Harding, Loevner, McNally & Co.

Global Core Equity Investing

The following material is excerpted from the 1991 annual 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:

Portfolio Overview

At December 31, 1991, the portfolio:

- held investments in 45 large companies, including 22 US companies;
- was broadly diversified in terms of geographic distribution (as illustrated);
- consisted of 90% common stocks, 4% convertible bonds, and 6% cash; and
- had an annual yield of 2.9%.

The Last 12 Months

Every year seems remarkable in hindsight, and 1991 had a tough act to follow. Despite that, it *was* a remarkable year in investment markets and nowhere more so than in the US. It opened in a mood of depression as investors, and, more importantly, mothers and fathers pondered the outcome of a potentially drawn out and bloody entanglement in the Middle East. It passed quickly through relief as that entanglement was brought to an end at unexpectedly low cost. Relief brought euphoria as the United States was rightly seen to have successfully exerted global leadership, ending an era of national self-doubt that began in the early 1970s.

By the end of the year, however, the Chairman of the Federal Reserve Board declared that the national spirit was as low as he had seen in his lifetime and economic malaise at home was pushing the electorate towards support for withdrawal from the very leadership role it had so recently and so enthusiastically embraced.

Throughout these violent swings in sentiment, US investment markets climbed the traditional “wall of worry” to register stunning gains, both in equity and bond markets. The sharp decline in interest rates necessary to combat recession has led to a revaluation of equities. In other markets, those declines have not been seen and equity markets were accordingly sluggish. European interest rates have been dominated by German requirements to cool down an economy to which the demand of an entire country was added. Elsewhere in Europe, domestic considerations of slower growth and rising unemployment

had to take second place to the need to defend currencies against the attractions of higher rates in the Deutschmark. End of year agreement on a common currency by the end of the decade means that the problems will be with us for a long time. In the meanwhile, agreement on currency union confirms that the progress toward integration of trade and services is on track.

The break up of the Soviet Union, creation of a plethora of "new" states and war in Yugoslavia have really been secondary reasons for market sluggishness in Europe, despite their enormous implications. Those implications are both negative—with dangers of continuing unrest on the borders of the EEC—and positive—with investment opportunities for Western European business as well as the intangible benefits to be gained from a victorious end to the Cold War. So far, most attention has been on the negative potential developments, which are mostly short-term in nature, rather than on the positive aspects, which will take much longer to come to fruition.

Asia continued in its own way. Growth rates were high as domestic demand, intra-regional trade and infrastructure spending moved to be the new engines of economic output, replacing sluggish export demand. High growth has brought with it higher inflation and higher interest rates. Equity markets responded accordingly and made little progress for the bulk of the year. The exception was in Hong Kong where the liquidity created by an extraordinary boom in Southern China led to massive rises in both physical assets—property—and financial ones—stocks.

Japan had problems of its own, all legacies of the 1980s boom. Financial scandals and the unravelling of inflated asset values resulted in a poor stock market, especially considering the favourable reaction elsewhere to falling bond yields and short-term interest rates. Equity values were broadly unchanged over the course of the year.

Investment Strategy

HLM's equity investment strategy has been remarkably stable throughout the year. There has been a consistent view that US recovery would be slow in coming and mild in extent. Stocks favoured in the US market have been characterised by good management, financial strength and, above all, by the ability to grow earnings in a difficult environment. These criteria have embraced companies sensitive to declining interest rates plus those where product or market strength have led to growth. Now that the decline in interest rates has come to pass, positions have been added in companies able to generate *volume* growth despite sluggish overall economic performance. These "soft cyclicals" include companies such as **Lubrizol** and **Union Pacific**.We emphasise volume growth as HLM believes that pricing power will be very rare

for the foreseeable future—demand will continue to be sluggish as the debt burden of consumers and producers is unwound.

In Europe, the policy has been constant. HLM is prepared to add to holdings in good quality companies at reasonable valuations. Companies such as **Nestlé** and **Bayer** have great financial strength and multi-national operations, enabling them to maintain earnings and dividends throughout the economic cycle. That cycle is more normal in Europe itself than it is in the US and companies with cyclical earnings can look forward to stronger demand and slightly higher product prices once German interest rates begin to fall. In a difficult environment for European equities, this relatively defensive strategy has been successful.

