



# Harbor High-Yield Bond Fund



Mark Shenkman



Mark Flanagan, CFA, CPA



Frank Whitley

## 4th Quarter, 2011 Commentary

*"The combination of a modest U.S. recovery and subdued investor expectations could allow for 2012 to develop into a year of pleasant surprises." -Mark Flanagan*

### Combination of factors could favor high yield issues in 2012

Continued economic recovery in the U.S. and strong investor demand for incremental yield could create a favorable climate for the high yield market in 2012, in the view of Mark Flanagan, Portfolio Manager of the Harbor High-Yield Bond Fund. Flanagan expects demand to outpace supply in the high yield market in the months ahead due in part to inflows from investors outside the U.S.

Yield spreads between the high yield market and U.S. Treasuries widened considerably during 2012 although the high yield default rate remained low by historical standards, Flanagan notes. He sees this as a disparity that could prove advantageous to high yield investors.

The Harbor High-Yield Bond Fund outperformed its benchmark, the BofA Merrill Lynch High Yield Index, for 2011 with a return of 4.83% versus 4.38% for the index. The Fund returned 6.05% for the fourth quarter while the index gained 6.18%. The Fund benefited from a strong performance by its high yield bond holdings, which generated aggregate returns of more than 7% for the quarter. Leading contributors included holdings in the utility, cable, health care, energy, technology, and gaming sectors. Investments in bank loans and convertibles detracted from Fund performance, as these holdings lagged the high yield bonds in the portfolio, Flanagan reports.

Mark Flanagan's comments were made in a January 12, 2012, interview. Highlights adapted from the interview appear below. All comments relate to the quarter ended December 31, 2011, unless otherwise indicated. All references to year-to-date are for the period January 1 through December 31, 2011.

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## INTERVIEW HIGHLIGHTS

### Investor opportunity

High yield default rates remained static at approximately 1.8% during the quarter, which is well below historical levels. While the default rate increased only marginally in 2011, high yield spreads, or the risk premiums for investing in the high yield sector, widened out significantly. We believe this spread-widening was excessive and clearly represents an opportunity for high yield investors.

### Subpar growth

Our outlook for the U.S. is GDP growth in the subpar range of 2% to 2.5% in 2012. One benefit of a modest rate of economic growth is that it would allow for the possibility of a retreat in global commodity prices. Clearly if inflation stays subdued it could benefit consumers. It also could allow central bankers to be accommodative for perhaps a more extended period, as they would not have to worry about inflationary fears.

### Modest recovery

The combination of a modest U.S. recovery and subdued investor expectations could allow for 2012 to develop into a year of pleasant surprises. We think more accommodative bank lending standards and continued doses of Fed liquidity should allow for a gradual strengthening of U.S. GDP, perhaps faster than the consensus growth rate of 2.2%. If the U.S. economy stays on track, we believe the high yield market appears poised for a year of solid performance in 2012.

### Demand for high yield

Fund flows into the high yield asset sector should accelerate, we believe, given record-low interest rates worldwide and demand for incremental yield. We expect a strong year of supply in the high yield market but we don't think it will meet demand. Furthermore, we expect M&A



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transactions, which oftentimes can be a positive driver for high yield, to accelerate this year as more companies deploy their cash to pursue growth strategies. Finally, we would expect significant inflows from foreign capital coming into the U.S. market, to meet both diversification and safety objectives.

### Low default rates

We're not that far beyond 2008 and 2009, when about 15% of the high yield market defaulted, so we feel that a lot of the weakest high yield issuers have been purged from the market. Moreover, we haven't had a significant increase in aggressive issuance or leveraging of balance sheets over the last three or four years; in fact, we've had quite the opposite. We've seen many companies improve their operations, build in flexibility, raise subordinated capital, and put cash on their balance sheets.

### Total Returns

As of 12/31/2011

|   | Three Months | One Year | Three Years | Five Years | Since Inception (12/01/2002) | Expense Ratios Net | Expense Ratios Gross |
|---|--------------|----------|-------------|------------|------------------------------|--------------------|----------------------|
| <b>Harbor High-Yield Bond Fund - INST</b> | 6.05%        | 4.83%    | 15.55%      | 6.46%      | 8.03%                        | 0.67%              | 0.70%                |
| BofA Merrill Lynch US High Yield Index    | 6.18%        | 4.38%    | 23.72%      | 7.34%      | 9.90%                        |                    |                      |

As of 12/31/2011, the Harbor High-Yield Bond Fund had invested the following percentages of its assets in the sectors listed: Consumer Discretionary, 27.22%; Energy, 11.61%; Industrials, 9.96%; Health Care, 9.31%; Telecommunication Services, 8.16%; Information Technology, 7.37%; Materials, 5.77%; Consumer Staples, 5.41%; Financials, 4.28%; Utilities, 3.04%;

**Performance data shown represents past performance, which is no guarantee of future results. Current performance may be higher or lower than the past performance data shown. Investment returns and the value of an investment will fluctuate, and an investor's shares, when sold, may be worth more or less than their original cost. You can obtain performance data current to the most recent month-end (available within seven business days after the most recent month-end) by calling 800-422-1050 or visiting [www.harborfunds.com](http://www.harborfunds.com).**

**Investors should carefully consider the Fund's investment objectives, risks, charges and expenses before investing. To obtain a summary prospectus or prospectus for this and other information about the Fund, visit [harborfunds.com](http://harborfunds.com) or call 800-422-1050. Read it carefully before investing.**

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*Fixed income investments are affected by interest rate changes and the creditworthiness of the issues held by the Fund. As interest rates rise, the values of fixed income securities held by the Fund are likely to decrease and reduce the value of the Fund's portfolio. High-yield investing poses additional credit risk related to lower-rated bonds. The Fund charges a redemption fee of 1.00% on redemption of shares that are held for less than nine months.*

*About Expense Ratios: All mutual funds have expense ratios which represent what shareholders pay for operating expenses and management fees. Expense ratios are expressed as an annualized percentage of a fund's average net assets paid out in expenses. Net expense ratios reflect adjustments due to voluntary or contractual fee waivers or expense reimbursements. Expense ratio information is as of the Fund's current prospectus, as revised and supplemented from time to time. The net expense ratios for this Fund reflect a contractual management fee waiver until 02/29/2012.*

*Performance figures discussed in any of the Manager Commentaries reflect that of the Institutional Class shares.*

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*The BofA Merrill Lynch US High Yield Index is an unmanaged index that tracks the performance of below investment grade U.S. dollar-denominated corporate bonds publicly issued in the U.S. domestic market. All bonds are U.S. dollar-denominated and rated Split BBB and below. This unmanaged index does not reflect fees and expenses and is not available for direct investment.*

*The views expressed herein are those of the portfolio managers at the time of the interview and may not be reflective of their current opinions or future actions. These views are not necessarily those of the fund company and should not be construed as such.*

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111 South Wacker Drive, 34th Floor | Chicago, IL 60606-4302 | 800.422.1050 | [www.harborfunds.com](http://www.harborfunds.com)