

Asset Class Change

Over the past 37 years we have written about many subjects. Normally, they are of an educational nature and/or intended to help take emotion out of the investment process. Usually, we shy away from discussing individual portfolio holdings; however, this quarter we have decided to break from this tradition as for the first time in over two decades, we have chosen to replace a manager of an entire asset class in our portfolios. Decisions like this are well thought out and done with a lot of discussion and research.

Previously, we used Harbor International Fund as the manager of the large capital international portion of our portfolios. We liquidated this position during the quarter and replaced it with two funds, T Row Price Overseas and ClearBridge International Growth.

What follows is a condensed version of our investment committee's decision-making process that led to this change in our large capital international holdings.

Due diligence on managers is performed quarterly. As with individual equity positions, we utilize written buy/sell disciplines for the funds we use. Funds are replaced whenever investment managers depart, we see style drift, or a change in their investment process. In addition to extensive manager discussions, our process also includes attribution analysis, position reviews, and index analysis.

Harbor International uses a sub advisor to manager their funds. Since 1987 it has been Northern Cross. Northern Cross had a change in management over 8 years ago when Hakan Castegren, the 79 year old founder, passed away. Northern Cross had a team approach. At that time, our due diligence process indicated that nothing would change in the funds management process and so we continued to hold and add to the fund.

For a number of years, Harbor International performed in line with expectations and the holdings in the funds fit their time honored process. In 2012 the Wallstreet Journal contained an article titled "Staying on Course After a Death" where they discussed Harbor International and how it had remained a solid choice for investors even after the founder had passed away.

Fast forward to 2016, Harbor International is underperforming the international index for the second year in a row. Most of this under performance was explainable because their investment process favored value stocks when growth investing was in favor. In 2017 they once again underperformed the index but still returned 22.90% to investors. While doing our customary due diligence in 2018, we noticed a style drift in their holdings. We did an in-depth review and decided it was time to diversify our holdings and sold half of Harbor International in client's portfolios and purchased T. Rowe Price Overseas. When making this change, we took the opportunity to rebalance accounts. If international holdings were less than our model target, we bought it up to target. If it was above our target, we purchased less than we sold.

The month after we made our decision, the managers of Harbor International made a similar decision and replaced Northern Cross as the Sub Advisor of Harbor International with Marathon Asset Management.

We did our due diligence on Marathon Asset Management and liked Harbors choice. Unfortunately, Marathon Asset Management plans to sell almost all the holdings in the fund. In doing this they will cause holders of the fund in December to have a capital gain of approximately 25%. A quirk in how mutual funds are taxed would cause holders to pay taxes even if they had a loss in the fund. This led us to the decision to sell the remainder of our holdings in Harbor International. At this time, we decided to diversify our holdings in large capital international and added a second manager ClearBridge International Growth.

In the end after a lot of discussion and research, we replaced our large capital international manager, Harbor International, with T Row Price Overseas and ClearBridge International. As we changed managers we rebalanced the percentage of clients' holdings to match our model.

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