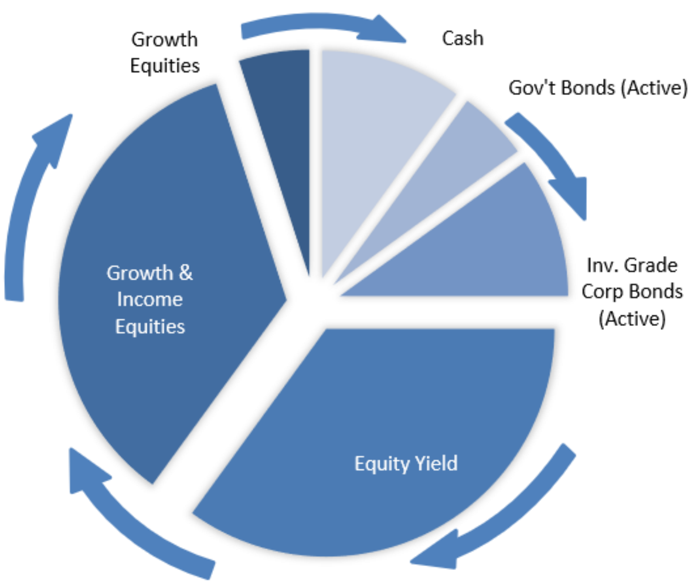
Market Commentary
Third Quarter 2018

Harbour Growth & Income Fund
Harbour Global Growth & Income Corporate Class

The investing conditions of the third quarter continued to exhibit the underlying trends and divergent themes that have existed since earlier this year. As we wrote in our commentary last quarter, the combination of peaking global liquidity together with the U.S. policies of domestic tax incentives and global trade hostility have created an increasingly volatile environment in which investors have gravitated overwhelmingly to U.S.-centric securities. This geographic bias, combined with a style bias to quality over price, has been ill-suited to our investment style and at odds with our approach to portfolio construction, leaving the Harbour balanced funds out of sync with global markets.

As a reminder, our approach to portfolio construction in the Harbour balanced funds is broadly defined as a series of different sleeves with a distinct risk profile and expected return. In building the portfolio this way, we are striving to offer transparency and a sense of stability to our investors – with broad allocations across equity and debt categories enabling our investors to form an expectation of how the funds might behave.



As the pie chart shows, the funds hold both equities and investment-grade bonds, and the stocks we hold are a combination of defensive, yield-supported names, dividend growers, and a small allocation to growth stocks. We use this schematic so that investors can see the stability that comes from a defined structure, and also estimate what sort of returns they might receive. With over half of the portfolios comprised of defensive securities, these funds attempt to provide balance in a rising interest rate environment and generate a total return that comes at an acceptable premium to the risk-free rate. Despite a weak last six months, in the five years since the current management team took over, Harbour Global Growth & Income Corporate Class – the most flexible variant of the strategy has delivered a compound return of 7.2% annually, a premium of roughly 500 basis points to the risk-free rate, while exhibiting considerable defensiveness.

In the third quarter, the equity sleeves of both the domestic and global balanced funds underperformed their benchmarks[1]. The more divergent result for the global fund was largely a reflection of the geographic location of the names we held – attempting to find value has not worked well this year either in geographic or stylistic terms as political factors have overwhelmed all others, causing investors to shun non-U.S. markets and any company perceived to be cyclical. In both funds, the fixed-income sleeves delivered negative returns, as bond investors behaved like their equity counterparts, favouring riskier non-investment-grade bonds to the investment-grade bonds that we hold. For the moment, what we consider to be "safety" is out of fashion.

For the record, at the time of writing, the only major developed stock markets in the world with positive returns this year are the three U.S. indexes (Dow Jones Industrial Average, S&P 500 and Nasdaq Composite), and to have invested anywhere else is to have lost money thus far. While U.S. equities have been buoyed by share buybacks, tax-cut savings and inventory build-ups in anticipation of tariffs, equity markets elsewhere are discounting a global slowdown based on the global trade dynamic.

As the U.S. attempts to redefine its trading relationships, its largely insular economy (lower percentage of trade to GDP) means that typically, any counterparty that it engages on trade has more to lose from the conversation than does the United States. This dynamic has empowered the U.S. to be aggressive, to the detriment of its trading partners. As the future terms of trade are uncertain in many regions (including Europe, and until recently, Canada and Mexico), these markets

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[1] Harbour Growth & Income Fund: The benchmark is a combination of the S&P/TSX Composite Total Return Index - 60% and the FTSE TMX Canada Universe Bond Total Return Index - 40%.

