

Harding Loevner LLC **Pinnacle Global Equity Fund** **First Quarter 2009**

New Purchases: Adobe, Canon, Charles Schwab, Logitech, Nintendo, Sigma-Aldrich, Staples, Teva Pharmaceuticals, WPP

Complete Sales: Electronic Arts, Genentech, Swiss Re

Portfolio Attribution

The portfolio declined for the quarter, outperforming the MSCI World Index, which fell 11.8%.

The portfolio's positive relative performance was achieved through good sector allocation and good stock selection. Our substantial weight in Information Technology and small weight in Financials were the biggest positive contributors due to sector allocation. The portfolio enjoyed positive stock selection in every sector except Financials. The good stock selection was pronounced in food & staples retailing (Olam International), transportation (China Merchants), retailing (Li & Fung), materials (Rio Tinto), and pharmaceuticals & biotech (Genentech), offset partially by poor stocks within banks (Wells Fargo), insurance (Swiss Re), and consumer durables & apparel (Coach).

As an aside, the portfolio outperformed the benchmark in the month of March—despite large weights in Health Care and Consumer Staples and a low weight in Financials being a losing combination during the Financials-led rally—thanks primarily to strong stock selection in nearly every sector. A modest triumph.

Outlook

We came into the New Year with grim optimism, writing about why the current environment wouldn't turn out to be "as bad" as the Great Depression. By mid February, we were watching stock prices, visiting companies, and speaking to peers—along with everyone else—and having our doubts. The financial system rescues, both those here in the US and those abroad, had stopped the spiral of distrust in short-term money markets but were making little further progress in working through the broader credit market issues. Indeed, the populist rhetoric stemming from the AIG bonus furor portended damaging populist policies that would hamstring the managements of financial institutions. We—and we assume others—were dismayed by the realization that any stimulus plan large enough and prompt enough to affect the rapidly imploding economy would emphasize consumption spending rather than investment. Such a skew conflicts with our bias that government expenditure be focused on building infrastructure that fosters long-term economic growth in the private sector, thereby creating productive assets that offset (and aid in repaying) the necessarily increased debt liabilities.

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We were further dismayed as details emerged in the wake of the President's speech on reforming the health care system, with plans to spend more than \$600 billion on expanded health care benefits over the next ten years. We are not enthused by the creation of a new entitlement of this magnitude at this particular moment in our country's fiscal history. Furthermore, we are disturbed that the money for it is planned to come not just from higher taxes on the wealthy (after all, a majority of wealthy and educated voters preferred Obama in the election), but in large part from a mandated reduction of Medicare payments to hospitals, doctors, and drug companies. In effect, private companies and non-profit organizations may be ordered by the US government to service tens of millions more patients with little increase in compensation, through the mechanism of reimbursement prices set by fiat, rather than by negotiation. We do not know whether this style of "reform" will survive the legislative process; but the mere articulation of it by administration insiders has at a stroke increased the riskiness of investing in nearly all Health Care companies that operate within the US—the largest, most innovative, and most profitable health care market in the world.

We have been inclined to accept that the established policies of financial rescue and liquidity infusion, along with fiscal stimulus supporting demand, were broadly the right ones—given the scale of the problems, the only ones that had even a modest chance of succeeding—in a world facing high risks of deflation brought on by severe de-leveraging, and already visible declines in global trade. Apart from the well-publicized measures taken in the US, the IMF led lending support for Romania and Latvia, which, along with disbursements of earlier support agreed for Hungary, has led to a stabilization of sharply weakening banking systems and currencies in Central Europe. This quarter, Britain and the Netherlands took additional major steps to re-liquefy their largest banks through government injections of capital, whilst we noted more than a score of private bank equity rights issues, including DBS Group in Singapore, SE Banken in Sweden, and HSBC Holdings in Hong Kong/Britain. China, along with the US an early convert to large fiscal stimulus efforts, has so far managed to keep domestic demand afloat, reporting strong retail sales growth in the first two months of the year, offsetting the 20% decline in (export-related) container volumes through its largest ports. Brazil's domestic economy also appears to be shrugging off the woes of the global trade decline that is hurting its commodity producers, while its banking sector, toughened by the huge volatility of both the economy and government policies over the past decades, continues to grow lending and is highly capitalized, with BIS capital ratios hovering near 16%.

Nevertheless, there exists strong partisan temptation in this polarized country to become either interventionist (as well as vindictive) on the one hand, rather than recognizing that market forces can be powerful tools for both discipline and efficiency in the medium term; or to be obstructionist on the other hand, rather than seeking to find some common ground on key policy measures. Meanwhile, abroad, there is a strain of "this problem was manufactured in your backyard; we've already done our share of repair", which leaves attempts at coordinating consistent policies to battle the synchronous downturn and financial crisis in

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some disarray. Most striking has been the role reversal between the European and the US stance on debt-financed government economic intervention illustrated by the reluctance of the Swedish Government to rescue automaker Saab (one of General Motors' last acquisitions) while the US Government throws tens of billions of dollars of support at GM and the rest of the US auto industry. We see, if murkily, a far wider range of investment outcomes—the proverbial “fat tails” of statistical distribution—beyond our central case. Risk premiums have risen everywhere—in stock prices, sovereign spreads, corporate bond yields, and inflation expectations—even if the sharpest rise in visible risk at the moment is in Health Care (taking the baton from Financials).

