HARDING · LOEVNER®

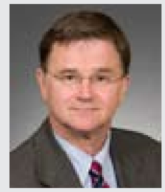
International Small Companies

Investing in International Small Companies

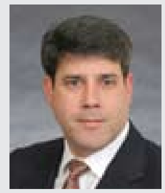
Harding Loevner launched its International Small Companies (ISC) strategy in January 2007.

In June 2009, the Portfolio Management team sat down to discuss investing in international small caps. Participating in the discussion were Simon Hallett, Chief Investment Officer; Robert Cresci, Lead Portfolio Manager; and Josie Lewis, Portfolio Manager. The discussion was moderated by John Parsons, Institutional Marketing Manager. This transcript has been edited for clarity.

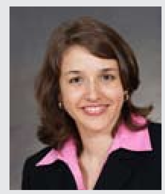
Participants



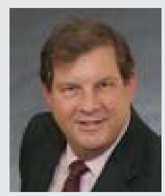
Simon Hallett, CFA
Chief Investment Officer



Robert Cresci
Lead Portfolio Manager, and Analyst



Josephine Lewis
Portfolio Manager, and Analyst



John Parsons
Manager, Institutional Marketing

Moderator: What led to Harding Loevner's launch of the ISC Strategy?

Hallett: Harding Loevner's investment philosophy is one of doing fundamental research and investing in high-quality, growing companies. Our investment process does not look at market capitalization as an investment criterion, so we've always invested in small cap stocks but we've been limited in how much of the asset class we can own in our all-cap strategies such as Global Equity and International Equity. We've been alert for someone with deep experience in the asset class to complement our investment team and allow us to establish a stand-alone small-cap strategy. And then Robert Cresci came along.

Cresci: I started my career in 1989 at Robert Fleming, a UK-based investment bank. Coincidentally, Simon and Rusty Johnson [Emerging Markets Portfolio Manager] were working at Jardine Fleming at the time. I had also interacted with Ferrill Roll [Global Equity Portfolio Manager] while he was working at CSFB. So I had been previously familiar with the people at HL, and more importantly, with the investment philosophy.

I have managed international small cap portfolios for 15 years. I became a Portfolio Manager at Vontobel, a Swiss private investment bank, working with Felix Rovelli, both on an emerging markets product and a non-US equity product. In 1997, Bob Michaelson took a team out from Mercury, and asked me to manage the international small cap product at his start-up company, Sagitta. In 2005, Sagitta was acquired by the Fleming Family Partners, which did not want to take the active management side. That was when I began speaking with Simon and David Loevner (CEO) at Harding Loevner.

Hallett: It was a great fit. Robert's investment approach was developed from over 15 years of experience working with small-cap portfolios, and is consistent with both the investment philosophy and process at HL. We launched our ISC Strategy in January 2007, and the mutual fund in March of 2007. We did not publicize it widely, as we were concerned about the short-term outlook for the asset class. Since then, we have added resources to the strategy, including Josie Lewis, who had joined HL in 2006 as an Emerging Markets analyst.

Lewis: I had come across Harding Loevner when I was a Consulting Associate at Cambridge Associates. Among other things, what attracted me to the firm was its commitment to fundamental research. I interned here at HL while I was in school for my MBA.

Moderator: Let's turn to the investment process. What is distinct about your investment process for this asset class?

Cresci: Two points: one is selectivity, and the other is patience. International small caps are a very broad universe of over 10,000 stocks; we choose to cover around 250, and invest in around 100. This means that we reject over 95% of the available stocks. We look for companies with strong, defensible competitive advantages. We like growing companies that have products and services that are mission-critical for their customers, such as drilling fluids and down-hold instrumentation for the mining & gas industry, or sterile supplies for medical services. We look for a company whose product has a resilient demand, and a defensible pricing strategy.

Lewis: Management is a major differentiator. We look for management teams with a proven track record of success. We want to see that their prior investments have been well conceived and well executed, and have strengthened their businesses. Looking forward, management must also articulate a clear, compelling vision for the future and their role in the future competitive environment.

