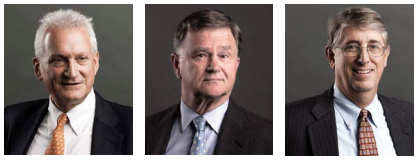
HARDING LOEVNER

LETTER TO OUR SHAREHOLDERS

OCTOBER 31, 2016

Excerpted from the Harding, Loevner Funds, Inc. 2016 Annual Report and Commentary



DAVID LOEVNER, CFA, CIC
CHIEF EXECUTIVE OFFICER

SIMON HALLETT, CFA
CO-CHIEF INVESTMENT OFFICER

FERRILL ROLL, CFA
CO-CHIEF INVESTMENT OFFICER

At Harding Loevner we pursue continuous improvement of how we go about our job of investing. We have to keep getting better, because our goal of superior risk-adjusted returns, never easy to achieve, keeps getting harder! The "market" today is dominated by professional and institutional investors. As the average active investment manager gets better at every aspect of its game, the market becomes more efficient and thus harder for any one of them to beat. Competition among them and with passive investment products pushes weaker managers out. Recent low nominal returns especially have laid bare the value-for-money shortcomings of the many managers who failed to deliver the long-term performance they promised.

The survivors of this contest include many of the best active managers—and just a few of the luckiest. Because variations among them in investing skill are now smaller, their relative results on all but the longest time frames, paradoxically, come to be dominated by luck rather than skill. The *paradox of skill* is that it becomes hard on the basis of results alone to discern differences in skill among the most highly skilled. The consequence for investment managers is even more intense competition.

Adding to our competitive challenge, the return premium that has been available to investors (both passive and active, including ourselves) who favor fundamental business quality has been eroded in recent years by a rise in relative valuation of high-quality companies. Hence the need for us to redouble our efforts to improve our investment process yet further and to stiffen our resolve to stick to that process.

Michael Mauboussin, a deep thinker about the practice of investing, identifies four potential sources of competitive advantage for investors: Informational, Analytical, Behavioral, and Organizational. We find his taxonomy useful for organizing our thoughts about self-improvement.

Information—What Data is Useful?

We've never felt we had much in the way of information advantage over other investors. In our early years, when gathering data about the companies in our global investment universe was essentially a manual task of requesting printed materials by mail and of travelling far afield to meet with company managements, there were simply too few of us to outdo others! Later we defended our choice not to have multiple research outposts by pointing to the internet as a means for instantaneous distribution of financial information and direct management contact. Nowadays, we face competitors who have torrents of incoming data and the computing capacity to crunch it, including a few who have turned to satellite or social media surveillance to detect changes in industrial, agricultural, and consumer activity in real time.

But Andrew West, our manager of research, points out that we have a different source of informational advantage: the advantage of looking for what few others care about, and finding it hidden in plain sight.

If the investment industry is increasingly focused on higher-frequency data, spending heavily to become the first to get, and to trade on, information, we are instead listening for longer-wavelength signals. While we may appear deaf to much of the high-frequency, big-data trends, we suspect these noisy signals are pulling investor attention away from more persistently meaningful information. We seek out only the kind of information that informs our understanding of medium- to long-term corporate value creation, rather than information that relates to any short-term "edge."

Our research analysts are constantly searching for indicators of the presence (or absence) of our four key investment criteria: competitive advantage, quality management, financial strength, and sustainable growth. When weighing a company's prospects, they are looking ahead five to ten years. Reading a quarterly report or meeting with management with an ear tuned for changes in competitive landscape and strategy leads to different observations compared with searching for information to refine an estimate of the next quarter's earnings.

Information isn't undifferentiated. Our research process provides both a filter for reducing noise and an amplifier for those signals that should be most important to our analysts. We may not know how many cars are in our companies' parking lots or their latest Twitter trends, but we do have the information that should allow us to predict which companies will have fuller parking lots and be more liked by customers in the years ahead.

Analysis—Where Information Becomes Insight

This pursuit of longer-term phenomena ties directly to our analytical process and its advantages. We get our edge by focusing on the fundamental factors that matter most to long-run success in business, integrating these factors into a consistent, repeatable process, and executing that process skillfully.

We have adopted a common language in which to discuss the long-run drivers of business success such as industry competitive forces and trends, company strategy and growth opportunity, and management skill. Our analysts proceed to research a company in depth only after they can make a hypothesis that it meets each of our four quality-growth criteria. After making that hypothesis, they assess and score the company on ten distinct quality aspects, including each of Michael Porter's five competitive forces*, as

well as growth, financial strength, management quality, and ESG (Environmental, Social, and Governance) risks. We use checklists when practical, to ensure that we cover what should be covered and do so as objectively as possible.

