Harding Loevner International Equity Portfolio

COMMENTARY

ASSET CLASS | INTERNATIONAL EQUITY

Investor | HLMNX — Institutional | HLMIX — Institutional Class Z | HLIZX

HARDING LOEVNER

Average Annual Returns (%)[1] (as of 12/31/18)

	QTD	YTD	1 yr	3 yr	5 yr	10 yr	Since Incpt.
HLMNX (Investor)	-15.13	-14.30	-14.30	5.22	2.31	8.47	5.24[2]
HLMIX (Institutional)	-15.05	-13.96	-13.96	5.58	2.64	8.82	5.69[3]
HLIZX (Institutional Class Z)	-15.05	-13.93	-13.93	—	—	—	-4.60[4]
MSCI ACWI ex-USA	-11.46	-14.20	-14.20	4.48	0.68	6.57	—

HLMNX (Investor) Expense Ratio (Gross/Net): 1.14%/1.14%
HLMIX (Institutional) Expense Ratio (Gross/Net): 0.82%/0.82%
HLIZX (Institutional Class Z) Expense Ratio (Gross[5]/Net)[6]: 0.99%/0.75%

Performance data quoted represents past performance; past performance does not guarantee future results. The investment return and principal value of an investment will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost. Current performance of the Portfolio may be lower or higher than the performance quoted. Performance data current to the most recent month end may be obtained by calling 877.435.8105 or visiting hardingloevnerfunds.com. Performance data shown does not reflect the 2.00% redemption fee imposed on shares held 90 days or less; otherwise, total returns would be reduced.

The **Harding Loevner International Equity Portfolio** (Investor Class) returned -15.13% during the fourth quarter of 2018 compared with the -11.46% return for its benchmark, the MSCI All Country World ex-USA Index. For the 12-month period ending December 31, 2018, the Portfolio returned -14.30%, compared with the -14.20% return for the Index.

Market Review

International stock markets suffered their sharpest quarterly fall in three years, led by double-digit declines in Developed Market equities amid worries that a global recession looms. Emerging Markets (EMs), weak all year, fell less in the quarter than Developed Markets, aided in part by rebounds in the weakest countries and currencies. Stocks of the fastest-growing companies reversed their earlier outperformance, posting some of the quarter's worst declines.

The U.S. Federal Reserve (the Fed) declared in October that it planned more hikes in short-term interest rates if economic data continued to be strong; in December, it duly delivered its ninth quarter-point rise. Long-term U.S. Treasury yields fell, however, flattening the yield curve. That and widening credit spreads in global bond markets suggested that investors foresee an end to the economic expansion. A precipitous decline in crude oil prices reinforced that suggestion. The European Central Bank formally ended its quantitative easing monetary policy in December, having bought nearly US$3 trillion worth of bonds with printed money.

Political developments around the world provided little support for investor sentiment, starting in the U.S. A hawkish foreign policy speech by Vice President Mike Pence at the beginning of October gave investors the impression that the tariffs President Trump imposed on China are more than just a negotiating tactic, despite the president's assurances that trade talks with China have been productive. Prospects of a protracted trade war threatened the growth of cross-border trade, raised the possibility of disruption to global supply chains, and discouraged company managements from making fixed-capital investments.

Outside the U.S., a "no-deal" Brexit scenario appeared increasingly likely as Prime Minister Theresa May pulled her negotiated proposal for withdrawal from the European Union before British lawmakers could reject it. German Chancellor Angela Merkel, long a steadying hand in volatile European politics, signaled an end to her 13 years in office by relinquishing the post of leader of her political party following recent election setbacks. French President Emmanuel Macron faced violent protests in a backlash against his fiscal reform agenda. Latin American politics intoxicated by populism lurched both left and right. The anti-corruption campaign of new Mexican President Andrés Manuel López Obrador (AMLO) claimed its first casualties: airport construction contracts signed by the government under the previous administration, which it immediately abrogated. In Brazil, voters elected an authoritarian but ostensibly business-friendly president, Jair Bolsonaro. Its equity market was one of the few to rise in the quarter.

Stocks in cyclical industries such as capital goods, energy, technology hardware, and semiconductors lagged in the fourth quarter, while non-cyclical sectors such as utilities, real estate, and consumer staples performed the strongest.