In Asia, there has been similarly little turnover. Although growth is easy to find, in S.E.Asia in particular, quality is more difficult, while in Japan, where quality is abundant, growth is rare and valuations still high.

The Year Ahead

This has already been one of the longest recessions on record in the US. It is likely that a modest and sluggish recovery will begin in 1992. Investment selections will be focussed more on companies relying on the economic cycle for their earnings, and, in particular, on an upturn in consumer and capital spending. Stocks such as **Deere** and **Lubrizol** have already been added to the portfolio. This new emphasis will be at the expense of long held, high quality but defensive and interest rate sensitive stocks such as **Sallie Mae**.

In Europe, the down leg of the economic cycle has further to go. It will be accompanied by decline in both long and short-term interest rates. In this environment HLM expects the "defensive" companies such as Nestlé and L'Oréal to see further revaluation of their earnings and to continue to offer good investment returns.

The holdings in Hong Kong constitute the bulk of the holdings in Asia. They still offer good growth and low valuations. HLM intends to stay with them. An opportunity is emerging in the Japanese market. Shares of good quality companies with the financial and product strengths that HLM favours are now trading at valuations comparable to other multi-national companies whose shares are traded on markets accorded less lofty valuations. Some of these "global blue chips" will probably be added to the portfolio.

Investment Performance

	Total Returns (%)		
	1990	**1991**	**Compound annual growth since inception**
Global Core Equity Portfolio	+5.1	+26.6	+17.0
Comparative Benchmarks:			
Average global equity fund (Lipper)	-11.3	+19.5	+4.6
Financial Times World Index	-17.0	+19.6	+1.2
Standard & Poors' 500 Index	-3.1	+30.2	+13.2

n.b. The Global Core Equity Portfolio and Lipper average returns are *after* all fees. Index returns do not take fees or commissions into consideration.

Total return of the Global Core Equity Portfolio since inception on 11/30/89 has been 38.7%.

Global Core Equity Portfolio
15 Largest Holdings December 31 1991

FNMA 4.7%

Country:	*US*	*ROE:*	*33.0%*	*5yr growth est:*	*12.0%*
Mkt Cap:	*$18768m*	*'92 PE:*	*12.0X*	*Div. Yield:*	*1.8%*

"Fannie Mae" is a government-sponsored agency which buys residential mortgages from savings & loans and other originators. It finances its purchases by issuing debt in the form of mortgage-backed securities (MBS), and derives its profits from the interest rate spread between its assets and debt, a securitization fee and a free float.

The company's shares have a low valuation because it is a financial intermediary, but FNM has delivered on its promise of sound credit quality and has a strong position in the growing wholesale mortgage market.

Merck 4.3%

Country:	*US*	*ROE:*	*47.0%*	*5yr growth est:*	*16.0%*
Mkt Cap:	*$64176m*	*'92 PE:*	*25.5X*	*Div. Yield:*	*1.5%*

Merck is the world's largest pharmaceutical company. Its portfolio of patented products dominate the largest and fastest growing therapeutic categories such as cholesterol reduction, anti-hypertension and anti-ulcer treatment.

The company continues to do everything right and justify its reputation as the biggest and best of the drug companies. Very successful new products are keeping Merck's drug portfolio young and rapidly growing. Management is taking an active and leading role in addressing health care pricing pressures. The premium valuation which the market accords the stock is justified by corporate performance and by the increasing scarcity of companies with such dependable and rapid future growth.

Royal Dutch 3.7%

Country:	*Neth.*	*ROE:*	*13.0%*	*5yr growth est:*	*8.0%*
Mkt Cap:	*$46096m*	*'92 PE:*	*12.5X*	*Div. Yield:*	*4.5%*

Royal Dutch is the premier large capitalization oil company in the world. It is the controlling parent (60% interest) of the Royal Dutch/Shell Transport group, the world's largest oil company. The Royal Dutch/Shell group is fully integrated and owns substantial oil and gas reserves worldwide.

Royal Dutch is undervalued given its financial strength and proven ability to generate solid shareholder returns. No company in this volatile industry is better at strategic planning or more far sighted than Royal Dutch.

