

Quality in Quotients

While many global funds scour the world to find the best companies in their countries, the Harding Loevner Global Equity Fund has quite a different strategy. In an increasingly global economy, the fund looks for companies with competitive advantage across global sectors. A well-defined research process and a long-term investment horizon help the fund keep its focus on quality names with durable growth.

Q: What's your investment philosophy?

A: Our philosophy is that disciplined investment research yields profitable insights. We're a bottom up, fundamental research shop. In other words, we believe in kicking the tires globally, and we do that through a consistent investment process.

Our core belief is that companies will see rising competition as barriers to entry decline around the world. We think that global research is essential in this environment. There will be winners and losers. In a nutshell, we try to identify the winners and buy them when attractively priced.

We consider ourselves high-quality, durable growth managers. High quality means companies with high returns, financial strength, low debt, and strong margins. Growth means that management can leverage structural competitive advantage to re-invest operating cash flows in the business and gain share across industry cycles.

We are an independent, employee-owned company with close to \$6 billion AUM. We've pursued the same philosophy and process since our inception 18 years ago. The core of our senior investment team has been very stable over the years and we continually hire research staff. We stick

to our style even through the difficult periods when our style was underperforming. Year after year, we retained a high-quality, growth-oriented, low-turnover portfolio because we think that these kinds of companies, bought at attractive prices, will outperform over time.

Q: Would you explain your definition of global winners?

A: Global winners are companies with competitive advantages to take share globally over long periods of time. For example, L'Oreal is a multinational player with franchises in Europe and North America, which generates 20% of its sales from the emerging markets. L'Oreal spends more than its peers on brand development and R&D and uses its global scale to amortize this investment. This spending drives innovation and product growth across geographies in a virtuous cycle, leading to more investment spending and market share at excellent incremental margins.

Cisco Systems is another company with global competitive advantages that management can lever to both take share and enter new markets as the network takes share of overall technology spending.

However, we make exceptions in specific cases, such as Japan, where some of the

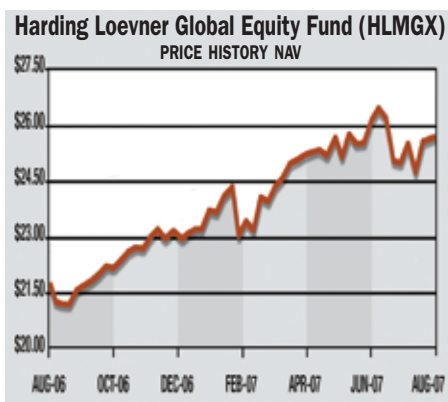


PETER J. BAUGHAN joined Harding, Loevner Management, L.P. in 1997. He has served as lead portfolio manager to the Harding Loevner Global Equity Fund since early 2003.

Prior to joining the company, Baughan worked as an Investment Analyst and Private Equity Manager for Rockefeller & Co., Inc.

Baughan received his BA in Political Science from the University of North Carolina, and he is a Chartered Financial Analyst.

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most attractive investment opportunities may be domestic, not global. We have Japanese commercial real estate in our portfolio, which is a domestic business by nature.

We would include companies like America Movil, the dominant wireless operator in Mexico and Latin America, which are regional winners, and its peers in the larger markets, such as China Mobile or Telekom Indonesia. We have followed wireless operators for many years, first in developed markets and now in emerging markets. We believe they have a global business model which we can understand to generate some insight.

We have a vibrant and deep emerging markets research platform, which is important because in the flat world almost any company in the developed markets can be threatened from the emerging markets. We need to be well versed in both worlds and aware of the competitive landscape as it evolves. In essence we are looking for the winners and trying to avoid the losers.

Q: What's your strategy and process for identifying those companies?

A: There's a lot of noise out there, and the challenge is to convert that noise to insight and then monetize the insight in the portfolio. We try to do that through our four criteria: growth, competitive advantage, financial strength and management. We approach all the companies in the various sectors and geographies through this lens, which drives our investment research process.

In our process, the analysis of the business comes first and the analysis of the stock comes second. Cheap stocks per se are not what we look for. We look for compelling business models globally. And then we try to value those and buy them when on sale.

By 'growth' we refer to the business, not to the security. We don't mean the price-to-book or the price-to-earnings ratio, but the fundamental growth of the business itself. It is the combination of top-line growth, operating margin expansion, and the ability to reinvest in the business at attractive returns, that leads to double-digit earnings growth across cycles.

That's where the role of the management comes in as we look for excellent capital allocators. Overall, the earnings growth should be a function of an attractive industry structure and clear competitive advantage. In other words, the companies should have the ability to grow faster than their industries and peers.

Q: Could you highlight your research process?

A: We have a four step process. For context, our universe consists of about 6,000 companies with market capitalization in excess of \$750 million. The first step of the process is qualification, where we apply the four criteria of growth, competitive advantage, financial strength and management. That gets us down to about 800 companies. Historically, that's been done by our analysts' judgment but to help avoid missing something we also rely on database work to screen through that universe on business quality metrics.

In the second step of the process, we take those 800 companies and apply our Quality Quotient (QQ) analysis. This is a comprehensive evaluation of the industry competitive structure and a specific company's ability to operate within it.

The QQ analysis has 10 components. Half of them are the well-known Porter indica-

tors, which include the risk of new entrants, the bargaining power of suppliers and buyers, the intensity of rivalry, and the substitutes. We spend a lot of time looking at this. The other five components are related to how the company has operated and how we think it will operate within that industry structure with a focus on the persistence and the durability of the company's growth. These indicators include free cash flow, balance sheet strength, corporate governance, management skills, and capital allocation.