Cresci: There are two other qualities we look for in management. Their ethics—are their interests and actions aligned with creating value for minority shareholders? And is there commitment to improving the liquidity and value of their stock? Small companies have to grow and increase the liquidity of their stock for us to realize investment gains. That's where the patience comes in. We wait for management strategies to be executed and for the market to recognize their profits and success. Our portfolio turnover is in the low 20s (%), which is low by any standards of active equity management, and very noticeably low compared to other international small cap managers.

Lewis: Financial strength is also a key criterion. We favor companies with strong balance sheets and high interest coverage, generally greater than 3 times. Interest coverage in our current portfolio is actually 15 times cash flow, excluding our modest holdings of financial companies. As a result, companies in our portfolio have not experienced financing problems in the recent difficult credit markets.

Cresci: Finally we look at not only growth, but the nature of that growth. We like companies that show consistent growth, both top-line and bottom-line. We would rather take a company with 8–12% steady growth and consistent margins than a company that grows 100% one year and declines 30% the next year.

Moderator: Did the credit crunch hurt the liquidity of small cap stocks in 2008?

Cresci: Yes. In any environment where there is a sharp reduction in liquidity, volumes drop off immediately and the bid and ask spreads tend to widen. The valuations of stocks got to a point, in this volatile period, of unreasonable value where in some cases the founding family or management took the companies private. An example of this in the portfolio was Marazzi, an Italian tile company, which no longer found any benefit in being listed.

Hallett: Small-cap stocks suffered even more than large cap stocks in the brutal conditions of 2008. That's a good thing for investors today, and one of the things that makes the asset class so attractive. As we return to more normal levels of liquidity, small company stocks should benefit disproportionately. Once again, investors are being offered a return premium in exchange for taking on the lower liquidity and higher risk of the small cap asset class. This was not the case at the height of the bull market.

Lewis: We are seeing a renewal of mergers & acquisitions (M&A) activity. Companies in which we invest have financial strength—they have low debt levels and strong cash flows. So we are seeing some of them take advantage of the current environment with its decreased asset prices to improve their competitive positions. For example, Bradken, an Australian mining services company, has purchased steel castings company Americast Technologies. This purchase has enabled Bradken to expand its product line. This is one of the ways that these companies grow, and it increases investor interest and their stock liquidity.

Cresci: Many investors tend to focus on M&A as large companies swallowing attractive small companies. Yes, that does happen—the types of companies we pick may be acquisition targets, and that is a catalyst for the realization of fair value. Historically around 8–10 holdings, approximately 10% of the portfolio's holdings, have been the targets of acquisitions annually.

Lewis: But we do not depend on our holdings being acquired—the investment case relies on the companies' ability to increase value through execution of their strategies.

Moderator: Where does International Small Companies belong in an investor's portfolio?

Hallett: Small cap stocks have historically outperformed large cap over the long term. That was true in the 2003–2007 period, and we have just been through a period of quite significant underperformance in the recent bear market. So valuations and prospective returns now are more attractive than they may have been in the past 2–3 years.

Cresci: Investors often think that small-cap stocks are much riskier than large cap. In terms of the business risk—the chance of a company failing—that is true, but we point out that our stock selection process mitigates those risks by focusing on the strong financial condition of these businesses. In terms of volatility, international small caps have historically had volatility that is a little higher than large-cap stocks, but not much.

Hallett: The other major concept to introduce, of course, in any discussion of where an investment fits into the portfolio is correlations. Small-cap stocks' correlations have varied between in the mid-50s (%) up to 85% in last year's global crisis, when all asset classes saw their covariance approach one. Historically, the correlation benefits of international small caps are a little better than those of emerging markets for US investors.

Lewis: The opportunity set for international small cap is sufficiently different from other asset classes. I believe that correlations will decrease from last year's peak. For example, the asset class has more Japan, and more exposure to Industrials, than the corresponding large cap indices. It is a different set of opportunities.

Moderator: How would you compare Harding Loevner's approach to other international small cap managers?

