

The Small-Cap Stock Boom Is Overdue. This Fund Is Ready.

By Ian Salisbury
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Wingstop is Harbor Small Cap Growth's third-largest holding. (COURTESY WINGSTOP)

Small-company stocks have been mired in one of their longest ruts in memory. The silver lining? For funds like Harbor Small Cap Growth, it means opportunities to find attractively priced stocks, even among companies with fast-growing profits.

Small companies, typically those with market caps below \$10 billion, have lagged behind large-caps in eight of the past 10 years. And while 2024 was supposed to be a breakout year—with declining interest rates lending smaller stocks a big tailwind—that hasn't happened. Instead, small-caps have returned just 3% so far, compared with 17% for large companies.

Still, William Muggia, president of Westfield Capital Management, which serves as Harbor Small Cap Growth's subadvisor, is bullish. He cites analyst forecasts that small-company profits should grow at a faster pace than large-caps later this year, and notes that some of the sector's biggest rallies have followed its deepest bouts of underperformance. "I can't tell you we are at the absolute bottom," he says. "But it sure smells like it."

Muggia and his team have done well in navigating a difficult market. The fund has outperformed Morningstar's small-cap benchmark over the past five-, 10-, and 15-year periods. While its 1.24% expense ratio is higher than average for U.S. stock mutual funds, it's in line with the 1.18% average for small-cap funds.

Investors may be inclined to take Muggia's bullishness with a grain of salt. But small-cap valuations suggest there is a real opportunity. While the S&P 500 index is trading at 25 times earnings, one of its highest levels since the dot-com bubble, small-cap stocks are trading at just 14 times.

Harbor Small Cap Growth

	Total Return		
	1-Yr	5-Yr	10-Yr
HISGX	11.0%	9.2%	9.5%
Small Growth Category	10.6	7.4	8.8
Top 10 Holdings			
Company / Ticker	% of Assets		
Ascendis Pharma / ASND	4.3%		
Comfort Systems USA / FIX	3.1		
Wingstop / WING	2.5		
ITT / ITT	2.4		
Casella Waste Systems / CWST	2.4		
Option Care Health / OPCH	2.4		
Insight Enterprises / NSIT	2.3		
Samsara / IOT	2.2		
Northern Oil & Gas / NOG	2.2		
AZEK / AZEK	2.1		
TOTAL:	25.9%		

Note: Holdings as of April 30. Returns through July 8; five- and 10-year returns are annualized. Source: Morningstar

What's more, the share of small-caps in the Russell 3000, an index of the 3000 largest stocks, has fallen to just 5.2%, down from 8.8% at their peak in early 2006 and a nearly 20-year low. It could mean that index fund investors—and others whose portfolios follow the market-cap-weighted contours of most index funds—may have seen their small-cap exposure dwindle by more than a third. Those investors could be leaving money on the table when small-caps finally turn around.

A rally could be in the offing as soon as historical norms reassert themselves, according to a recent note from independent researcher Leuthold Group. "This dramatic valuation gap is the result of large-cap's excess returns of late, but is also suggestive of a potential reversal of fortune," the firm writes.

Lagging returns have made it relatively easy for Harbor Small Cap Growth to find stocks that fit its stated goal of "growth at a reasonable price." In general, Muggia says, Harbor looks for companies with profit growth of at least 10% annually that have been overlooked for some reason. The focus on growth limits the menu of options the fund can pick from—only about 60% of small-cap stocks are profitable today, down from more than 70% before the pandemic. But it also means the fund is focused on stocks with big potential that the market has overlooked, as opposed to value bets that he calls "melting ice cubes."

"Something that has been perceived as a slower grower or a 'B' business model [that] all of a sudden makes a change to more recurring revenue or better visibility," Muggia explains, "that's where you really get big stock [gains]."

One name that fits that bill: Comfort Systems USA, an industrial company that provides heating, plumbing, and air conditioning products to commercial building sites. It isn't the most glamorous business, but the company's profits are expected to surge 36% this year as it rides the AI-driven chip-plant boom.

While the stock is trading at about 25 times forward earnings, Muggia, who says the company has been using its cash wisely to buy back stock and pursue bolt-on acquisitions, calls the valuation "pretty reasonable."

He's also bullish on financials, such as property and casualty insurer Kinsale Capital Group. In an industry where many companies are slow to change, Kinsale has leveraged new technology to give customers quotes faster than competitors, Muggia says. That has translated into higher profits, which are expected to increase 17% this year. While the stock is trading at 22 times next year's earnings, Muggia says its rivals won't catch up anytime soon. "[Kinsale's] technology is a real differentiator," he says.