By style, stocks of the fastest-growing companies performed much worse than their slower-growing counterparts, a reversal from the first nine months of the year. The MSCI All Country World (ACW) ex U.S. Growth Index underperformed its Value Index counterpart, but we find no pattern in the returns of cheaper stocks relative to pricier ones in the quarter; if anything, cheap stocks fared slightly worse than other valuation cohorts.

The least-volatile stocks outperformed, and only the utilities sector finished the quarter in positive territory. Equity investors had nowhere else to hide: no regions, other sectors, or styles gained in the period.

[1] Returns for periods less than one year are not annualized.
[2] Since the inception of the Portfolio's Investor Class shares on September 30, 2005.
[3] Since the inception of the Portfolio's Institutional Class shares on May 11, 1994.
[4] Since the inception of the Portfolio's Institutional Class Z shares on July 17, 2017.
[5] The Gross Expense Ratio is as of the Prospectus dated February 28, 2018.
[6] The Net Expense Ratio is as of December 31, 2018 as the Portfolio is operating below the contractual agreement, which is in effect until February 28, 2019.

Performance and Attribution

The Harding Loevner International Equity Portfolio (Investor Class) fell -15.13% in the fourth quarter, considerably more than the index's -11.46% decline. The quarter's weak performance nearly negated the positive relative performance for the prior nine months. For the year, the Portfolio fell -14.30%, slightly lagging the index, which declined -14.20%.

For the quarter, our underperformance was primarily due to weak stock selection. By sector, our stocks in healthcare detracted the most, led by two Japanese companies. Shares of **M3**, a medical information services provider, sold off after the company reported larger-than-expected margin declines due to acquisitions and investments in artificial intelligence technology, which we believe will pay off over time. **Sysmex**, a leading manufacturer of blood-testing equipment and associated consumables, reduced its sales growth forecast for this fiscal year to 6% from 10% as hardware sales weakened. Our top detractors in industrials were also Japanese capital goods companies: **JGC**, **Fanuc**, and **Komatsu**. Our financials stocks helped relative returns, led by EM banks. **ICICI Bank** and **HDFC Bank** in India and **Itaú Unibanco** in Brazil all rebounded from prior weakness.

We underperformed across all major regions in the quarter, especially Japan and EMs. In the latter, China (due to search engine company **Baidu**) and South Africa (due to energy and chemical technology developer **Sasol**) hurt returns.

For the year, our slightly negative stock selection was mostly offset by positive sector allocations (including, in the fourth quarter, a small cash balance), notably the Portfolio's light holdings in consumer discretionary, the worst-performing sector, and large holdings in healthcare, the second-best-performing sector. Our stocks in the latter detracted, however, especially German life sciences company **Bayer**. Our stocks in communication services also hurt, especially three companies exposed to the Chinese internet and social media industry: Baidu, **Weibo** (a social media platform), and South Africa's **Naspers** (which holds a large stake in Tencent, the Chinese online games and social media giant). We benefited from stocks in financials, where strong performers included Hong Kong-based insurer **AIA Group**, Singapore-based commercial bank **DBS Group**, and Itaú Unibanco. In IT, our good returns were led by **Dassault Systèmes**, a 3D-design software company.

By geography, our poor stocks in Japan (Fanuc and Sysmex) and in EMs (Baidu, Weibo, Naspers, and South Africa's **Aspen Pharmacare**) partially offset positive selection elsewhere. In Europe outside the eurozone, all five of our Swiss holdings contributed to our returns. Pacific ex Japan benefited from financial companies AIA and DBS. France's Dassault, **L'Oréal**, and industrial gases company **Air Liquide** were our top performers within the eurozone.

Perspective and Outlook

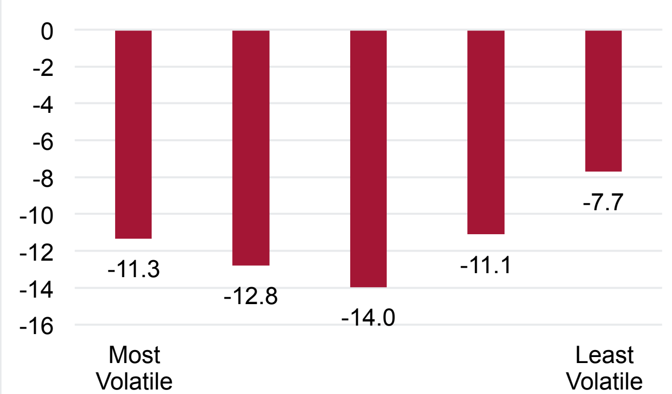
In an environment in which the Fed has been steadily raising short-term interest rates, leading other central banks to signal a retreat from the ultra-low interest rate policies of the last decade, combined with rising risks of trade disruption for political reasons from Brexit to U.S. tariffs, what should an investor reasonably expect from our strategy? We believe that stocks of high-quality companies generally offer a return premium over the market return. That premium is due in part to the competitive advantages and financial strength of the businesses themselves, which makes them more resilient and maneuverable in shifting economic currents. And it is due in part to the behavior of investors, who time and again demonstrate their love of exciting "stories," their irrational preference for risk, and their overconfidence in extrapolating today's growth. These foibles tend to result in the underpricing of boring and steady profitable growth at less-than-heady rates.