Cresci: There are many different styles of investing, and what we have talked about here is the very specific disciplined style that we use at Harding Loevner, a style that we believe will result in advantaged risk-adjusted returns for the long term. I'd boil it down to a couple of key characteristics. At the core of what we do is our bottom-up research, our robust investment process to look for strong, growing small companies.

Lewis: The size of the companies in the portfolio is a differentiator. The weighted average market cap of our portfolio is less than $500 million—it's actually around $350 million today—compared to the benchmark [MSCI All Country World ex-US Small Cap Index] of around $750 million. I've seen competitor strategies with an average weighted market cap of $3 billion and even higher. So one thing to look for is whether you're truly getting a small cap portfolio.

Cresci: Another factor is the number of holdings. We hold between 70–150 stocks, enough to ensure diversification, and enough to allow us the patience to invest for the long term and get turnover down into the mid-20s (%). But you can only have so many "best ideas". We think that strategies that hold thousands of stocks—and there are several—cannot possibly have that many great ideas. Some of them, such as the index and quasi-index managers, are of course absolutely explicit that they have no ideas, and are purely there to provide easy access to the asset class. It seems a shame in an asset class that is inefficient and provides many opportunities for active investors to add value.

Lewis: We believe we can add value for investors by bottom-up stock picking based on fundamental analysis through the framework of our four criteria [competitive advantage, management, financial strength, growth]. Portfolios that hold too few stocks tend to have higher turnover and so they can't have the patience to wait for a company to execute its strategy and add value. Portfolios with higher turnover tend to be placing a macro bet and so are either piling into or out of Energy, for example. We don't believe that we can create consistent value for investors by investing in that manner.

Cresci: Finally, investors should look at the asset level of an international small cap strategy. We estimate the capacity of our strategy to be \$1–2 billion based on today's markets and liquidity. There are some managers out there with \$3 billion, \$5 billion in assets. That causes position sizes to be too large for trading flexibility.

Moderator: What would you say to investors who would like to look at international small cap strategies?

Hallett: That it's a good idea! We have talked about relatively attractive valuations, reasonable risks, and correlation benefits of international small cap as an asset class. We think international small cap fits well into diversified portfolios, and this is a timely opportunity to make a move into the asset class.

Cresci: This is an asset class for the long term. Small companies are vital to the economy. Investors in the US have accepted the role and attractiveness of US small cap in portfolios. We think it's time to consider adding international small caps. We think that the way that we invest in the asset class can result in a long-term value added for investors.

Please contact John Parsons if you have any questions about the international small cap asset class or about Harding Loevner's International Small Companies strategy.

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Portfolio Characteristics as of March 31, 2010

	HL International Small Companies[1]	MSCI All Country World ex-US Small Cap Index[1,2]
Number of Holdings	79	4,225
Avg. Weighted Market Cap (\$Mil)	\$605	\$1,360
Quality		
Return on Assets	6.4%	2.9%
Return on Equity	12.6%	7.7%
Debt/Equity	15.6%	31.1%
Profit Margin	6.8%	4.2%
Growth[3]		
5-Year Sales Growth	11.7%	11.6%
5-Year Earnings Growth	4.2%	2.0%
5-Year Cash Flow Growth	6.0%	3.7%
Valuation[4]		
Price/Earnings	16.3	32.7
Price/Cash Flow	9.4	10.0
Price/Book	1.7	1.4
Dividend Yield	3.0%	2.2%
Turnover (3 year trailing average)	24.0%	–
% Ten Largest Holdings	17.3%	–

[1]Data expressed as weighted median except Market Cap and Valuation; [2]The Benchmark Index; [3]Trailing 5 years annualized; [4]Harmonic Mean.
Source: Wilshire Atlas (Run date April 8, 2010); Harding Loevner International Small Companies Composite; MSCI Barra

The disclosures on the last page are an integral part of this presentation.

About Harding Loevner

Harding Loevner invests in growing companies in the US, non-US developed, and emerging markets with the goal of achieving high excess returns with at- or below-market risk. Employing a fundamentally-based, bottom-up stock picking approach, we build portfolios of high-quality growth stocks.

