Harbor International Small Cap Fund

Manager Commentary
As of 03/31/2019

Subadviser: Baring International Investment Limited *(Since 02/01/2016)*
Portfolio Managers: Nicholas M. Williams, Colin C. Riddles, Rosemary C. Simmonds, CFA

1st Quarter, 2019

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Baring International Investment Limited (Barings)

Economic Overview

During the first quarter of 2019, world equity markets enjoyed a partial recovery from the sharp sell-off that impacted the previous quarter. While economic news flow during the quarter tended to confirm expectations of a slowdown in economic growth around the globe, the deterioration in global trade, business confidence, and profit growth forecasts proved less extreme than had been feared late last year. In this context, the continuing growth in U.S. economic activity, hopes of a relatively timely resolution to the Sino-U.S. trade dispute, and a less hawkish tone on the withdrawal of monetary stimulus measures from the Federal Reserve (the Fed) and the European Central Bank all helped to stabilize equity markets, while foreign exchange rate volatility also diminished in comparison to the previous quarter.

Government bonds also strengthened during the quarter, with yields falling across the range of maturities in many of the developed world's sovereign debt markets. We believe this development tends to be consistent with a less positive outlook for economic growth and reflects continuing uncertainties surrounding a range of macroeconomic and geopolitical issues, including trade disputes, Brexit, eurozone tensions, and the domestic economic growth prospects in both Japan and China.

Portfolio Review

In the first quarter of 2019, the Harbor International Small Cap Fund (Institutional Class) returned 10.95%, outperforming its benchmark, the MSCI EAFE Small Cap (ND) Index, which returned 10.65%.

Smaller companies across all the major countries represented in the index typically benefited from the recognition that, at the beginning of the year, valuations were attractive. Furthermore, while business confidence declined from the highs of early 2018, global trade growth forecasts for 2019 remained positive. In general, stock selection during the quarter was positive for relative performance, while asset allocation by country and by sector detracted from the Fund's relative return.

On a country basis, stock selection in Japan, Switzerland, and the U.K. were key contributors to relative performance. In both Japan and the U.K., the Fund benefited from strong recoveries in companies that experienced share price weakness during the fourth quarter. Despite the overall weak performance of Japanese smaller companies relative to the benchmark during the quarter, the Fund's Japanese holdings performed quite strongly. In contrast, U.K. smaller companies generally showed strong performance during the quarter, boosted by the Pound's recovery relative to the U.S. Dollar.

In the Pacific ex-Japan region, the Fund benefited from positive stock selection in Hong Kong, driven by our purchase of real estate developer China Jinmao. Conversely, our holdings in Australia contributed negatively to relative performance, primarily due to a sharp pullback in the share price of Costa Group, a premium fruit and vegetable farmer whose profits were impacted by a range of factors, including a weak pricing environment, expansion costs, and a poor harvest.

On a sector basis, stock selection in Industrials and Real Estate drove outperformance. Meanwhile, stock selection and an overweight allocation to the Consumer Staples sector detracted from relative performance.

The top individual contributor to performance during the quarter was JD Sports Fashion, a U.K.-listed retailer of athleisure footwear and clothing. Against a backdrop of weak U.K. retail spending figures, JD Sports delivered a robust trading update in January, with sales growth ahead of expectations, and provided a confident outlook statement. Additional news flow in March announcing JD Sports' acquisition of Footasylum, a U.K.-listed competitor, consolidated the retailer's leading market position.

TechnoPro, a Japanese provider of professional technical personnel for temporary project work, was the second largest contributor to relative performance during the quarter. Financial results released in early February reported operating profit growth of 38%, which was ahead of expectations. Accompanying commentary indicated that demand remained strong, which we believe supports the prospect of further profit growth.

The largest detractor during the quarter was Costa Group, an Australia-based horticulture company that grows a variety of fruits and vegetables. Although Costa Group was the largest positive contributor to performance last quarter, its performance reversed in early 2019 with the publication of a weak trading update. Management reported that demand in categories like berries and avocados had been weak, which had a negative impact on pricing given the short shelf life of these products. After speaking with management, we concluded that while disappointing, the factors causing the problems were temporary, and some had already been resolved. We received further reassurance toward the end of February with the release of the company's interim financial results, in which management stated that selling prices had increased and demand for products – especially citrus fruit – was strong.

