Marble Harbor Investment Counsel, LLC
Excerpt from
Second Quarter, 2010 Letter

July 2010

Dear Client:

Debt levels in developed countries around the world, as well as in many states, a pullback in spending by consumers (great for the long-term, but painful for the economy in the short-term), and a focus on more speculative investments as if there's been no turmoil in the financial world over the past two years: Lately we hear much chatter on themes that we've been discussing for a while. As these concerns became more recognized, stock markets around the world became more volatile, with the U.S. having gone from being up a few percent at the end of March to being down about 7% by the end of June. As we write this in July, the market is back to about even for the year.

Certainly we're not giddy about seeing the economy struggle and the stock market fall. However, the first step to fixing a problem is admitting that one exists. We recently saw a poll cited where two-thirds of Americans were concerned about the increasing size of the Federal Deficit while the remaining one-third were worried about the risks of a weakening economy. To us, this seems healthy. We acknowledge the non-trivial risks of an over-zealous commitment to austerity. Significant and prolonged deflation is not a fire we wish to play with. However, as the sheer math of the deficits becomes more clear, the prospects for individuals and for companies becomes more uncertain. Speaking with our companies reveals some consistent themes. First, consumers are being careful. Retailers continue to see spending patterns suggesting that many are living paycheck to paycheck. People see their neighbors out of work or afraid of losing their jobs, and so they too become more cautious. Savings rates in the U.S. are holding at, or above, 4% of income. Households are replenishing their coffers.

Industrial companies tell us that they are not seeing weakness in the global, industrial economy. Inventory levels are good and reorders are healthy. But they have all their antennae up looking for any signs of weakness. More importantly, they are being very cautious about hiring and investing in new machinery and equipment. As we have cited in the past, the persistence of workers who remain out of work for six months or more is unprecedented. Long-term this implies the rise of a new, more cautious generation of consumers and workers. Our economy may lose a little of its "mojo."

We are seeing an attractive opportunity in the sorts of strong, global companies we own for you. Historically to invest in a group of these businesses, one had to pay a significant premium to the rest of the market. In fact, during the early 1970s, speculators were willing to pay valuations that were as much as triple the market averages. Today the premium we pay is about 10%. It's a nice luxury to be able to buy a Rolls Royce for the price of a 20-year-old Kia. On top of that, we receive a yield that is about 40% higher than the overall market from companies with balance sheets that are strong – in many cases with no debt.

Let's think about that for a moment. If we pay only a 10% premium for these companies, we capture the following benefits:

1) In a time of great uncertainty, we hold a group of companies with almost no chance of bankruptcy – it is hard to go bankrupt with a strong balance sheet – one that is stronger, in fact than many governments.

2) We get paid a much higher income for holding stocks that are in fact safer than the average stock.

3) We receive income that is similar to that of longer-term corporate bonds, but we also get a chance for dividend increases over the years (highly likely given these company's prospects), and we get more favorable tax treatment than bonds.

4) We take very little valuation risk versus buying lower-quality stocks – these companies *are* the cheap stocks in the market today.

It is highly unusual to see this sort of opportunity. Twenty years ago, we'd consider these sorts of stocks cheap if we could buy them at a 25% premium to the overall market. Today they are even cheaper.

The world is still topsy-turvy. Greece, Spain and Portugal are a mess. North Korea is run by an increasingly desperate madman. The US Federal Deficit is likely to keep growing for a number of years. But in this uncertain world, we can feel more comfortable knowing that we own businesses for you that are strong, profitable and growing. We have even more comfort knowing that we own them at bargain prices. If we do get surprised by much stronger economic growth than anyone expects, we suspect that our solid, steady companies will do *worse* than the overall market. That is a surprise we would all welcome, and we'll adapt your investments accordingly. But if, as is more likely, the world continues to be more than a bit treacherous, then the strength of your companies should provide a relative haven in stormy seas.

We hope you are well. As always, please don't hesitate to call with questions or comments.

Marble Harbor Investment Counsel, LLC

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