This belief in high-quality businesses' return premium underpins our investment philosophy. Over the several cycles we have experienced since starting our firm nearly 30 years ago, our performance in falling markets has been relatively better than the market. And as we got better over the years at identifying quantitative financial metrics associated with the essentially subjective label of "quality," we could see a positive connection between our preference for high-quality companies and outperformance in periods of stock market declines (as well as underperformance in some periods of "risk-on" rallies).

In this most recent market decline, however, our Portfolio underperformed, even though stocks of higher-quality companies in general fell less than other market constituents, and despite our Portfolio being laden with companies that exhibit high-quality characteristics. That unaccustomed outcome demands some investigation into what was different about this market decline, or, alternatively, what we got wrong in the environment before the decline that left our Portfolios unprepared to withstand this particular episode of market weakness. First, the decline itself was marked by the most-liquid stocks—which describes many of our holdings—falling the furthest, while less liquid ones had smaller declines. That strikes us as a common feature of rapid crashes in the past, and it has often just meant that investors sold first what they could sell efficiently, while the stocks with less turnover take more time to find the price level that attracts new willing owners and experience longer, slower declines that end up of similar magnitude. As we experienced it, the 1987 crash very distinctly had that feature. Second, lower stock prices are likely reflecting higher discount rates demanded by investors to incorporate the unstable business environment created by politicians in the U.K. and U.S., which heretofore have been fairly predictable places for profit-making activities, in contrast to, say, Russia, Brazil, or Indonesia. We are underweight the U.K. in our Portfolio, although our holdings in the country (and elsewhere) are multinationals that generally benefit from rising global trade.

A third notable feature of this decline is the dreadful performance of stocks of the fastest-growing companies, the cohort most avidly pursued by investors over the past few years. If your portfolio did not emphasize fast growth, your relative performance over the past 12 quarters until this one was likely poor. Our Portfolio has always emphasized growing businesses, a look that was certainly "in fashion" over the past couple of years. What has been different in this cycle is that many of the fastest-growing companies also rank objectively among the highest-quality, so that it has been possible to own a portfolio that was both fast growing and high quality. We had our share of those fast-growing stocks that suddenly went out of fashion. The benefit we normally get from our high-quality focus was lost in the rush to exit from the fastest-growth companies.

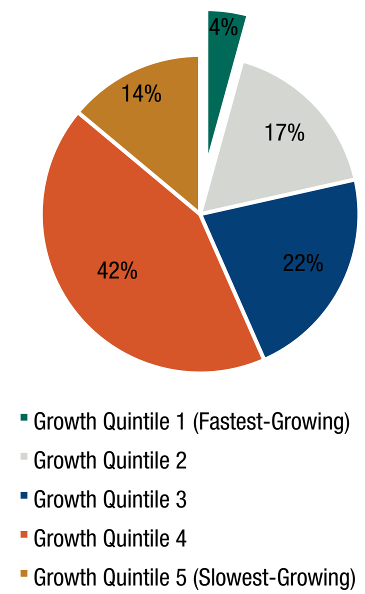
A final feature of the quarter was the smaller decline of "low volatility" stocks. As shown in the chart below, the quintile of stocks in the index with the lowest volatility fell only two-thirds as much as the broad index.



Source: FactSet (data as of December 31, 2018); MSCI Inc. and S&P.

Investors sometimes conflate low-volatility stocks and high-quality companies, and indeed, there is some overlap, not least because, in our taxonomy, one of the hallmarks of high quality is low cyclicality, for which we take the volatility of returns on capital as a proxy. But low-volatility stocks are just that: stocks whose share prices vary less than that of the average stock, and many of those companies do not meet our standards as high quality. They are over-represented in the "defensive" sectors of utilities, real estate, and consumer staples, along with a portion of healthcare known as "Big Pharma," and, surprisingly, a considerable part of financials. It is no surprise that those were the best-performing sectors this quarter. We have owned—on quality grounds—very few companies from the utilities and real estate sectors over our firm's history. They tend to be both highly regulated and highly leveraged, with low unlevered profitability. Our holdings of financials are light for similar reasons.