The second largest relative detractor was Bic Camera, a Japanese audiovisual equipment and electrical appliance retailer. Bic's share price weakened following the release of financial results in mid-January. Despite several positive elements within the report, the statement also highlighted areas of concern, including a decline in Japanese tourism, particularly among the Chinese. The decline has negatively impacted the company's sales, as tourists often take the opportunity to purchase Japanese electronics during their trip. In addition, a shift in sales trends during the period resulting in a higher percentage of sales in less profitable product categories pressured profit margins.

At the start of 2019, Industrials and Financials were the largest overweight sectors in the Fund, while Real Estate and Information Technology were the largest underweight positions. By the end of the quarter, Consumer Staples had become the largest overweight sector, followed by Industrials, while the largest underweights – Real Estate and Information Technology – remained unchanged. The Fund's sector weights are derived from individual company investment decisions rather than reflecting top-down asset allocation decisions.

The increased weighting in Consumer Staples can be largely explained by the purchase of two Japanese food manufacturers, Morinaga and Nichirei, and the sale of Calbee, a Japanese confectionary producer. In addition, we sold five Industrials holdings during the quarter, including Loomis, a cash transit company based in Sweden. We exited Loomis after a period of solid performance on concerns that labor cost inflation and greater investment requirements may reduce future profit growth potential.

Our underweight in Real Estate reflects our general caution on valuations within the sector, especially given the potential for interest rate increases. Our stock-specific approach, however, resulted in the purchase of China-based Jinmao Holdings, a Hong Kong-listed developer of residential and commercial buildings, during the quarter. Meanwhile, our underweight position in Information Technology narrowed due to the purchase of Spectris, a U.K.-based developer of measurement and analysis instrumentation, and Chinasoft International, a Hong Kong-based IT services company.

Spectris has a number of market-leading businesses. We believe these leadership positions are supported through heavy investment in research and development, which helps sustain technological advantages and in turn helps support a sticky customer base, as well as excellent gross margins and strong returns on invested capital. In addition, a new management team has announced its intention to cut costs and sell subscale business units moving forward.

We sold Carl Zeiss Meditec (CZM), a German medical technology company, following a meeting with company management and strong share price growth since we initiated the position in February 2016. Shares of CZM performed strongly over the holding period, primarily as a result of solid organic sales and profit growth. Product innovations in both surgical microscopes and diagnostics have been well received, reflecting CZM's ability to offer superior technical and digital capabilities relative to its peers. For example, its innovative robotic orientation system has allowed surgeons to completely free up their hands in theatre and has enabled greater instrument precision. Underlying market growth has also been supportive, as developed markets have been impacted by an aging population and the resulting higher disease recurrence and incidence of eye disorders. Meanwhile, emerging markets have experienced rising health care spending trends. As such, CZM has been able to deliver excellent sales growth, margins, and returns. Having reached our price target during the quarter, we exited the position.

Outlook

Following the positive returns generated by international smaller companies during the first quarter – recovering a large proportion of losses from the final quarter of 2018 – the valuation of the asset class has increased while forecasts for profits growth in 2019 have been revised downward. We believe that in the very short-term, international smaller companies are less clearly oversold and cheap than they were at the beginning of the year, implying further progress may be more challenging in the coming quarter.

Furthermore, macro-level and political challenges identified at the beginning of the year remain unresolved. A more sustained recovery in either share prices or business confidence is not certain amid persistent pressures from tariffs, input costs, and demand on corporate profitability. More positively, however, central banks around the world have followed the lead of the Fed in indicating their preparedness to support growth and confidence.

While the Sino-U.S. tariff disputes also remain unresolved, negotiations are underway, and there appears to be a more constructive background to the current talks. In our view, resolution would help restore some confidence in the outlook for global trade growth. Meanwhile, the Chinese government appears to be addressing the domestic economy through reforms, spending, and restructuring, while value-added taxes are due to be cut later this year.

