

Letter To Our Shareholders

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Our investment philosophy—focusing on high-quality companies with promising growth prospects and acquiring their shares at reasonable prices—has been tested of late. Although the market has been harsh on the stocks of faster-growing companies, those of high-quality businesses have weathered the storm more effectively. With the relative shellacking that investors in high-quality, fast-growing companies have taken in the past two to three years, it's timely to review why we insist on high business quality in the companies we pursue for investment. Although our preference was established in our beliefs and investing habits more than 30 years ago, the empirical evidence pointing to an enduring return premium for high quality came later, and theories as to why, later still. Our belief has been that high-quality businesses will weather difficult or shifting economic environments better than most, and that our confidence in their operational resilience would allow us to hold on to our investments in their shares during periods of stock market turmoil—which usually overlap with those inevitable, yet unpredictable, economic stresses. With that confidence, we could keep our heads while those around us were losing theirs, sometimes even picking up bargains being thrown out in the general panic. Staying invested in the market, so as not to miss rebounds and uptrends, was the idea, along with avoiding large losses in the downturns.

The conundrum is why such a return premium for high quality exists at all, if markets are weakly efficient. Academia hasn't coalesced around a single cause, as noted recently by our own Edmund Bellord in a piece called "A Quality Problem" that you can read on our website. But, at the risk of exhibiting confirmation bias, the explanation we like best is a behavioral one: Investors, far from being perfectly rational optimizers, are attracted to novelty, the "new, new, thing" in Silicon Valley's parlance from the late 1990s. Even worse, they often fear missing out on that next

big thing, the (insert your latest investment theme here)—and we believe that leaves the field wide open for investors willing to be bored by steadier returns from shares in more prosaic, but sustainably profitable, companies. There is also the generally poor understanding of investment arithmetic that manifests itself in hyperbolic discounting of far-away returns in favor of near-term ones. That illiteracy may also cause investors to overlook the arithmetical difficulty of recouping large drawdowns in a long-term return series, or the benefits of only suffering smaller ones. Moreover, the sheer durability of the businesses we invest in offers a chance to trade less frequently, which reduced the chance of missing sudden market gains, while reducing both taxes paid and transaction costs incurred.

It's not just our preference for high quality that is grounded in the key findings of behavioral finance, but also many facets of and structures in our investment process. Having a process in the first place is meant to put guardrails on our human tendencies to seek novelty, extrapolate recent trends, succumb to halo effects, or abandon discipline when we fear missing out on great new ideas.

That philosophy and process is currently challenged by the staggeringly rapid advances in the development of artificial intelligence (AI), which promises to revamp much of the economy, if not society itself over the next couple of decades. As we wrote in our International Equity Strategy Quarterly Report in December 2023, AI is likely to be the latest illustration of Amara's Law—that the effects of technological advances are overestimated in the short run but underestimated in the long run. It's tempting to get caught up by dramatically expanding estimates of markets that can be addressed by AI applications, but those initial estimates tend to ignore both hurdles to implementation and competitors elbowing their way to a share of the economic pie, let alone government regulation (always late to the game, but usually intrusive in the end).

We, too, are attracted to the growth opportunities afforded to the early leaders in this field, and some of those leaders are held in our portfolios. But our process demands that we analyze the competitive structure of the industry for potential risks, including the possibility that the handsome benefits will flow elsewhere to customers or suppliers, or not materialize at all due to rivalry or regulation. Modeling company revenues, profits, and the investment required to achieve those revenues means making judgments about the capital required, where it will come from, and how fruitful such investments will be in delivering those revenues. Much of AI, excepting the hardware merchants enabling the vast scale of computing power required, doesn't yet have a clear revenue model; instead, many of the valuations afforded to companies with a story to tell about AI are based on just that: storytelling.

A less obvious use of our Porter-centric competitive analysis is in identifying where the losers to the disruption of AI technology reside: which business models are dependent on the status quo in terms of work flows, customer service, or identifying new business prospects. Who—meaning which company or which set of personnel—can, nay, inevitably will be, replaced by intelligent, adaptive software? On the other hand, which companies can exploit the power of AI to delight their customers with greater efficiency or more bespoke service, and lower costs?

Another rich vein to mine is that of the AI-impervious industry. Which industries or companies will be least affected by the near- or medium-term advances in AI? After all, our definition of quality essentially boils down to the resilience and sustainability of profitability notwithstanding changes in the economic

environment. It may well be that in the medium-term, the companies furthest removed from the changes being wrought by AI will be the ones whose profits are more steady and predictable, while everyone else, our own firm included, joins the arms race seeking a way to either exploit or avoid the disruption foreseen by the visionary.

Our long experience may not be a guarantee of skill or prescience. But it does afford us perspective on the ways technological advances affect a wide variety of industries, and the companies operating within them globally. We're optimistic that our thoughtful and evolving process to analyze those businesses, will, with dedicated effort, yield good long-term investment results.

We appreciate, as always, the trust you have placed in us.

Sincerely,

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