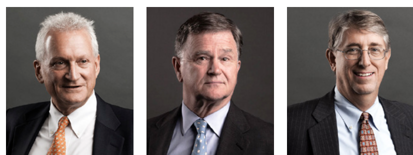
HARDING LOEVNER

LETTER TO OUR CLIENTS AND FUND SHAREHOLDERS

OCTOBER 31, 2020

Excerpted from the Harding, Loevner Funds, Inc. 2020 Annual Report and Commentary



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Value investing, the notion of excluding all but the most unloved stocks from portfolios, is dead. Following value's decade of underperformance of the broad market, the *coup de grâce* was delivered by the pandemic. Then again, value investing has been readied for a spot in the ground before, only later to leap back to life.

The Wall Street Journal in its October 23rd edition wrote about one high-profile casualty of value's latest demise: systematic value investor Ted Aronson, who's thrown in the towel by deciding to dissolve his longstanding investment fund. Aronson, who was highly successful throughout most of his long career, said of his—or any—particular investment approach: "It can all work for years, for decades, until or except when the not-so-invisible hand comes down and slaps you and says, 'That's what worked in the past, but it's not going to work now, nope, not anymore.'" A useful reminder that, in investing as in life, nothing works always or forever.

The efficacy of investment styles tends to ebb and flow, and on these cycles float the fortunes of investors. An earlier generation of value managers suffered a similar fate to Ted Aronson at the peak of the technology-media-telecom ("TMT") bubble twenty years ago. In the space of three months in early 2000, Gary Brinson, founder of Brinson Partners, Julian Robertson of Tiger Management, Tony Dye of Phillips and Drew, and George Vanderheiden of Fidelity, all storied value investors with once-enviable track records, decided to call it quits after a run of disappointing returns. The Nasdaq index, a useful proxy for growth stocks, saluted their departure by peaking on March 10, 2000, at 5,132, at a price to trailing earnings multiple of 72. "Value managers are fast becoming a rare species" quipped Jeremy Grantham, one of value's handful of survivors, in his first quarter letter of 2000.

Growth investors for their part took to explaining why their approach must out of necessity win always, from that point onwards and into eternity and, as a corollary, why value investing was destined to fail. Heedless, value stocks commenced outperforming growth stocks and continued to do so over the next five years. Now, twenty years on, growth at any price rules the roost once again. Earnings, profits, and cash flows, the building blocks at the foundation of any sensible fundamental investment approach, have been cast aside in favor of revenue growth rate and the potential size of the addressable market. The latter term is a conveniently malleable notion that admits any number of self-contradictory futures featuring incompatible outcomes. An electric car in every driveway? Sure. And a swarm of on-demand self-driving taxis, too? Why not!

We are suspicious of value calculations that project galloping growth out beyond the horizon. No tree grows to the sky. Most phenomena are cyclical, even within secular trends. Investors are apt to make their biggest blunders when they forget this and extrapolate current trends *ad infinitum*. Every valuation model embeds opinions about the future, but without evidence opinion morphs into conjecture, making it indistinguishable from hearsay. And as the rationale for high valuations drifts further away from actual observable cash flows and profits the greater is the risk that stocks slip their valuation anchor entirely. Unmoored from any rational basis, stock prices become ever more sensitive to fickle changes in mood, in either direction.

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The last few years have been brutal for any investor seeking a margin of safety, that is, a discount to fair value intended to insure against unforeseen risks. It may yet get more merciless. A person forming their view of markets could easily be convinced that valuation no longer matters, that price can safely be ignored. We believe they do so at their peril. Many analysts who'd started their careers in the late '90s appeared to be mentally stunted by the bursting of the TMT bubble in 2000, left wondering why what had worked in their formative years and filled their playbook no longer held. Growth is ascendant again but it's a different generation of analysts leading the charge—a generation comprised of many who have yet to experience their investment style fall out of favor.

Even the most sensible investment policies will get you into trouble sometimes. Because markets are the collected actions

of individual human beings, they don't follow fixed rules. Previously reliable relationships can evaporate without warning and, although conditions may be similar, they are never the same. Every investor is faced with the same dilemma: how to be consistent and yet still be sufficiently flexible to adapt and evolve.

Our response to this dilemma is threefold: avoid slavish devotion to any single market factor (such as quality, value, or growth), disaggregate our investment decisions and distribute them among our numerous analysts and portfolio managers, and erect strong guardrails around our investment process. Sovereign about which companies they cover and which they recommend, our analysts are free to judge the merits of different businesses, but they must follow a fixed set of research protocols. Managers are not free to add just any company to their portfolios but, rather, must choose from among those covered by our analysts; they are, however, free to disagree with an analyst by owning it over objections as to the current price. Likewise, the resulting portfolio can range widely but must obey rules that enforce diversification.

These guardrails are sometimes a source of tension and abiding by them probably means we miss out occasionally, but on balance this is more than made up by some fatal crashes we have avoided. We do not favor a single factor because we don't believe any factor is permanently endowed with alpha creation. Even combinations of factors guarantee success only in hindsight. We train our sights on quality, growth, and value because each helps us to view different constellations of stocks. Quality is the closest thing we have to a lodestar since in our experience it narrows the range of potential bad outcomes. But value and growth are at opposite celestial poles, each with opportunities and traps; you cannot afford to focus on one at the expense of the other.

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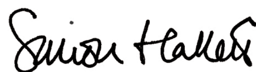
Aronson, Brinson, Robertson and the rest are all smart fellows. We don't believe for a minute that we are any smarter. As we have seen, what befell their value-oriented approach can befall a growth-oriented approach like ours. For the time being, the global policy direction continues to smile upon growth while frowning upon value. But change may be afoot—the underpinnings don't seem very stable to us.

As always, we are honored by your continued trust in us.

Sincerely,

David R. Loevner, CFA, CIC



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