Harbour Global Growth & Income Corporate Class: The benchmark is a combination of the MSCI World Total Return Index - 60% and the J.P. Morgan Global Government Bond Total Return Index - 40%.

have sold off as investors expect both an overhang on investment and future trading terms that are likely less advantageous than today. The effect, particularly when combined with the (likely short-term) effects of the U.S. tax cut, has caused investors to overwhelmingly favour the United States as an investment destination – driving up U.S. equity and high-yield debt markets, and the currency – believing it to be both faster growing and less at risk from global trade tensions. Price has not been a big part of this money flow decision – investors this year have bought what was working, rather than focus on how much they paid for it. Paying a premium for perceived certainty is not our game.

Passive strategies have certainly played a role. Dominant in fund inflows, and typically market based, these passive strategies are structurally defined to buy the biggest and/or most expensive stocks in the index in the greatest proportion. As such, exchange traded fund (ETF) flows have exacerbated market trends, bidding up the largest growth stocks in a self-fulfilling fashion.

For capital stewards like us, managing high active share portfolios is to be, by definition, different from the market. Sometimes that means short-term performance is ahead of the market, and sometimes not – but over time, it means adding outperformance and critical diversification to our clients' portfolios. We would suggest that at a time when U.S. markets are overwhelmingly favoured, index concentration is near record highs, and market breadth is narrowing, the case for what has <u>not</u> worked – active management such as our portfolios – is more compelling than ever.

As is our style, throughout the quarter we continued to identify potential sources of risk to the portfolio and removed them – attempting to ensure a margin of safety for investors at all times. This has been an unrewarding approach this year; stocks we have considered to be worthy of trimming or selling have kept going up, and "cheap" stocks to which we have reallocated to, have gotten cheaper. As we have often stressed, it is our philosophy to focus on the potential for cost rather than opportunity cost for our clients. This means investing only in investment-grade bonds at all times, diversifying geographically, selling securities where we can no longer justify a margin of safety, giving away upside to buy downside protection, and buying into new positions where we feel there is fundamental value and a price buffer. All of these traits have worked against us this year: Selling too early, giving away upside to buy not-yet-needed protection, investing in cheap names that got cheaper, and failing to geographically concentrate the whole portfolio in the U.S.

The investing climate remains concerning to us. The U.S. 10-year yield appears to have broken a 37-year downtrend. While rising U.S. yields are often associated with economic optimism (and this is the way it is described in the media), we have long believed that huge U.S. funding requirements coupled with fading foreign investor interest in U.S. Treasuries is a source of upward pressure on yields.

U.S. funding needs in 2019 are twice what they were this year and the current administration's hostile geopolitical attitude is biting the hand that feeds the U.S. Treasury market. Global stock

markets are hitting new lows, yet the U.S. markets have been resilient thus far – although economically sensitive sectors (banking, housing, autos, industrials) in the U.S. have not performed well.

More than 50% of all global stocks are trading more than 20% below their 52-week highs and we do not believe the U.S. can remain immune forever. U.S. stocks may be safer than U.S. bonds in a rising rate environment, but investing effectively is what you buy, and how much you pay. Our portfolios are positioned at the lower end of the range for equity weight, carrying above-average cash and short duration bond portfolios. We carry gold exposure as a hedge and this has been a source of drag this year. It is our view that at some point the U.S. Federal Reserve will likely be forced to move off its aggressive hiking schedule – either because of slowing economic data or by a significant market correction. If this were to occur, the resulting U.S. dollar weakness would favour commodities such as gold.

At Harbour, our priority is to protect our investors' capital by incorporating a margin of safety at every level of the investment process. In a world of contracting global liquidity, we still think there is a tipping point in rates somewhere. It is the right time to be conservative. Our philosophy has not changed, nor has our process – as an out-of-favour, high-active-share manager, our diversification value to your portfolios is as important as ever.

We are appreciative of your continued confidence and welcome your questions at any time.

Roger Mortimer
Senior Portfolio Manager
CI Global Investments Inc.

Class F Returns (in %) as at September 30, 2018	**Year-to-date**	**1 year**	**3 year**	**5 year**	**10 year**
Harbour Global Growth & Income Corporate Class	-3.7	-0.5	6.2	8.5	7.6
Harbour Growth & Income Fund	-4.0	-1.0	3.2	4.4	4.0

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