



# Harbor International Small Cap Fund



Nicholas M. Williams



Colin C. Riddles



Rosemary C. Simmonds, CFA

## 1st Quarter, 2017 Commentary

*"The major geopolitical event of 2016, the U.S. presidential election, continued to be the major macro-level factor affecting equity markets generally, and international small-cap equity markets specifically." -Baring International Investment Limited (Barings)*

### **Election results still creating positive economic outlook**

In the first quarter of 2017, renewed optimism in President Trump's policy agenda, specifically regarding taxation and infrastructure spending, boosted confidence in the outlook for U.S. economic growth and the ability to continue growing as benchmark interest rates continue to be raised by the U.S. Federal Reserve. This positive view provided a supportive backdrop for global trade growth forecasts. Political developments in Europe had a more limited impact. The U.K. began the Article 50 Brexit procedure triggered by last year's referendum, and there are now indications of a more cautious assessment of future economic growth in more recent confidence surveys.

Against this backdrop, the Harbor International Small Cap Fund advanced for the quarter, posting a return of 9.40%. The Fund outperformed its benchmark, the MSCI EAFE Small Cap (ND) Index, which returned 7.97%. Relative outperformance was due mostly to strong stock selection in the Industrials sector. Negative stock selection in the Information Technology sector detracted from relative results. Among countries, stock selection drove a contribution from Japan, but sector allocation in Israel had a negative effect.

Baring International Investment's comments were made in an April, 2017 report. Highlights adapted from the report appear below. All comments relate to the quarter ended March 31, 2017, unless otherwise indicated. All references to the year-to-date are for the period January 1 through March 31, 2017.

---

## **HIGHLIGHTS**

### **Strengthening of Japanese Yen Relative to U.S. Dollar**

The major currencies of countries in the International Smaller Companies Index were reasonably stable relative to the U.S. Dollar during the quarter. The most notable movement over the quarter was the partial strengthening of the Japanese Yen relative to the U.S. Dollar. Yen strength had the effect of causing profit taking in export oriented Japanese companies, although the strength of the currency mitigated this impact somewhat. Companies exposed to growing niche markets of domestic consumer and industrial demand correspondingly performed relatively strongly.

### **Decreasing Exposure to Developing Markets**

Direct exposure to developing markets fell during the quarter due to the sales of two of the Fund's China-based holdings. Stock selection driven investment decisions were the key rationale for these changes; however, reinvestments after these sales contributed to an increase in developed market exposure to Japan and Europe. While economic data indicated a more positive outlook for most developing economies in the coming year, the valuations of Asia-based smaller companies in developing markets already appear to discount significant recovery. Among the holdings in developed markets, a number can be expected to benefit markedly from any strengthening in developing economies' growth rates. While such an acceleration is not the primary rationale for any of the individual holdings, some companies would benefit from stronger consumer spending in Asia.

### **Optimistic Long-Term Outlook for International Smaller Companies**

Our outlook for international smaller companies remains positive regarding the long-term potential for the asset class, and more importantly, the stock selection opportunities within this diverse and entrepreneurial group of companies. Our slightly more positive outlook for



# Harbor International Small Cap Fund

international smaller companies at the end of last year proved reasonably accurate, given the strong performance in the first quarter. Going forward, economic and world trade growth forecasts are well-supported by economic data releases in the first quarter. The key short-term concerns surround uncertainty for the outlook of the U.K. economy amid rising inflation rates, as Brexit negotiations gather pace, and the release of some more mixed domestic economic data in Japan. The weakness in oil prices during the first quarter could also be seen as signaling potential demand weakness and inventory build.

Furthermore, while interest rates remain low around the world relative to historic trend levels, concerns about global synchronized tightening of monetary conditions may return to prominence later in the year. Overall, our short-term outlook is now slightly more balanced than at the beginning of the year. International smaller company valuations remain relatively attractive compared to other asset classes, and relative to larger companies, while short-term economic developments remain supportive. However, evidence of profit growth will be a key support for share prices going forward.

## Total Returns

As of 03/31/2017

	Three Months	One Year	Three Years	Five Years	Since Inception (02/01/2016)	Expense Ratios Net	Expense Ratios Gross
<b>Harbor International Small Cap Fund - INST</b>	9.40%	10.59%	N/A	N/A	13.17%	0.95%	2.56%
MSCI EAFE Small Cap (ND) Index	7.97%	10.99%	N/A	N/A	16.78%		

**Sectors:** As of 03/31/2017, the Harbor International Small Cap Fund had invested the following percentages of its assets in the sectors listed: Industrials, 24.54%; Consumer Discretionary, 21.13%; Information Technology, 11.20%; Financials, 10.63%; Materials, 8.54%; Consumer Staples, 7.68%; Health Care, 6.39%; Real Estate, 2.88%; Utilities, 1.16%; Energy, 1.01%;

**Performance data shown represents past performance and is no guarantee of future results. Past performance is net of management fees and expenses and reflects reinvested dividends and distributions. Past performance reflects the beneficial effect of any expense waivers or reimbursements, without which returns would have been lower. Investment returns and principal value will fluctuate and when redeemed may be worth more or less than their original cost. Returns for periods less than one year are not annualized. Current performance may be higher or lower and is available through the most recent month end at [www.harborfunds.com](http://www.harborfunds.com) or by calling 800-422-1050.**

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

This information should not be considered as a recommendation to purchase or sell a particular security. The holdings or sectors mentioned may change at any time and may not represent current or future investments.

Expense ratio information is as of the Fund's current prospectus, as supplemented. Gross expenses are the Fund's total annual operating expenses. The net expense ratios for this fund are contractually capped, excluding interest expense (if any), through 02/28/2018.

The MSCI EAFE Small Cap (ND) Index is an equity index which captures small cap representation across developed markets countries around the world, excluding the U.S. and Canada. This unmanaged index does not reflect fees and expenses and is not available for direct investment.

Investing in international and emerging markets poses special risks, including potentially greater price volatility due to social, political and economic factors, as well as currency exchange rate fluctuations. These risks are more severe for securities of issuers in emerging market regions.

Stocks of small cap companies pose special risks, including possible illiquidity and greater price volatility than stocks of larger, more established companies.

Stock markets are volatile and equity values can decline significantly in response to adverse issuer, political, regulatory, market and economic conditions.

The views expressed herein are those of the subadviser, Baring International Investment Limited, and may not be reflective of their current opinions or future actions. These views are not necessarily those of Harbor Funds and should not be construed as such.

**Investors should carefully consider the investment objectives, risks, charges and expenses of a Harbor fund before investing. A summary prospectus or prospectus for this and other information is available at [www.harborfunds.com](http://www.harborfunds.com) or by calling 800-422-1050. Read it carefully before investing.**

**Harbor Funds is distributed by Harbor Funds Distributors, Inc.**

HARBOR FUNDS and the Lighthouse Design are Reg. U.S. Pat. & Tm. Off.