Harbor International Small Cap Fund

Manager Commentary
As of 12/31/2019

Subadviser: Cedar Street Asset Management LLC *(Since 05/23/2019)*
Portfolio Managers: Jonathan Brodsky, Waldemar Mozes

4th Quarter, 2019

"Our strategy seeks to establish new positions when company fundamentals are at their weakest and valuation discounts are at their highest. When fundamentals improve, the market response can be dramatic."

Cedar Street Asset Management LLC

Market in Review

Macroeconomic conditions appeared to deteriorate during the fourth quarter of 2019, with gross domestic product (GDP) growth slowing in most developed markets outside the U.S., reflecting a generally weaker global pattern. Likewise, most leading indicators such as the Purchasing Managers' Index (PMI) signaled additional contractions ahead. With limited global growth, commodity input prices continued to remain weak and most inflation indicators showed no reasons for concern.

From our perspective, the most significant macroeconomic change for the quarter came from a shift in sentiment, not statistics. The extreme pessimism regarding trade and broader political tensions between China and the U.S. that built up during the summer gave way to an acceleration of talks between trade negotiators and an eventual "Phase I" trade deal in December. Similarly, when the U.K.'s Boris Johnson took over as Prime Minister in July, his premiership looked destined for failure, but by October he pulled off a surprise new agreement with the European Union, which he followed up with a resounding election victory in December.

As these geopolitical risks moderated and financial asset prices continued their climb to new records, most central banks resisted the urge to cut interest rates further, which allowed bond yields to climb from their summer lows. The rising yield environment for most of the fourth quarter caused a reversal of the dominant factor trends that had been in place for most of the year. The Harbor International Small Cap Fund (the Fund) benefited from this reversal, due to its significant exposure to the value factor and limited exposure to momentum.

Portfolio Review

In the fourth quarter of 2019, the Harbor International Small Cap Fund (Institutional Class) returned 13.44%, outperforming its benchmark, the MSCI EAFE Small Cap (ND) Index, which returned 11.52%.

The main driver of portfolio performance during the quarter was stock selection, as a number of companies reported improving fundamentals and other positive strategic developments. Our strategy seeks to establish new positions when company fundamentals are at their weakest and

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valuation discounts are at their highest. When fundamentals improve, the market response can be dramatic, as new prices consider improved fundamentals and higher valuation multiples that reflect more favorable forward sentiment.

A secondary but likely equally important driver of performance during the quarter, in our view, was the significant reversal in factor performance during the quarter. As indicated above, a large number of portfolio holdings are exposed to value factors, which is consistent with our value philosophy. During the summer, as perceived risks grew on escalating trade tensions, bond yields declined, favoring momentum factors regardless of underlying valuation. During the quarter, the inverse was true: rising bond yields made high valuation-multiple names less attractive than low valuation-multiple names. We believe this trend generally benefited the Fund during the quarter.

Contributors and Detractors

The top contributor during the quarter was Virgin Money UK (formerly CYBG), a U.K.-listed challenger bank. Interestingly, the bank was one of the top detractors in the third quarter of 2019, when it reported a higher-than-expected level of claims related to a faulty Payment Protection Insurance (PPI) scheme. After the final accounting of claims, the company reported capital ratios well ahead of consensus estimates and net interest margin guidance that was also better than most analysts had expected. In our view, the PPI impact turned out to be a one-off item, not likely to hinder capital ratios or growth plans in the future.

Another top contributor was Fujitsu General, a Japan-based HVAC manufacturer. The company reported better-than-expected results during the quarter thanks to growth in the U.S. and Europe due to new product launches, especially a new replacement air conditioning system in Europe. In addition, there is heightened, but unsubstantiated, speculation that Fujitsu, the parent company, may consider a share sale of its holding in Fujitsu General.

Healius was the Fund's largest detractor during the quarter. The company operates health care clinics in Australia and has been undergoing a major restructuring effort. Healius reported results during the quarter which disappointed some analysts, due to weaker general practitioner recruitment and weaker cost controls, both relative to previous longer term growth guidance.

Another major detractor during the quarter was Criteo, a French digital advertising firm. Criteo has been revamping its business model due to increasing privacy concerns around data tracking. During the quarter, the company announced its new product suite is taking longer to gain traction than previously hoped and that its iconic, founding CEO is relinquishing duties to a new CEO.

Buys and Sells

During the quarter, we focused extensively on rebalancing existing holdings by reducing weights of positions that have seen meaningful increases and increasing weights of positions that have been weaker. As such, we only added one new name and exited one name in the portfolio during the quarter.

We initiated a position in Indra Sistemas, a Spanish industrial and defense technologies business with specialized knowledge in developing advanced systems for toll roads, rail ticketing, and air traffic control. Due to a number of recent missteps in the company's business management, shares of Indra are trading at book value and enterprise value-to-earnings before interest, tax, depreciation and amoritization (EBITDA) valuation multiples that are lower than one standard deviation from their five-year average. With a new management team, Indra completed a reorganization of the business units and is in the process of optimizing margin and return on equity performance of the group, while also contemplating a spin-off of its information technology outsourcing business unit. We believe management's restructuring plan could result in a significant re-rating of the shares and that a spin-off, if completed at market multiples, could unlock significant additional value.