A more obscure truth about low-volatility stocks is that they encompass very few growth businesses. By our count, just 4% of the companies in the least-volatile quintile of stocks also rank in the fastest growth quintile, as seen in the chart below—meaning less than 1% of stocks in the index.



Source: FactSet (data as of December 31, 2018); MSCI Inc. and S&P.

Because growth holds equal rank alongside quality as a fundamental underpinning of our investment philosophy, it's relevant to point out that the number of companies that rank highly on both quality and growth, and whose stocks also display minimal price volatility, is a small minority. Of the 2,136 stocks in the MSCI ACW ex U.S. Index, only 36 were at the intersection of good growth, high quality, and low volatility, as seen in the diagram below. A rare breed indeed. The best place to hide this quarter was in low-volatility stocks—but owning more of those might have forced us to abandon our insistence on growth.

MSCI ACW ex U.S. Index Low-Volatility Stocks of Above-Average Growth and Quality

Source: FactSet (data as of December 31, 2018); MSCI Inc. and S&P.

In that small opportunity set, we have limited scope to own a large proportion of low-volatility stocks while still adhering to our philosophy. We clearly failed to seize that slim chance. In our defense, shifting our aim explicitly toward those most “defensive” of stocks would have required an insight that the fashion of pursuing highest growth regardless of price was about to change—a grasp at market timing that we take pains to avoid in our utter mistrust of our ability to make such top-down calls on the market. In our studied agnosticism about predicting the behavior of others, it’s quite possible that we paid insufficient heed to how much “the crowd” had moved toward our own preferences, or, more accurately, failed to identify an adequate shelter against the moment that fashion shifted elsewhere.

Instead, the risk that we have been focusing on for the past several years is the increasingly high prices commanded by stocks of high-quality, growing companies. As habitual readers of our letters will know, we first voiced concern in the fourth quarter of 2014 and have returned often to this theme. As already noted, the least-volatile stocks have not appeared particularly cheap. As a case in point, our recent low holdings of consumer staples stocks relative to our own long-term history is grounded in that disconnect of rich prices and steady but modest growth. Nevertheless, even if we had shifted our emphasis from growth toward cheaper valuations some time ago (which would have come at great cost to investment returns over the past couple of years), we still would have likely underperformed in the recent market decline. Our rankings of stocks in the index by value show no return advantage this quarter for the cheaper stocks. Among the stocks that we own, those that rank as better value actually hurt relative performance in the quarter (and in the year), typically because the trade-off to lower valuation was a more cyclical business.

Over the past two years or so we have reduced or sold a larger-than-usual number of holdings that had reached what we considered to be extremely rich valuations. Those proceeds have been reinvested in other companies whose share prices were less pricey, sometimes due to a sharp decline following a business hiccup that we deemed temporary. Those shifts away from the most highly priced stocks now seem to us—at least emotionally—too incremental. However, in hindsight we’re doubtful that we’d have reinvested the proceeds of additional sales into companies that would have weathered this market decline much better. It wasn’t cheaper valuations that helped; it was avoiding the stocks of the fastest-growing companies, whatever their valuations.

Moving ahead, we are unwilling to reduce either our emphasis of growth or of quality, and we will continue to build a Portfolio of companies that exhibit both. But, as hinted earlier, we do worry about the bias we manifest in favor of multinational businesses. These companies are repeatedly recognized by our process: they tend to be more diversified and less cyclical, with higher profit margins and returns on capital, and are thus able to operate with less leverage while investing around broader growth opportunities. As the trade war worsens, it becomes an attack on the bounty of globalization: the efficiencies of global supply chains that have benefited consumers everywhere while bolstering the profits of those companies most adept at exploiting them. If global supply chains are further disrupted, we will be working overtime to identify less-exposed companies, using the same analytical framework (that is, our criteria of competitive advantage, good growth prospects, sound management, and financial strength) that led us in the past to so many beneficiaries of trade.