Investment Strategies

Harding Loevner offers six related investment strategies – International (non-US) Equity, Global Equity, Emerging Markets Equity, International Small Companies, Global Multi-Asset and Frontier Emerging Markets. Strategies are offered as institutional separate accounts, mutual funds, and through sponsored wealth management programs. We accept custom investment guidelines, including social restrictions and after-tax return objectives.

The Organization

Former global investment managers for the Rockefeller family established Harding Loevner in 1989. Our staff of 21 investment professionals has an average 20 years investment experience, and eight years with the firm. Assets under management as of March 31, 2010 were $7.3 billion. Our clients are both tax-exempt and taxable, and include major foundations, endowments, pension plans, private family offices, and individuals. We offer comprehensive client service, timely communication, portfolio transparency, and appropriate access to portfolio managers.

In August 2009, Affiliated Managers Group (NYSE: AMG), an investment holding company with stakes in a diverse group of boutique investment firms, acquired an interest in Harding Loevner. The remaining interest continues to be held by a broad group of Harding Loevner's professionals. The firm is governed by a management committee of eight senior employees. The operational and investment autonomy of Harding Loevner is assured by the terms of the limited partnership agreement.

Investment Philosophy and Process

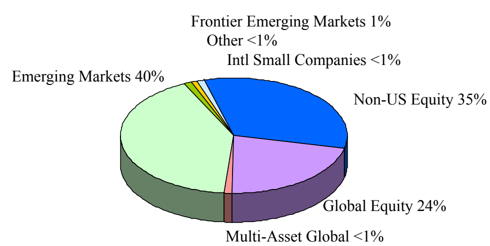
Harding Loevner seeks superior returns from portfolios of companies that are well managed, financially sound, possess global competitive advantages and are positioned for superior growth. We believe that the insights gained through careful study of individual companies are more valuable and reliable in the long term than forecasts of aggregate stock market directions.

Harding Loevner undertakes in-depth fundamental research to identify growing companies and owns their shares when their prices are attractive. We analyze a company's business model and its competitive position *before* making judgments about its share price. Harding Loevner, as distinct from other managers, screens for apparent bargains only stocks of companies that it has already determined are suitable candidates for investment by virtue of their business quality. Up-front business analysis enables us to recognize when transient market misperceptions create investment opportunities.

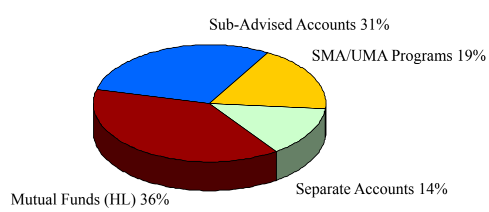
Each of Harding Loevner's analysts is an industry specialist and a geographic generalist. This division of responsibilities encourages development of deep expertise in the global competitive dynamics of industries and facilitates cross-border comparisons.

Portfolio managers combine analyst recommendations with considerations of risk and their own investment views to construct an optimal model portfolio upon which all client portfolios are based. The portfolio is concentrated to maximize the impact of analysts' insights, yet diversified to reduce risk. The portfolio managers sell a stock when it is 'crowded out' by a more attractive investment opportunity, or downgraded due to price or deterioration in its fundamentals.

INVESTMENT STRATEGIES



ACCOUNT TYPES



Portfolio statistics are supplemental information only and complement the fully compliant International Small Companies Composite GIPS Presentation, which is available upon request. The portfolio is actively managed therefore holdings shown may not be current. They should not be considered recommendations to buy or sell any security. A complete list of holdings is available upon request. Past performance does not guarantee future results. The portfolio invests in smaller companies which involve additional risks such as limited liquidity and greater volatility.

The MSCI All Country World ex-US Small Cap Index is a free-float market capitalization index that is designed to measure small cap developed and emerging market equity performance. The Index consists of 44 developed and emerging market countries, targeting companies market capitalization range of USD 170—4,200 million in terms of the company's full market capitalization. You cannot invest directly in this Index.

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