During the quarter, we exited our position in Bank of East Asia (BEA), a Hong Kong-based bank. Our initial thesis on BEA centered on the value of the bank's Hong Kong banking license, a very rare and valuable asset, which we continue to believe will be better utilized by new management or a new owner in the years to come. Unfortunately, given the extensive and ongoing political unrest in Hong Kong, the value of that core asset is under significant pressure, in our view, and may never be fully realized in the current environment. We exited our position in favor of other names with better relative opportunities.

Country Allocation

There were no major changes to the Fund's country allocations during the quarter, nor were there major changes to our exposure to developing markets.

Outlook

We have tangible reasons to begin 2020 with renewed optimism. First, the tit-for-tat escalations between China and the U.S. that sapped economic confidence in 2019 are set to dissipate with the expected Phase I trade agreement. More than the nominal value of any levied tariffs or promised commodity purchases, we believe the main impact of this initial trade deal will likely be an improvement in confidence by both businesses and consumers to increase spending. We note that almost every earnings call and management meeting we attended in 2019, regardless of geography or sector, included some mention of trade tensions hampering orders or investments. As such, the de-escalation represented by this initial deal could be significant, in our view.

We believe the other main risk factor that changed materially in 2019 is Brexit. Although a trade deal between the European Union and the U.K. is still far from certain, the key shift in sentiment stems from the removal of uncertainty that plagued the U.K. parliament. Boris Johnson, the U.K.'s new Prime Minister, was elected in a resounding victory and now has a very clear mandate and, if he so chooses, a five-year term. From our perspective, the U.K. has experienced the most significant multiple compression of any major equity market over the past 18 to 24 months due to heightened uncertainty. While we would not expect a significant rebound in economic activity in the U.K. in 2020, we would not be surprised if valuation multiples reverted closer to global averages.

At a broader level, we would also note that the U.S. equity market's relative outperformance in 2019 was quite significant. In our view, macroeconomic conditions and earnings growth in the U.S. did not support this level of relative performance. As such, we would not be surprised if economic fundamentals reasserted themselves in the form of higher earnings growth and multiple expansion in non-U.S. markets with multiple compression commensurate with earnings declines in the U.S. market.

Harbor™
Trusted Partnerships › Trusted Solutions

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ECONOMIC SECTORS

	% of Net Assets
Industrials	33.34
Financials	11.49
Consumer Discretionary	10.77
Information Technology	9.67
Materials	8.26
Consumer Staples	8.12
Health Care	7.28
Energy	3.14
Communication Services	1.77

TOP TEN HOLDINGS

Company Name	% of Net Assets
1. Jafco Co. Ltd.	2.36
2. Clarkson PLC	2.34
3. Ontex Group NV	2.29
4. Northgate plc	2.24
5. Krones AG	2.18
6. Arcadis NV	2.13
7. Japfa Ltd.	2.11
8. Ebro Foods SA	2.06
9. Dksh Holding AG	2.05
10. Tarkett SA	2.04

ADDITIONAL HOLDINGS

Company Name	% of Net Assets
Fujitsu General Ltd.	2.04
CYBG PLC	1.98
Healius Ltd.	1.96
Criteo SA ADR	1.77
Indra Sistemas SA	1.63
Bank of East Asia	0.00

TOTAL RETURNS

	Three Months	1 Yr.	5 Yr.	10 Yr.	Since Incp. (02/01/2016)	Expense Ratios Net	Expense Ratios Gross
Harbor International Small Cap Fund - *INST*	13.44%	22.13%	N/A	N/A	9.58%	0.96%	1.16%
MSCI EAFE Small Cap (ND) Index	11.52%	24.96%	N/A	N/A	11.17%		

TOP TEN COUNTRIES

Country	% of Net Assets
Japan	25.98
United Kingdom	12.57
Germany	8.81
France	5.64
Australia	5.08
Netherlands	4.59
Hong Kong	3.78
Switzerland	3.76
Spain	3.69
Sweden	3.56

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This information should not be considered as a recommendation to purchase or sell a particular security. The holdings or countries 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 subject to an expense limitation agreement, excluding interest expense, if any, through 02/29/2020.

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.

There is no guarantee that the investment objective of the Fund will be achieved. Stock markets are volatile and equity values can decline significantly in response to adverse issuer, political, regulatory, market and economic conditions. 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.

Views expressed herein are drawn from commentary provided to Harbor by the subadviser, Cedar Street Asset Management LLC, and may not be reflective of their current opinions or future actions, are subject to change without prior notice, and should not be considered investment advice.

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 harborfunds.com or by calling 800-422-1050. Read it carefully before investing.

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