Sidebar: The Economic Environment and Our Process

When describing market developments, we normally touch on significant economic shifts and political forces that we think provide context. Sometimes a newer colleague asks us why we do that. After all, we take pains to say, over and over, that we make investment decisions from our bottom-up analysis of companies, rather than from a top-down view of the economy or political climate. In one tantrum, we couldn’t help ourselves from telling our readers to stop asking us about our outlook, because we didn’t have one. All of that remains true.

Still, we believe that reviewing the economic environment, and sometimes the political environment, is a way to provide context for not only our decisions but also our Portfolio returns, which are often better than the market, but sometimes—like in this quarter—worse. We think that such a review helps set our investors’ expectations of what might be possible, and what would be unlikely in the short run, even as we focus on forecasting the long-term prospects of individual businesses.

The main economic factors that affect the environment for making investment decisions include inflation, interest rates, and broad economic growth. Inflation, when not subdued as at the present time, can have a significant impact on individuals’ consumption behavior, on corporate cash flows, and on investor preferences. We pay attention to inflation expectations revealed in markets, even though we don’t try to forecast inflation. In an unconstrained market, inflation expectations exert direct influence on interest rates, which act as the great equalizer of cash flows from different time periods and different currencies. As current focus on the yield curve demonstrates, long-term interest rates driven by those expectations can diverge from short-term rates controlled by central banks. The level of long-term interest rates also has a huge effect on the willingness of individuals, companies, and governments invest, either in housing or consumer durable goods financed by debt, or in plants and equipment, or in infrastructure and public works, which, in turn, spurs or reins in overall economic activity.

Economic activity waxes and wanes. When generalized growth is strong, opportunities are plentiful for most companies. Rivalry among them declines, and most companies are able to expand their sales at profitable prices. When economic growth is less abundant, only those companies with the strongest competitive advantages manage to maintain profitable growth.

Politics can foster benign climates for corporate expansion, or can create instability, which raises the variability of returns that any investment made today will have over the coming years. The only way of improving expected returns in such a situation is to shorten the payback period, which is tantamount to saying “raise the required return” of any investment project. Unstable political environments will cast a chill over most investment plans in this way, such that only the expected returns of the most lucrative projects meet the hurdle of the higher required return. Fewer projects initiated leads to both slower revenue growth and lower employment. The U.K.'s struggle with Brexit and the U.S.'s unilateral instigation of trade hostilities are two current instances of politically rooted sources of instability.

Portfolio Highlights

The quarter brought sharply lower share prices for many of the companies in our coverage universe. The speed, depth, and breadth of the precipitous selloff brought with it a silver lining: the likelihood that mispricings occurred as investors ratcheted down risk exposure without due regard for price. In contrast to the very low turnover experienced in the Portfolio over the past few years, we were quite active this quarter, spurred on by the opportunity to buy several high-quality, growing businesses at newly attractive valuations.

Among the new investments made in the quarter were two in EMs, Mexican conglomerate **FEMSA** and Russian search-engine-and-ridesharing company **Yandex**, which brought our EM exposure to just under 20% of the Portfolio. Despite strong fundamentals at both businesses, their shares have been under pressure from the general disfavor of EMs, made worse by the vicorty of President Andrés Manuel López Obrador (AMLO) and the additional U.S. sanctions imposed against Russia. We think the growth outlook for each is far brighter than investors are giving them credit for. While FEMSA is perhaps better known for its Coca-Cola bottling business (it owns 47% of Coca-Cola FEMSA, also listed on the Bolsa), its engine for growth recently has been its OXXO convenience stores throughout Mexico and Colombia, which now number around 17,500. OXXO now accounts for over 35% of FEMSA's revenues, having grown sales at a 13% compound annual growth rate over the past five years.

Yandex has been aided recently by court rulings against Google's favored pre-installation on Android smartphones. Yandex accounts for about 55% of all search requests in Russia but for a much higher percentage of search-related advertising revenues. Yandex.Taxi recently merged with the Russian subsidiary of Uber. Yandex now owns 59% of the combined business, ending a rivalry that inflicted large losses on both companies as they fought one another for market share. Ridesharing constitutes about 14% of Yandex's overall revenues, with the volume of rides more than doubling in the past year.

While we have written in the past on our investment in semiconductors, specifically **Samsung Electronics**, **TSMC**, and more recently, **Infineon Technologies**, we believe their businesses are even more attractive today, for two reasons. First, the industry structure has improved from a rivalry standpoint due to some consolidation and to rising barriers (capital costs and engineering know-how) to new entrants. Second, sources of demand for microprocessors and memory chips are broader and more disparate than in the past. Silicon chips are increasingly embedded in appliances and automobiles, alongside their traditional uses in PCs, smartphones, servers, and consumer electronics. A less competitive industry structure coupled with more diversity in applications should result in better pricing and steadier, less cyclical demand.