This process is only as good as the discipline with which we follow it. No company can be held in our portfolios unless it has been through this process and continues to be covered by an analyst, with the analyst's work subject to criticism from anyone and everyone in the research group. It is a painstaking process— this year our analysts each added just three new companies on average to our list of eligible investments. Analysts must regularly update companies' operational mileposts and financial models, with all such updates and other company notes captured in our all-encompassing research database.

Behavior—Where Insights are Converted into Returns (Or Squandered!)

For years we have striven to raise our ability to identify and overcome our own biases as investors (by which we mean, our biases as humans, which carry over to our investing instincts). In searching for potential new investments our analysts use objective screens of fundamental data to avoid the high potential opportunity costs of analyzing companies that have low likelihood of ultimately meeting our stringent criteria. And we disaggregate our decision making into discrete components to avoid the *halo effect*, where attractive attributes from one facet are conflated with the assessment of another facet, rendering a higher overall assessment than is actually warranted.

One common bias is to only look for information that confirms your prior beliefs or hypothesis, known as *confirmation bias*. Confirmation bias is often compounded with *groupthink*, where a given hypothesis is arrived at by consensus, and no one has incentives to challenge it. We've tried hard to rid our process of consensus decision-making, while retaining, even emphasizing, the benefits of debate and challenge. Each investment decision is made by an individual, and the results of those decisions are measured, aggregated, and then fed through to that individual's compensation, linking incentives and good decisions. By continuing to raise the bar in demanding feedback from colleagues, we raise the quality of the debate without raising the rancor.

Another inherent bias is that of *overconfidence*. We resist overconfidence in several ways. Our culture of debate inspires analysts regularly to reconsider their assumptions. Moreover, portfolio managers may hold (and act on) opinions that differ from those of the analyst. Our diversification rules also preclude over-concentration of our portfolios, while our preference runs to making individual stock picks over making big strategic bets. Growth investors can compound overconfidence by extrapolating a rosy past into the future, which we resist by adopting into our valuation models the concept of fading returns.

Investors can also fall under the spell of the *endowment effect*, whereby they're more comfortable keeping what they already own than switching to better-priced investments. We raise yellow flags to alert PMs to this bias risk.

Finally, we strive to communicate and capture as much of our reasoning as possible in writing (with over 100,000 analyst notes recorded in the past five years), which allows us to re-examine our prior decisions. The purpose of such self-criticism is to root out behavioral errors that bedevil all human decisions.

Organization & Culture—Where Incentives Reinforce Behavior

One of the hallmarks of the culture at Harding Loevner is the transparency that surrounds each decision. Analysts are solely responsible for choosing which companies they believe meet our criteria, but they have to lay out the rationale for their choices and invite input from colleagues. Every financial model they build to inform their buy/sell recommendations is open to all for scrutiny. But their recommendations are their own decisions. A PM can own only stocks that are rated by analysts, and thus is tied to the effectiveness of their combined efforts. But a PM's decisions are independent of analysts' decisions, since to be eligible for inclusion in the portfolio we require only that a company's quality meet our threshold, not that its valuation or timeliness receive consensus approval. That each analyst and PM *owns* their own decisions engenders maximum accountability and minimum finger-pointing.

We aspire to provide the ideal organizational environment for making investment decisions under conditions of uncertainty. The firm's compensation framework aligns employee interests with client aims, rewarding good decisions over diplomacy and salesmanship, and reserving our largest compensation for partners who have demonstrated a sustained ability to deliver good decisions tied to clients' interests. That framework has fostered long-term employee loyalty, yet has proven flexible enough to accommodate the unpredictability of our trade. Our success at attracting a global clientele lends greater commercial diversification, and by extension, greater stability, to the organization. All this means our investment team can focus primarily on their job of delivering superior risk-adjusted returns for clients—even as others in the industry around them cope with turmoil.

In the years ahead, we'll be looking for additional ways that we can improve the conversion of our insights into the portfolios we manage, and continue to justify the trust that you have placed in us as stewards of your capital.

Sincerely,

David R. Loevner, CFA

Simon Hallett, CFA

Ferrill D. Roll, CFA

*Threat of Entry, Power of Suppliers, Power of Buyers, Threat of Substitutes, and Industry Rivalry. Michael Porter, "The Five Competitive Forces that Shape Strategy," *Harvard Business Review*, January 2008, 78–93.

400 CROSSING BLVD, FOURTH FLOOR • BRIDGEWATER, NJ 08807
T (908)218-7900 • F (908)218-1915 • HARDINGLOEVNER.COM