a fixation on US monetary policy (mindful of the appalling damage wreaked by a tick up in short interest rates in February 1994).

In Europe, the agonies on the road to EMU are creating pressures in countries, such as France and Italy, that thus far seem incapable of mustering the political will to commit to the fiscal restraint needed for EMU to be anything more than a way station on the road to German domination of Europe. In Germany itself, the strong D-Mark and inflexible workplace rules have combined to make its production costs among the

highest in the world, and to threaten the global competitiveness of those manufacturing firms, particularly the traditional, mid-sized family concerns, that have not 'globalized' their costs through offshore sourcing or production. The portfolio's emphasis in Europe on larger, defensive growth companies paid off in the year.

The Japanese market recovered in the second half of 1995, but only in response to a much weaker yen that largely offset stock market returns to unhedged dollar-based investors. The accustomed rate of Japanese economic growth can only be regained when the health of the banking system is restored, and the deregulation of the consumer sector that we have referred to in the past becomes a reality. Until then, Byzantine political maneuvering, a volatile exchange rate, and low levels of optimism among Japanese consumers and workers make most of that market overpriced and speculative, for investors seeking absolute returns.

### ***The response***

We pursued a defensive policy in 1995. We always like to own the best companies and businesses in the world, defined by high and sustainable financial returns, strong balance sheets, and good growth prospects. (We do not like to pay too high a price, of course, even for the highest quality.) In 1995, volatility in some non-US markets enabled us to add to our preferred type of company, through purchases of such nonpareil, growing firms as **Rentokil** and **Wolters Kluwer** in Europe, **Canon**, and **Ito Yokado** in Japan, and **Sime Darby** in South East Asia. Portfolio exposure to smaller companies and to emerging markets was less than in the past.

This defensive policy worked. These companies have all done a good job in a difficult competitive environment, growing their market share, reducing their costs, and increasing their earnings and dividends— in short, they have grown even bigger and better, and served as excellent sanctuaries for portfolio capital during this period of circumspection. Concentration on these great companies enabled us to avoid many (though by no means all) of the pitfalls presented by riskier alternatives: smaller European companies, cyclicals, and emerging markets.

### ***The future***

As in other years, we spent a great deal of research time in 1995 visiting established companies in established markets. While it is always gratifying to confirm our prejudices in favor of such peerless companies as **Nestlé**, **Schlumberger** or **Brown Boveri**, these are businesses that nearly always prosper. While such primary research sometimes offers insights that may bear on financial markets, it rarely produces much company-specific information that is not already widely available and fully discounted. So, in 1995 we also spent a considerable amount of time visiting smaller companies and smaller markets, including emerging markets that are less well followed, in the hope of finding the same qualities in lesser-known companies that we can find in established blue chips. In 1995 we visited companies in Argentina, Brazil, Hong Kong, Mexico, Norway, the Philippines, South Korea, Singapore, Sweden, Thailand, Chile, the Czech Republic, Poland, China and Vietnam, as well in the United States, the UK, Canada, Germany and Japan.

Our objectives in making such visits are several: we want, of course, to monitor existing holdings, we want to check out companies that we have identified as prospective investments, and we want to judge whether financial markets are properly aligned with reality. At the moment, we think that in many cases they are not. As the world's financial community, chastened by the pitfalls of the last two years, has come to share our view of market risks and opportunities, there has been consistent buying of the companies we referred to above, to which list can be added many of our older holdings like **Royal Dutch**, **Abbott Labs**, **Surveillance**, and **Hutchison Whampoa**. Low interest rates and low inflation have placed a great premium on the prospective long-term earnings growth of such companies. The best quality, most widely followed growth companies are now, simply, fully priced.

Our response will be to become more aggressive in company selection. We are finding reasonably priced companies, with many of the characteristics of industrial and financial excellence we demand, in emerging markets. What they lack is institutional recognition and sponsorship. They may, in some cases, also lack a high degree of market liquidity, which, though in itself a valuable feature, is one less valuable to long-term investors such as ourselves than to those seeking short-term trading gains.

We recognize that this adjustment in strategy carries some risk, but we believe that it is risk that will be suitably rewarded. Our travels to companies in 1995 have confirmed our conviction that the world is in remarkably good shape, that a less defensive posture is called for, and that 1996 will be a good year for international investing. We have already begun moving in this direction in the early days of 1996.

## Quarterly Transactions

During the quarter, we sold the positions in five companies and bought four new ones. Of the sales, four were of companies that failed to meet our expectations of corporate progress in a difficult world. In both global and international portfolios, sales included:

- **Krones**, a German manufacturer of beverage bottling machinery, whose management failed to respond in adequate and timely fashion to the cost pressures exerted on them by a strong currency in their domestic production base.
- **Hanson**, a disappointing investment. Our patience ran out when it became clear that the slow-growth businesses into which the new generation of management has diversified jeopardize the company's ability to grow its dividend.

In international portfolios, we sold:

- **BSkyB**, the sole provider of satellite TV services to consumers in the UK. Its success has been based on excellent service and outstanding programming, particularly in comparison with the limited offerings from the land-based channels, two of which are government-owned. This success has not gone unnoticed, by the stock market, by politicians, or by the governmental authorities. On price grounds alone, after a 40% rise in the second half of 1995, they would have been a candidate for profit-taking, but threats of heightened regulatory review made sale compelling.