The share price performance of the semiconductor industry group this past quarter—down 15%—would suggest an outlook different from our own. Yet, we do not see any new fundamental evidence contrary to our thesis. No new entrants loom and, while demand has slackened cyclically and pricing is softer, the companies remain hugely profitable. Samsung's operating margins in 2019, for example, are estimated to be about 20%. Perhaps the disconnect between the falling share prices and the undimmed long-term outlook for the underlying businesses reflects the short time horizon of other investors, heedless of Ben Graham's admonition that the stock market is "a voting machine in the short run, but a weighing machine in the long run." We now own a roughly 5% weight in semiconductors, double that of the index.

Portfolio Management Team Update

As previously announced, Andrew West, a portfolio manager of the International Equity strategy since 2014, became a co-lead portfolio manager of the strategy on January 2, 2019, replacing Alec Walsh. Ferrill Roll continues as the strategy's other co-lead portfolio manager. Alec, along with Bryan Lloyd and Patrick Todd, remains a portfolio manager of the strategy. The assignment change was made in anticipation of Alec's retirement at the end of this year.

The views expressed represent the opinions of Harding Loevner LP as of December 31, 2018, are not intended as a forecast or guarantee of future results, and are subject to change without notice.

Top Ten Holdings (%)[7] (as of 12/31/18)

Holding	% of Net Assets
AIA Group	3.89
Nestle ADR	3.75
Allianz	3.62
Royal Dutch Shell	3.27
Samsung Electronics	3.05
DBS Group	2.92
L'Oreal	2.88
Taiwan Semiconductor	2.80
Check Point	2.76
Air Liquide	2.67
TOTAL %	31.61

[7] Mention of a specific security should not be considered a recommendation to buy or a solicitation to sell that security. Holdings are subject to change.

Disclosure

The Portfolio's investment objectives, risks, charges and expenses must be read and considered carefully before investing. The statutory and summary prospectuses contain this and other important information about the investment company. They may be obtained by calling toll free 877.435.8105, or visiting hardingloevnerfunds.com. Read it carefully before investing or sending money.

The Portfolio invests in foreign securities, which will involve greater volatility and political, economic, and currency risks and differences in accounting methods. It also invests in emerging markets, which involve unique risks, such as exposure to economies less diverse and mature than the U.S. or other more established foreign markets. Economic and political instability may cause larger price changes in emerging markets securities than other foreign securities. Such risks may be magnified for securities in frontier emerging markets. Investing in participation notes involve the same risks associated with a direct investment in the underlying security, currency or market.

Past performance is no guarantee of future results.

Diversification does not guarantee a profit or protect from loss in a declining market.

Earnings growth is not a measure of the Fund's future performance.

The MSCI All Country World Index (ACWI) ex-USA is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of developed and emerging markets. The MSCI ACWI ex-USA consists of 22 developed and 24 emerging market country indices.

The MSCI ACWI ex USA Growth captures large and mid cap securities exhibiting overall growth style characteristics across 22 Developed Markets (DM) countries and 24 Emerging Markets (EM) countries.

The MSCI ACWI ex USA Value captures large and mid cap securities exhibiting overall value style characteristics across 22 Developed and 24 Emerging Markets countries.

Please go to msci.com for most current list of countries represented by the MSCI indices.

Unlike the Fund, the Indices are unmanaged, are not available for investment, area net of foreign withholding taxes on dividends and do not incur expenses.

Return on capital measures the return that an investment generates for capital contributors, i.e. bondholders and stockholders. Return on capital indicates how effective a company is at turning capital into profits.

Cash-flow is the net amount of total cash transferring into and out of a business.

Growth stocks typically are more volatile than value stocks; however, value stocks have a lower expected growth rate in earnings and sales.

An American depositary receipt (ADR) is a negotiable certificate issued by a U.S. bank representing a specified number of shares (or one share) in a foreign stock traded on a U.S. exchange.

All holdings and sector/region allocations are subject to review and adjustment in accordance with the Portfolio's investment strategy and may vary in the future, and should not be considered recommendations to buy or sell any security. The Portfolio is actively managed; therefore holdings may not be current.

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