This analysis is also tied to our security evaluation process. This is where the business analysis meets security analysis. We use the QQ score as a substitute for Beta because we're interested in fundamental earnings risk going forward. We develop financial models and discounted cash flow analyses, which give us an idea of what the security is worth.

This leads to the third step, which is valuation and rating. Analysts rate the securities that make it this far in the process buy, sell, or hold. We're now down to about 400 companies and we call that our qualified investment universe. This is the universe from which the portfolio managers can select stocks.

I should add that a key element of the process is contact with management because that's where we frequently get insight. I believe that last year we had over 850 management contacts; this year it should be over 1000. The idea is to create a mosaic of contacts, understand where the value is going in the industry, and position the portfolios accordingly.

The final fourth step is the portfolio construction. We have pretty concentrated portfolios of approximately 55 stocks and low turnover ratios of about 25%. So our average holding period is about four years.

Q: How do you construct the portfolio from this qualified universe of 400 stocks?

A: Portfolio construction is an ongoing series of judgments. We're continually making judgments, most frequently about the expected return of various securities. We're always communicating with our analysts, debating growth assumptions and company specific risks. We judge the expected returns of the stocks we don't own and compare them to the stocks we own.

Portfolio construction is thus a bottom-up stock by stock process, where one stock squeezes out another one. With our turnover and number of portfolio companies, we change about 12 stocks a year, or one per month.

Correlation is another important factor in portfolio construction. When an attractively priced security is not correlated with many other securities in the portfolio, it will receive a bigger position size.

Conversely, we don't own any Brazilian securities not because we are unaware of the opportunities, but because we aren't comfortable with the correlation among Brazil, China, and the US. For example, Brazilian commodities are sold to Chinese manufacturers and then the goods are sold to the US consumer. If the US consumer rolls over, does that reduce the demand for Chinese exports and thus for Brazilian commodity exports? We're really cautious about the US consumer and don't want unintended exposure anywhere in our portfolio.

Of course, the Chinese consumption of Brazilian commodities could continue without the US consumer if the domestic Chinese market and intra-Asian trade gain real traction. And that could happen with the long anticipated de-linking.

Q: What are the most important elements of your sell discipline?

A: The sell discipline is an important part of the process, especially in the current environment, where high-quality growth has underperformed value for six years. We have taken the opportunity to tighten our discipline because we do not want to find

ourselves selling stocks out of exasperation.

Before buying a stock, we have to define investment benchmarks to help us track the thesis as time goes by. Basically, we have to follow if the company is on plan or not, if it gains the market share, raises margins, introduces the new product, etc. When we experience negative volatility in the shares, we go back to those benchmarks and review them with the analyst before selling.

That process can help us avoid the behavioral traps of selling when you should be buying. A company like L'Oreal is a very good example of a high-quality global growth name, but it underperformed for quite some time. It is our benchmark analysis that prevented us from selling. 3M is another example where this sell discipline helped avoid what would have been a very poor sale.

We also sell when shares become overvalued on our analysis, or when we anticipate fundamental deterioration in the business model.

Q: What's your view on risk control?

A: We think about risk in a couple of ways. First, there is active risk. This is the benchmark risk/ tracking error. Our portfolio weights are driven primarily by bottom-up stock selection, but we keep an eye on divergences and tracking error to make sure that we are aware of the relative bets our bottom-up views are generating.

Of course, we also consider absolute risk. We have a series of investment guidelines that steer the portfolio construction process. For example, the allocation to the US is between 35% and 75%. The emerging markets exposure is limited to 15%, and we can't have more than 5% in one emerging market, such as China. While ensuring risk control, these guidelines still provide enough flexibility and allow us to be significantly overweight and underweight to the index, which is the MSCI All Country World Index. 

Harding Loevner Global Equity Fund

Symbol	HLMGX
Website	www.hardingloevner.com
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Tel. No.	908-218-7900
Inception	12/01/1996

PORTFOLIO	
Total Net Assets*	\$35.6
Avg Mkt Cap (\$ Weighted)*	\$70,800
Average Price/Earnings Ratio	23.3x
Average Price/Book Ratio	5.09x
Turnover Ratio	27%

INVESTMENT INFORMATION	
New Investment	Open
Min Initial Investment	\$100
Min Subsequent Investment	\$0.00
Min Initial IRA Investment	N/A

RISK (AGAINST MSCI WORLD INDEX - 3 YEARS)	
Alpha	0.31
Beta	0.93
R-Squared	0.91
Ann. Std Deviation	8.19
Sharpe Ratio	1.82

RETURNS VS. MSCI EAFE ND INDEX		
	HLMGX	Index
1 Year (Cum.)	19.31%	18.71%
3 Year (Ann.)	20.35%	22.16%
5 Year (Ann.)	15.94%	19.53%

RETURNS VS. MSCI WORLD GROWTH P INDEX		
	HLMGX	Index
1 Year (Cum.)	19.31%	16.34%
3 Year (Ann.)	20.35%	17.08%
5 Year (Ann.)	15.94%	15.40%

FEES AND EXPENSES	
Max Sales Charge - Front	0.00%
Max Sales Charge - Deferred	0.00%
Max Redemption Fee**	2.00%
Total Expense Ratio	1.25%

PORTFOLIO MANAGER	
Peter Baughan	02/28/2003
<i>* millions **3 months after purchase</i>	
<i>Data through: 08/31/2007</i>	
<i>Source: Company Documents; Lipper</i>	

Ticker staff searches for mutual funds for their consistency in performance and durability of investment style.

Our interview covers investment philosophy and strategy, research process, portfolio construction and risk control for funds. Through an interview we uncover long-term strategies and processes that help to generate long-term returns.

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