The only industry where Harbor doesn't necessarily need to see rapid earnings growth is healthcare. That's because companies can be unprofitable until a key innovation hits the market and then becomes a home run.

All the same, Muggia prefers drug companies developing platforms with numerous potential applications, as opposed to ones that have everything riding on a single portfolio. That's the case with Ascendis Pharma, Harbor's single-largest holding, whose TransCon technology can be used to improve existing drugs. While the company has yet to post a profit, the approach should give it "multiple shots on goal," he says.

Of course, Harbor's diligence and patience won't be rewarded as long megacaps like Nvidia continue to power the market's returns. As a group, small-caps have been hampered by high interest rates. These businesses, almost by definition, tend to be less stable and less well established than blue chips. That means they typically borrow more and pay higher interest rates.

While 2024's long-expected interest-rate cuts have yet to materialize, Federal Reserve officials' collective forecasts still suggest at least one cut this year. A so-called soft landing, with the Fed lowering interest rates while the economy remains strong, would be an ideal scenario for small-caps: As less stable, less established businesses, they are also more sensitive to economic climates.

Of course, things might not work out that way. If the slowing U.S. economy tips into a recession, that could spell trouble for small-caps' frequently-iffy balance sheets, regardless of where interest rates end up. Still, Muggia argues, with small-caps already trading so cheaply, any potential decline would be shallow.

"It could be bumpy again for small-caps," he says. "But I feel like you're kind of falling out of the basement."

Harbor Small Cap Growth Fund (HISGX): Average Annual Returns as of 6/30/24							
	3-mth	YTD	1 Yr.	3 Yr.	5 Yr.	10 Yr.	Since Inception (11/1/2002)
Harbor Small Cap Growth Fund	-5.67%	2.74%	8.70%	-1.27%	9.24%	9.22%	10.32%
Morningstar Small Growth Category	-2.58%	4.78%	9.11%	-4.42%	7.50%	8.48%	NA
Russell 2000 Growth Index	-2.92%	4.44%	9.14%	-4.86%	6.17%	7.39%	9.80%
Russell 3000 Growth Index	7.80%	19.90%	32.22%	10.33%	18.55%	15.75%	12.36%

The Harbor Small Cap Growth Fund gross expense ratio is 1.24%

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

For an updated list of the Harbor Small Cap Growth Fund's holdings and weights, please access [HISGX](https://www.harborcapital.com).

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Important Information

Investors should carefully consider the investment objectives, risks, charges and expenses of a Harbor fund before investing. To obtain a summary prospectus or prospectus for this and other information, visit [harborcapital.com](https://www.harborcapital.com) or call 800-422-1050. Read it carefully before investing.

Risks
Investments involve risk including the possible loss of principal. 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. Stocks of small cap companies pose special risks, including possible illiquidity and greater price volatility than stocks of larger, more established companies.

Benchmarks
The Russell 3000 Growth Index is a market capitalization-weighted index based on the Russell 3000 Index. The Russell 3000 Growth Index includes companies that display signs of above-average growth. The Russell 2000® Index measures the performance of the small-cap segment of the US equity universe. It is a subset of the Russell 3000® and includes approximately 2000 of the smallest securities based on a combination of their market cap and current index membership. The Russell 2000® Index, Russell 3000® Growth Index and Russell® are trademarks of Frank Russell Company. This unmanaged index does not reflect fees and expenses and is not available for direct investment. The S&P 500 Index is an unmanaged index generally representative of the U.S. market for large capitalization equities. This unmanaged index does not reflect fees and expenses and is not available for direct investment.

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

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As of 6/30/24, the Top Ten Holdings of the Harbor Small Cap Growth Fund: Ascendis Pharma (4.2%), Comfort Systems (2.7%), Casella Waste Systems, Inc. Class A (2.5%), ITT (2.3%), Vaxcyte, Inc. (2.3%), Insight Enterprises (2.3%), Wingstop, Inc. (2.2%), Option Care Health Inc. (2.2%), Northern Oil and Gas, Inc. (2.0%) and Super Micro Computer Inc. (1.9%) and comprised 24.6% of the Fund's total holdings. Fund holdings are subject to change.

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Westfield Capital Management Company, L.P. is an independent subadvisor to the Harbor Small Cap Growth Fund.

Expense ratio information is as of the Fund's current prospectus, as supplemented. Gross expenses are the Fund's total annual operating expense. Alpha refers to excess returns earned on an investment.

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