Another of those fat tails relates to the uncertain fate of the US dollar over the next few years. While the dollar has rallied throughout the crisis, perhaps as a safe haven reflex, perhaps as a technical result of de-leveraging, we fail to see how investors abroad can view it as a “bargain” and want to increase their holdings, given the very large debt issuance envisioned by the current stimulus, rescue, and reform plans, not to mention the still large, if shrinking, US current account deficit. If the current reflation policies being pursued by the Federal Reserve, US Treasury, and US Congress, along with the UK, Japanese, and Chinese authorities, actually manage to offset the severely deflationary pressures of the debt deleveraging—even creating significant inflation a year or two down the road—then we foresee a sustained depreciation for the US unit. Individuals and institutions alike would then be scrambling for ways to maintain purchasing power.

For that, while many are intrigued by the idea of gold as a store of value, we sense that a dividend stream from strong companies operating in the less debt-encumbered economies in the world will likely be not just a depreciation hedge, but an inflation-adjusted, income-generating winner.

Portfolio Structure

We have been unwinding our negative bias toward consumer-related companies over the past two quarters. With the issues of consumer indebtedness and rising unemployment putting spending growth at risk, the share prices of all consumer-related companies have been under considerable pressure. The result is that even the most durable of franchises are priced for perpetual recession. Given the scale of government intervention through the massive stimulus plans, alongside previously established “shock absorber” social policies, we are willing to look to the longer-term prospects of consumer-facing companies that we are confident have the competitive moxy, financial strength, and management acumen to survive in bad times and thrive in good ones.

This quarter we bought a new holding in advertising giant WPP, a company we have followed for years and owned before. The company has steadily diversified from traditional commission-based advertising to fee-based media services such as public relations and marketing research, and developed or acquired expertise in the various new media channels

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that advertising is gravitating towards. Their global franchise is both broad and deep, but their large free cash flows are ignored by investors fixated on the atrophying of TV ad spend that has been evident for quite some time. We also bought a new holding in office supply retailer Staples, whose small business and individual customers are currently under pressure, but whose competitive position continues to strengthen as its acquisition of Corporate Express builds its European market presence even as its largest US competitors are being strangled by their own financial distress. These purchases combine with existing holdings to increase the portfolio's weight in the Consumer Discretionary sector to roughly that of the benchmark, including luxury retailer Coach, whose retail expansion in Asia continues to perform well and promises strong growth in future years, cruise operator Carnival, and longstanding holding Li & Fung, outsourcing agent/ designer to US and increasingly European retailers from low-cost consumer product manufacturers across Asia and elsewhere.

We have also added a number of consumer-facing companies within our large holdings in the Information Technology sector. We bought back a longstanding favorite—Japanese camera, printer, and copier maker Canon. We expect the company to maintain its remarkable record of innovation and growth, with management exploiting its enviable and large free cash flow to launch new products, and extend its distribution and brand awareness in emerging markets. We also bought Logitech, the Swiss-domiciled manufacturer of branded peripheral equipment for personal computers, such as keyboards, speakers, web cameras, and mice. Logitech enjoys large global market shares in its selected product niches, enabled by manufacturing scale in low-cost locations and broad distribution. The increasing consumer use of multi-media internet services underpins demand for its products, while short-term inventory de-stocking has hurt its revenues and its share price. Nintendo, maker of the popular DS portable gaming device and Wii video entertainment console, has demonstrated its innovative genius by expanding the potential market beyond the traditional “gamer” to include Japanese matrons looking to exercise their mental acuity with word and number games, as well as younger, professional women in the US seeking new options to stay “fit”. The company should benefit from growth in its installed base of consoles, which form the platform for the ongoing development and recurring sale of entertainment software, a highly cash-generative business.

Usually, when we notice competitive structures changing for our companies, it affects one or two companies that we own or follow and for that reason, changes to the portfolio in response tend to be made in incremental steps, building the portfolio “one stock at a time” as we often say. This quarter, we saw a potential shock to the competitive structure of the entire US health care sector, in the threat of a sudden assertion of monopsony (a monopoly customer) bargaining power by the Federal government. In response to the mooted reforms previewed by the Obama administration, we reduced our investment in health care companies, by selling a portion of most of our holdings. We have held roughly double the benchmark weight in the sector for a couple of years, a source of significant outperformance

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over a number of successive quarters. The reductions leave the portfolio still slightly above the benchmark weight, and we may yet take further action on specific holdings as we examine their individual merits or exposures.

We reduced holdings in six of our fourteen holdings, and in addition sold biotech pioneer Genentech altogether, happy (at this moment) to oblige Swiss giant Roche Holding in its cash bid for the portion it did not already own—although we are irritated at the disappearance of the public listing of this very well-managed, rapidly-growing business in which we have invested successfully on two separate turns over the last seven years. In counterpoint to our allocation move, we actually bought shares of Teva Pharmaceuticals, the dominant producer of generic pharmaceuticals. With a 25% share of the US generics market, Teva is very well placed to benefit from any mandated efforts to reduce the per-patient costs of extending health care benefits to a larger population.

We have so far failed to envision a credible growth case for the broad Financials sector, and while there are clearly “deep value” arguments to be made, we are not constitutionally capable of making them without having some confidence about the robustness of franchises and the prospect of growth. Hence we have altered our holdings in the sector very little so far, except for the sale of Swiss Re this quarter, which appeared at risk of permanent impairment from its financial derivative exposures. We bought a new holding in Charles Schwab, which has very little balance sheet exposure to the mortgage crisis, and has, despite the stock market decline, continued to gain market share in asset management and custody for affluent individual investors—and, increasingly, their independent advisors—by building on its reputation for impartiality and efficiency.

The changes leave the portfolio with a benchmark weight in the Consumer Discretionary sector, a modest overweight in Health Care, a large underweight in Financials, and a large overweight in Info Technology. We have few divergences from the benchmark viewed by geography, having last year resisted reducing emerging markets despite their poor performance. The portfolio is near the benchmark weight in the US.

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