



Harbor Small Cap Value Opportunities Fund

Manager Commentary

As of 12/31/2018

Subadviser: Sapience Investments, LLC (Since 08/01/2017)

Portfolio Manager: Samir Sikka

4th Quarter, 2018

"As value investors, we view the shift to a risk-off market as a better investment environment with a broader opportunity set."

Sapience Investments, LLC

Economic Overview

During the fourth quarter of 2018, stock market participants were buffeted by successive waves of both economic and political concerns, motivating many to flee from risky assets. In a so-called "risk-off" environment, asset price volatility generally rises as correlations within the stock market, and across asset classes, increase. In our view, the sharp reversal during the quarter was based on a combination of three factors: valuations were perceived to be stretched, there was an erosion of investor confidence on multiple fronts, and a heavily automated market mechanism fueled rapid downward momentum. There were mixed fundamental signals. However, we believe the causes for the decline in investor confidence centered on a few factors: 1.) uncertainty about the magnitude and timing of U.S. Federal Reserve tightening; 2.) increasing risks of the tariff war between the U.S. and the world, especially China; 3.) falling oil prices, which are a proxy for reduced global industrial demand; and 4.) mounting political risks (e.g., the imminent break of the U.K. from the European Union, and a variety of U.S. congressional and presidential actions that demonstrated less-than-optimal leadership).

Portfolio Review

In the fourth quarter of 2018, the Harbor Small Cap Value Opportunities Fund (Institutional Class) returned -24.20%, underperforming its benchmark, the Russell 2000® Value Index, which returned -18.67%.

During the quarter, Energy, Consumer Discretionary, Information Technology and Financials detracted from relative performance, primarily due to stock selection. In contrast, stock selection in Health Care and Materials benefited relative results.

Individual detractors from relative performance included oilfield services company Weatherford International plc. During the quarter, we saw a significant disconnect between the company's fundamentals and its stock price performance. Weatherford reported earnings before interest, taxes, depreciation and amortization (EBITDA) that exceeded consensus expectations, as well as steady progress in reaching its goal of \$1 billion in incremental EBITDA from transformational benefits. In addition, the company confirmed a \$200 million sale of its non-core laboratory business. However, Weatherford also reported a \$30 million shortfall in free cash flow, which missed consensus expectations of slightly positive free cash flow. We believe much of the turmoil in the company's stock price is due to the high level of debt on its balance sheet, as well as fears among investors that Weatherford may not be a going concern for long. We believe these fears are somewhat overblown. A severe sell-off in the broader

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equity market and in oil prices further aggravated the company's share price decline. During the quarter, we significantly reduced the Fund's position in Weatherford, which was a special situation and a contrarian call at our initial investment.

Forum Energy Technologies, Inc. also hindered relative results. The company's shares performed poorly during the quarter, largely due to the decline in the price of oil, its mixed record in meeting its targets and an inability to generate free cash flow during the past few quarters. We believe the company has an attractive and diversified mix of businesses in the energy equipment and services industry. The current chairman and former CEO, Chris Gaut, was reappointed as the CEO during the quarter after a lack of consistent execution under the outgoing CEO.

In Information Technology, Diebold Nixdorf, Inc., detracted from relative performance. In October, the company reported better than expected results, and its stock price rallied. In November and December, however, the company's stock price declined materially in a weak market. There were no incremental negative headlines from the company. We spoke with Diebold's management team, and we believe there is a sense of urgency at the company to right its cost structure. Management provided itemized cost takeout plans, and we built a conservative estimate for the restructuring. Furthermore, Diebold's management team believes it has enough capital to get through the restructuring program.

Contributors to relative performance included EVERTEC, Inc., a leading full-service transaction processing business in Latin America and the Caribbean region. The company's shares performed well during the quarter. Similar to recent quarters, EVERTEC reported strong results as the company benefited from rebuilding efforts and relief funding in Puerto Rico.

Shares of Argo Group International Holdings Ltd., a provider of specialty property and casualty insurance and reinsurance, advanced during the quarter. Despite elevated natural disaster losses in 2018, Argo Group has consistently reported solid results, due to management's successful focus on expense ratio improvement, platform modernization and active capital management.