In the U.K., Brexit discussions continue to dominate headlines, with no greater certainty on Britain's future trading relationship with the European Union (E.U.). Any clarity would be welcomed on both sides of the channel; however, we believe the most likely development at present is that deadlines will be postponed with the grudging acquiescence of the E.U. The uncertainties are having a negative impact on the U.K. domestic economy – investment decisions are being postponed, and property prices and consumer spending are stagnating. To some extent, Brexit negotiations have distracted from domestic economic developments elsewhere in the E.U. Most European economies experienced a marked slowdown in the second half of 2018, with business confidence declining. Unemployment and consumer spending trends are still improving, however.

Business confidence in Japan has also deteriorated in recent months, due in part to concerns about the Chinese economy but also reflecting fears that inbound tourism numbers are falling. Meanwhile, domestic enthusiasm for Prime Minister Abe's leadership has declined, and tax increases are due this year. More positively, however, Japanese companies continue to increase their focus on return on equity, efficiency gains from outsourcing, and shareholder returns, while construction trends and 5G spending are very strong. Australian business confidence has been similarly affected by developments in China, while domestic elections are generally expected to result in a Labour Party victory, which is viewed as unfavorable to equity markets.

In summary, economic growth was widely anticipated to slow in 2019, and so far this year, this caution has been confirmed. Nevertheless, economic growth and global trade growth remain positive, confidence in a resolution of the Sino-U.S. tariff disputes is rising, and fears of central banks making a policy mistake by tightening monetary conditions too quickly have declined. As a result, while international smaller companies are, on average, valued closer to the higher end of their historic range on a number of valuation measures, when adjusted for lower interest rate expectations, valuations remain below historical averages. In addition, although corporate earnings growth continues to face challenges, Europe, Australasia, and Far East smaller companies are still expected to grow profits this year.

Our outlook for 2019 is now quite balanced. Despite political and economic uncertainties, the dismal outlook propounded by some commentators during the fourth quarter of 2018 looks unlikely. Central bank policies have become more accommodative, and global trade volumes are expected to grow. Although valuations have risen following the strength of equity markets in the first quarter, our bottom-up approach and focus on individual companies' ability to improve profitability and returns over the longer term will not change.

Harbor Funds

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ECONOMIC SECTORS

	% of Net Assets
Industrials	23.57
Financials	12.91
Consumer Discretionary	12.82
Consumer Staples	9.37
Materials	8.51
Health Care	7.89
Information Technology	6.35
Real Estate	4.46
Energy	3.67
Communication Services	3.66
Utilities	1.43

TOP TEN HOLDINGS

Company Name	% of Net Assets
1. JD Sports Fashion plc	1.24
2. Relo Group Inc.	1.18
3. Nihon M&A Center Inc.	1.18
4. AEON Delight Co. Ltd.	1.17
5. Intermediate Capital Group plc	1.14
6. Marshalls plc	1.14
7. B&M European Value Retail SA	1.13
8. Homeserve plc	1.13
9. Hera SpA	1.13
10. Barco NV	1.11

ADDITIONAL HOLDINGS

Company Name	% of Net Assets
Nichirei Corp.	1.07
Morinaga & Co. Ltd./Japan	1.04
Technopro Holdings Inc.	1.00
Spectris plc	0.90
BIC Camera Inc.	0.75
Costa Group Holdings Ltd.	0.67
China Jinmao Holdings Group Ltd.	0.60
Chinasoft International Ltd.	0.56
Calbee Inc.	0.00
Carl Zeiss Meditec AG	0.00
Loomis AB	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*	10.95%	-11.11%	N/A	N/A	8.64%	0.96%	1.16%
MSCI EAFE Small Cap (ND) Index	10.65%	-9.36%	N/A	N/A	9.71%		

TOP TEN COUNTRIES

Country	% of Net Assets
Japan	29.51
United Kingdom	20.35
Italy	5.55
Netherlands	5.09
Sweden	4.42
Australia	4.34
Germany	3.66
Belgium	3.15
Switzerland	3.12
France	2.55

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 harborfunds.com or by calling 800-422-1050.

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 02/20/2020.

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.

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.

Views expressed herein are drawn from commentary provided to Harbor by the subadviser, Barings International Investment Limited (Barings), 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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