In global portfolios, we sold:

- **Crown, Cork and Seal**, which has found it impossible to grow earnings at a time of rising raw material prices. As a result it has been forced into making a large, costly and risky acquisition, of Carnaud Metal Box, its largest competitor in Europe. In the long term, this may prove a good acquisition, provided cultural differences do not derail progress towards rationalization. In the short term, it increases the risk to a business that is already less profitable than we had expected.
- **Lubrizol**, whose oil additives business has undergone a fundamental change for the worse: Government regulation has increased at a time when demand for the product has declined. Even Lubrizol's good management was unable to overcome these setbacks and restore the company to its accustomed growth path.

We also sold, in global portfolios only, the holding in Japanese auto parts maker **Nippon Denso**, after very good absolute and relative long-term performance, to fund a new holding in Honda Motor.

New purchases were:

- **Honda Motor**, which is among the world leaders in automobile production and is the largest manufacturer of motorcycles. It was the first of the Japanese car makers to manufacture offshore and is now the most 'global' of them all, in the distribution of its sales and assets and, perhaps most important, in its corporate culture. In 1996, for the first time, Honda's overseas auto production will exceed that in Japan. The company offers the combination of a cyclical recovery in Japanese auto demand, a favorable phase of its new product cycle, and secular growth in demand for motor cycles.

In global portfolios, we added:

- **Silicon Graphics**, the industry leader in the production of graphical 3D workstations. Demand for SGI's products is being driven by two main forces: lower prices and much greater processing abilities of workstations, and by the drive by business/industry to adopt 'smart' manufacturing technologies, such as computer-aided design (CAD-CAM). SGI's products lead in this field, driven largely by their advanced 3D graphics capability that differentiates the company's products from its peers'. Longer term, joint ventures with ATT, Time Warner and Nintendo should help open new markets beyond SGI's core area: design engineering for industry, medicine and financial services.
- **Boeing**, which is the world leader in the design and construction of commercial jet aircraft, and one of America's top three exporters in revenue terms. The company is now facing a cyclical upswing in commercial airline demand that should continue into the next century. Following the last industry peak in 1992 and subsequent decline in airline profitability, growth in passenger demand has finally led to capacity constraints. Demand is also underpinned by Boeing's next generation of aircraft, the 777-series. Boeing is also in the process of implementing a serious cost-cutting program along with adopting wide-ranging 'smarter' manufacturing techniques for the whole design/production process. The combined effect of rising demand and higher production efficiencies should allow both earnings and cash flows to rise faster than revenues over the next cycle.
- **FlightSafety International**, the largest independent provider of simulator-based training to operators of aircraft, ships, electrical utilities and steam generating plants. FlightSafety has managed to deliver flat earnings and increased dividends despite a long downcycle in the commercial aviation industry. Coming out of this four-year industry downturn, FSI emerges well positioned in terms of training capacity and finances to capitalise on the current recovery. A stock buyback program, combined with a long history of steady dividend increases, enhances the attractiveness of this unique, dominant service company in a growth industry.

**HARDING, LOEVNER MANAGEMENT**  
**Global Equity Performance Summary 12/31/95**

	Calendar Year Returns					
	1995	1994	1993	1992	1991	1990
<b>HLM Global Equity Composite</b>	<b>19.0</b>	<b>-0.1</b>	<b>24.2</b>	<b>9.1</b>	<b>31.6</b>	<b>3.6</b>
<i>Financial Times World Index</i>	19.6	5.9	22.6	-5.1	19.6	-17.0
<i>Morgan Stanley Capital International World Index</i>	21.3	5.6	23.1	-4.7	18.7	-16.4
<i>S&amp;P 500</i>	37.5	1.3	10.1	7.7	30.2	-3.1
<i>Lipper Global Fund Index</i>	14.0	-2.2	32.8	0.1	20.3	-9.1

	Average Annual Returns for periods ending 12/31/95			
	1 year	3 years	5 years	Since Inception*
<b>HLM Global Equity Composite</b>	<b>19.0</b>	<b>13.9</b>	<b>16.2</b>	<b>14.5</b>
<i>Financial Times World Index</i>	19.6	15.7	12.0	7.0
<i>Morgan Stanley Capital International World Index</i>	21.3	16.4	12.3	7.4
<i>S&amp;P 500</i>	37.5	15.3	16.6	13.3
<i>Lipper Global Fund Index</i>	14.0	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: 13.
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: \$147,062.

**HARDING, LOEVNER MANAGEMENT**  
**International (Non-US) Equity Performance Summary 12/31/95**

	Calendar Year Returns					
	1995	1994	1993	1992	1991	1990
<b>HLM International (non-US) Equity Composite</b>	<b>13.2</b>	<b>2.5</b>	<b>46.3</b>	<b>9.9</b>	<b>21.9</b>	<b>-12.9</b>
<i>Financial Times World ex.-US Index</i>	10.4	8.4	32.1	-13.1	13.3	-23.1
<i>Morgan Stanley Capital International World Ex-US Index</i>	11.8	7.6	32.6	-11.9	12.4	-22.8
<i>Lipper International Fund Index</i>	9.3	-0.9	39.2	-4.3	13.2	-12.4

	Average Annual Returns for periods ending 12/31/95			
	1 year	3 years	5 years	Since Inception*
<b>HLM International (non-US) Equity Composite</b>	<b>13.2</b>	<b>19.3</b>	<b>17.9</b>	<b>12.5</b>
<i>Financial Times World ex.-US Index</i>	10.4	16.5	9.3	3.7
<i>Morgan Stanley Capital International World Ex-US Index</i>	11.8	16.9	9.6	4.2
<i>Lipper International Fund Index</i>	9.3	14.7	10.3	6.8

\* 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: 26.
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: \$347,107.