Archer Daniels 3.6%

Country:	*US*	*ROE:*	*13.3%*	*5yr growth est:*	*15.0%*
Mkt Cap:	*$9431m*	*'92 PE:*	*17.3X*	*Div. Yield:*	*0.4%*

Archer Daniels is the largest US processor of agricultural products. An extremely well-managed company with worldwide sales, ADM achieved 29% compound annual growth over the past five years partly through the expansion of its core businesses into higher value added products such as processed soy products and food additives.

The farm sector is now in better shape to face the 1990s than it was in the 1980s. Meanwhile, Archer Daniels has diversified into related areas of speciality chemicals and natural food additives. Thus, although earnings may continue to be volatile in the short-term, they should show continued long-term growth. That consistency alone deserves a higher valuation than the stock's present market earnings multiple.

Abbott Laboratories 3.5%

Country:	*US*	*ROE:*	*34.7%*	*5yr growth est:*	*15.0%*
Mkt Cap:	*$28542m*	*'92 PE:*	*22.3X*	*Div. Yield:*	*1.5%*

Abbott produces a broad range of quality health care products including pharmaceuticals, diagnostics, intravenous solutions, laboratory and hospital instruments, prepared infant formulas, and nutritional products. It is the dominant company in diagnostic products. Abbot manufactures and distributes its products worldwide.

Abbott's ability to produce consistent 15% earnings and dividend growth reflects the company's strong market positions in growing health care business. New drug approvals should more than offset any slowdowns in US health care revenues and enable ABT's excellent management to sustain the company's 15% growth. In a low inflation, low growth world, that growth is increasingly valuable.

MMM 3.3%

Country:	*US*	*ROE:*	*22.8%*	*5yr growth est:*	*11.0%*
Mkt Cap:	*$20900m*	*'92 PE:*	*16.2X*	*Div. Yield:*	*3.7%*

3M is a global manufacturer of over 60,000 industrial, electronic, information and imaging technologies, health care, and consumer products. The company boasts leading positions in virtually all of its major businesses.

Growth for 3M is cyclical, but of high quality, because of its new products, unit growth and market strength. The company's technical expertise, efficient manufacturing and distribution systems, and strong global presence justify its blue chip reputation. 3M is qualitatively and quantitatively superior to the broad market averages but sells at a lower valuation.

Nestlé 3.2%

Country:	*Switz.*	*ROE:*	*10.7%*	*5yr growth est:*	*12.0%*
Mkt Cap:	*$22100m*	*'92 PE:*	*11.6X*	*Div. Yield:*	*2.6%*

Nestlé is the world's largest food company It boasts strong market positions across a diverse range of food products and has one of the world's most extensive and efficient distribution networks. Nestlé has the financial might, world famous brand names and global presence necessary to prosper in the current sluggish economic environment.

Nestlé is an excellent company whose stock is too cheap. The share price has been depressed by a strong domestic currency and by high European interest rates. Underlying growth from the international markets in which the company operates is strong and will eventually be reflected in a higher valuation.

ServiceMaster LP 3.2%

Country:	*US*	*ROE:*	*n/a*	*5yr growth est:*	*8.0%*
Mkt Cap:	*$1190m*	*'92 PE:*	*12.3X*	*Div. Yield:*	*5.2%*

ServiceMaster provides a wide range of personal services such as cleaning and maintenance to the health care, educational, residential and commercial markets. Recent acquisitions and continuing diversification efforts should offset the maturation of its original hospital service business and enable the company to sustain an attractive rate of earnings and dividend growth.

ServiceMaster is a defensive, consistent growth investment with a high, tax-advantaged dividend yield producing a solid and predictable total return.

Bayer, A.G. 3.1%

Country:	*Germany*	*ROE:*	*10.1%*	*5yr growth est:*	*8.0%*
Mkt Cap:	*$11720m*	*'92 PE:*	*9.0X*	*Div. Yield:*	*5.0%*

Bayer is the world's fourth-largest chemicals company and tenth-largest pharmaceuticals company. Bayer's worldwide operations produce over 10,000 products in a balanced mix of commodity and high-grade specialty chemical businesses.

The company offers a high yield and low multiple. It is valued as a cyclical chemical company rather than for its fast growing and increasingly important drug business. As a result it is far cheaper than its international peers in the chemical industry and represents solid value.

