HARDING LOEVNER

LETTER TO OUR SHAREHOLDERS

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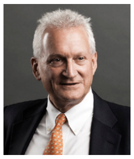

DAVID LOEVNER, CFA, CIC
CHAIRMAN AND CHIEF EXECUTIVE OFFICER

SIMON HALLETT, CFA
CO-CHIEF INVESTMENT OFFICER

FERRILL ROLL, CFA
CO-CHIEF INVESTMENT OFFICER

The market turmoil unleashed by the COVID-19 pandemic has been nothing short of astonishing. Initial apprehension about the outbreak's severity, spread, and persistence triggered a breathtaking dive in equity prices that was followed by an equally vertiginous rebound as global policymakers responded with unprecedented monetary and fiscal support. Preliminary estimates indicate that up to a third of global economic capacity may be lying fallow in the battle to combat the pandemic. Tentative forecasts project output declines that range from substantial to positively horrifying. With almost every country grappling with a collapse in output and employment of unknown duration, a cloud of uncertainty now hangs over global markets.

For investors, the pandemic and accompanying economic fallout are startling reminders of the notion of fundamental uncertainty, the collection of vague, indeterminate, and ever-present dangers that lurk just below the surface in every society. A reminder that a fair chunk of what passes for risk defies estimation and therefore cannot be reliably re-engineered, packaged, and hedged away. A wake-up call that, despite mankind's technological sophistication, foreknowledge of our fate will always remain just beyond our grasp.

Because humans are purposeful and pragmatic animals, we are inclined to dismiss the significance of wild uncertainty. Instead, we assume that the unknown is bounded and that the full range of possible outcomes is somehow under our control. It's an unrealistic but practical assumption that speeds along decision-making by side-slipping the inevitable log jams thrown up by incessant ambiguity. To banish chaos and assert control, we adopt a hodgepodge of expedient habits so ingrained that we barely notice them. Taking history as our guide, we proceed as though tomorrow, in most respects, will resemble the recent past. We assume that the prices we observe, with a handful of piffling exceptions, reflect a correct summation of all relevant probabilities. And in the absence of confidence in our own views about the future, we look to others and mimic their behavior, knowing that, if we fail, we do so in good company. But this collection of soothing modalities is no more than a convenient fiction. Our willing suspension of disbelief should not fool us into thinking that uncertainty has been brought to heel. Human affairs forever remain at the mercy of unseen hopes and fears that can take charge at any moment.

The problem with these habits, based as they are on a shaky premise, is that they are prone to sudden collapse. The outward pattern of stillness, confidence, and equanimity can shift violently, shattering in an instant the prevailing basis for discounting the future. By definition, the accompanying sudden shift in enterprise value takes us by surprise, and equity holders—those at the foundation of the capital structure—are first to get walloped in the ensuing debacle. But lest we forget, fundamental uncertainty is also what animates the notion of an equity risk premium. After all, if risk could be tamed, the rewards to equity holders would shrivel to match the lesser rewards available higher up the capital structure. Equity holders are consigned to bear this implacable uncertainty in exchange for a prospective and highly uncertain reward that varies inversely with prices.

A weary acceptance of this dismal state of affairs is why we return ceaselessly to our investment philosophy—the beliefs that guide us in tackling not only what is probable and, therefore, quantifiable, but also that which is intrinsically unknowable.

To survive the inevitable bouts of violent uncertainty, investors need to prepare themselves. Our preparation is encapsulated in how we tackle each investment. Before a company can be considered for investment, let alone included in our portfolios, it must satisfy four conditions. It must have a competitive edge: something that keeps rivals at bay, discourages new entrants, or somehow locks in customers or suppliers on preferable terms. It must have superior growth opportunities in which it can reinvest earnings at high rates of return. It must possess financial resources that equip it to weather more than just a passing squall. And, finally, it must be guided by prescient and trusty management capable of adapting to different environments.

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In the near term, the first line of defense during a crisis is a strong balance sheet. We insist on financial strength because we know that liquidity is plentiful when least needed and can evaporate in an instant. Not having to worry about survival in the event of a downturn means we can spend time thinking about the long-term prospects of the business. But in a raging storm, a strong balance sheet is much more than mere extra ballast that helps to smooth the ups and downs of the business cycle. A retreat in business sentiment also signals a shift in the balance of corporate power. Companies previously shunned because of their perceived outdated conservatism are now inundated with offers from ardent supplicants seeking a lifeline. Suppliers are suddenly keen to secure long-term commitments for their goods and services, while customers are more than willing to extend the life of their purchases in exchange for some form of upfront relief. And anxious rivals are now eager to discuss the benefits of a strategic tie-up. But make no mistake: this is about more than simply being able to consummate a merger on favorable terms. A judicious deployment of balance sheet strength can entrench a dominant position for the next cycle and in some cases even reshuffle the competitive landscape.

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Over the medium term, the importance of sustainable growth will also be magnified in a world reeling from a colossal shock. Especially vulnerable, in our view, are the business models that stress short-term earnings targets, improbably large dividend payouts, and lavish spending on stock repurchases at the expense of productive investment. Financial engineering loses much of its appeal, and profitless growth is harder to justify, when investors are focused on resilience. Moreover, seismic shifts are often a powerful catalyst for new growth vectors, akin to the rapid growth you see in a forest after a wildfire. The adoption of new technologies and business models is pulled forward as consumers and businesses adapt to new consumption and work habits. Companies predisposed toward innovation will be best placed to evolve and reap the benefits.

In the very long term, our emphasis on management quality—shorthand for an essential combination of integrity and expertise—is the cornerstone of our philosophy. The notion that investing (and by extension business more broadly) is based on trust sounds a little old-fashioned. Yet without the assurance of probity, the chances that management will actually deliver those long-lived future cashflows to shareholders diminish rapidly. Hubristic overreach and entitlement are fixtures of every expansion. When capital is plentiful and business booming, investors are drawn to the rosiest and most ambitious projections. And with this expansion having lasted longer than any prior episode, with record loose borrowing conditions to boot, we can expect a lengthy hangover as the extent of the overreach is slowly revealed. The disclosure of accounting irregularities at Luckin Coffee, China's answer to Starbucks and until recently a darling of many growth-oriented investors, is an unfortunate and bitter foretaste of what to expect.

Trying to see through the pandemic at this juncture is little more than an exercise in guesswork. Myriad uncertainties need to be unwound before we can confidently predict how this episode will end. Although risk markets have recovered somewhat, it's still too early to tell how the forced experiment in flash-freezing economic activity will pan out. Once economies thaw, will workers and businesses coordinate to reconfigure themselves quickly into some semblance of their pre-crisis selves? Or will freezing lead to lasting damage that overwhelms businesses resulting in a prolonged slump? We don't pretend to know the answer, nor do we believe our guesses are better than average. But we are confident that high-quality growth at reasonable prices is an appropriate standpoint from which to face down fundamental uncertainty.

As ever, we remain grateful for your ongoing willingness to entrust us with the management of your assets.

Sincerely,

David R. Loevner, CFA, CIC

Simon Hallett, CFA

Ferrill D. Roll, CFA

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