In Consumer Staples, TreeHouse Foods, Inc., a leading private label food company, benefited relative performance. The company's shares performed well during the quarter as investors became more comfortable with the turnaround and portfolio restructuring outlined at an analyst day by the new CEO, Steve Oakland.

A position added in the quarter was Cadence Bancorp which is a bank holding company for Cadence Bank, NA. Cadence provides commercial banking products and services to businesses, business owners, high net worth individuals and retail customers in the U.S. The bank's segments include Banking, Financial Services, and Corporate. As of December 31, 2017, Cadence's assets were nearly \$11 billion. Among the sustainable business model characteristics that we have identified are a solid management team with banking experience that averages more than 30 years, which affords them the knowledge and relationships necessary to prudently grow the franchise, and a superior balance sheet and net interest income. The value drivers we have identified for Cadence are stronger growth prospects than many of its peers and stabilization of net interest margin in the fourth quarter as short-term fluctuations in LIBOR even out and expansion of net interest margin into 2019.

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During the quarter, the Fund's sector weights changed in part due to market movement, as well as strategy-wide investment decisions. The Fund's overweight in Industrials increased, while its underweight in Utilities and Information Technology increased and its underweight in Financials decreased. All sector weights are a by-product of our bottom-up stock selection process and are not tactical allocation decisions.

Outlook

We believe many of the factors that induced the volatility in the fourth quarter are likely to persist into the new year. As value investors, we view the shift to a risk-off market as a better investment environment with a broader opportunity set. Superior businesses are also de-rated when investors sell indiscriminately, without regard to the underlying intrinsic value. Best investments are often initiated with some discomfort and when the outlook is hazy. We were able to upgrade the Fund's holdings during the quarter as valuations became decoupled from fundamentals for several high-quality businesses. In addition, we added to existing positions that we believe were oversold.

Harbor Funds 

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ECONOMIC SECTORS

	% of Net Assets
Financials	26.92
Industrials	21.80
Consumer Discretionary	13.39
Real Estate	7.53
Energy	6.91
Health Care	5.31
Materials	3.51
Consumer Staples	3.42
Information Technology	3.20
Communication Services	3.03
Utilities	1.41

TOP TEN HOLDINGS

Company Name	% of Net Assets
1. Beacon Roofing Supply Inc.	3.32
2. Michaels Cos Inc.	3.21
3. Kar Auction Services Inc.	2.61
4. Sterling Bancorp	2.51
5. Outfront Media Inc.	2.39
6. Ascena Retail Group Inc.	2.36
7. WPX Energy Inc.	2.31
8. Syneos Health Inc.	2.30
9. Diebold Nixdorf Inc.	2.21
10. Wintrust Financial Corp.	2.19

ADDITIONAL HOLDINGS

Company Name	% of Net Assets
Argo Group International Holdings Ltd.	2.05
Forum Energy Technologies Inc.	1.54
TreeHouse Foods Inc.	1.48
Cadence Bancorp	1.41
Evertec Inc.	1.00
Weatherford International plc	0.15

TOTAL RETURNS

	Three Months	1 Yr.	5 Yr.	10 Yr.	Since Incp. (08/01/2017)	Expense Ratios	
						Net	Gross
Harbor Small Cap Value Opportunities Fund - INST	-24.20%	-17.98%	N/A	N/A	-10.53%	0.88%	1.24%
Russell 2000® Value Index	-18.67%	-12.86%	N/A	N/A	-5.08%		

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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 subject to an expense limitation agreement, excluding interest expense, if any, through 02/28/2019.

The Russell 2000® Value Index is an unmanaged index representing the smallest 2000 stocks with the lowest price-to-book ratio and future earnings. This unmanaged index does not reflect fees and expenses and is not available for direct investment. The Russell 2000® Value Index and Russell® are trademarks of Frank Russell Company.

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

At times, a value investing style may be out of favor with investors which could cause value securities to underperform growth or other equity securities.

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, Sapience Investments, 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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