Sandoz 2.9%

Country:	*Switz.*	*ROE:*	*11.0%*	*5yr growth est:*	*12.0%*
Mkt Cap:	*$8996m*	*'92 PE:*	*11.0X*	*Div. Yield:*	*1.9%*

Sandoz is a Swiss multinational pharmaceutical and specialty chemicals company. Sandoz' pharmaceutical division produces 45% of sales but nearly 90% of profits.

Investors in the depressed Swiss market continue to value Sandoz as a cyclical chemical company in spite of its large and successful, world-wide pharmaceutical business. Sandoz is a progressive Swiss company and is improving its shareholder disclosure, which should attract more international investors to its modest valuation.

Unilever 2.7%	*Country:*	*Neth.*	*ROE:*	*18.1%*	*5yr growth est:*	*10.0%*
	Mkt Cap:	*$21210m*	*'92 PE:*	*9.5X*	*Div. Yield:*	*4.2%*

Unilever is a leading manufacturer of consumer products with worldwide revenues of $30 bn. The company has the largest global market share in margarine, tea and consumer detergents and is an important producer of a variety of food categories, drinks and specialty chemicals.

The company is a world leader in a wide range of consumer goods categories. Despite this leadership, excellent management and global presence, the shares are rated in line with domestic stocks in the Netherlands and the UK. They represent excellent value

AIG, Inc. 2.5%	*Country:*	*US*	*ROE:*	*15.0%*	*5yr growth est:*	*12.0%*
	Mkt Cap:	*$20776m*	*'92 PE:*	*12.2X*	*Div. Yield:*	*0.4%*

AIG is an insurance holding company whose constituent operating companies offer a variety of specialized insurance, risk management and agency services throughout the world. Owing to its size and long experience, the company is able to provide coverage in many profitable, niche markets such as specialty casualty insurance and international life insurance.

AIG has a healthy balance sheet (one of the last companies with a AAA rating) with no real estate holdings or junk bonds in its portfolio. Management is very shareholder-oriented and regarded as the best in the industry. The company should continue to benefit from the financial problems of its weaker competitors and is well positioned for an eventual upturn in the property/casualty insurance cycle. In the meantime, its international operations will ensure steady growth in earnings.

L'Oréal 2.5%	*Country:*	*France*	*ROE:*	*28.8%*	*5yr growth est:*	*14.0%*
	Mkt Cap:	*$5582m*	*'92 PE:*	*15.5X*	*Div. Yield:*	*1.4%*

L'Oreal is a leading global personal care products and pharmaceutical company with a strong presence in most of the major international markets. The company's highly profitable and rapidly growing Perfumes and Beauty division markets brands such as "Lancome," "Guy Laroche" and "Cacharel."

The company is partly owned by Nestlé, another portfolio holding, but is the last of the major cosmetic companies to keep its independence. The non-voting shares held in the portfolio trade at an unjustifiably large discount to the ordinary.

Hong Kong Gas 2.5%

Country:	*HK*	*ROE:*	*26.4%*	*5yr growth est:*	*17.0%*
Mkt Cap:	*$1405m*	*'92 PE:*	*12.0X*	*Div. Yield:*	*3.2%*

Hong Kong Gas is a fast-growth company with the earnings quality of a monopoly utility. It is Hong Kong's only supplier of towngas, a naptha-based fuel used in place of natural gas. The company has grown rapidly by expanding its piped distribution network in the residential market. Longer term, HK Gas may import liquid natural gas to enable it to become a major energy supplier to industry.

The company's franchise has generated rapid earnings and dividend growth consistently over the last ten years yet the shares trade at a low Hong Kong valuation. Future steady earnings growth is expected as the company expands its residential service and turns its attention to the industrial market.

Canon, Inc. 2.2%

Country:	*Japan*	*ROE:*	*10.0%*	*5yr growth est:*	*13.0%*
Mkt Cap:	*$8350m*	*'92 PE:*	*16.3X*	*Div. Yield:*	*1.0%*

Canon, a classic global company, is the world's leading producer of a wide range of visual image and information equipment with a globally known brand name and reputation for quality.

The company's commitment to research and development has given it a technological lead over competitors and enabled it to gain dominant share in new, fast growing segments of the office automation market. Unlike many Japanese companies, Canon, in spite of its better business products and stronger growth prospects, is valued at levels similar to leading US blue chip companies.