Marble Harbor Investment Counsel, LLC
Excerpt from
First Quarter, 2014 Letter

Dear Client:

"It's never paid to bet against America. We come through things, but it's not always a smooth ride."
– Warren Buffett

"Remember, my son, that any man who is a bear on the future of this country will go broke."
– J. P. Morgan

Today it is easy to be a pessimist. Vladimir Putin is executing a slow-motion invasion of a neighboring country, China's growth is slowing and staring down the barrel of a demographic disaster, Brazil is unwisely unwinding many previously successful economic policies, and while the U.S. is reporting much better unemployment figures, they are almost entirely due to an abysmal drop in the labor participation rate. Finally unusually harsh winter weather has weighed on recent corporate results in the U.S. Each of these is in some specific way "unexpected," but they also fall within a range of reasonable issues that arise during the ebb and flow of history. Most frequently, financial markets react negatively in the short term, but viewed over longer time horizons, markets show remarkable resiliency. Given these circumstances, the quality of the companies you own is even more acutely critical to the long-term health of your portfolio.

Another area of concern that has recently been picked up by the popular press is "High Frequency Trading" (HFT). This is the practice of taking price data gathered directly from exchanges and using it to make enormous numbers of computer-driven ("algorithmic") trades that exploit slight price differences between and across markets and individual securities. This activity has been estimated to account for more than 60% of all stock trading. In pursuit of advantages measured in micro-seconds, funds that practice this speculation on the fluctuations of stock prices pay the stock exchanges enormous fees for a preferential data feed and have driven up the price of both real estate directly adjacent to the exchange as well as high speed data access to the exchanges. Some have equated this to a form of insider trading. Others celebrate it as promoting liquidity and efficiency in markets. Strictly speaking it may not be illegal, but it does have an off-smell.

The handmaidens to HFT are so-called "Dark Pools." This is the term for trading stocks off the exchanges. As any skier knows, while sometimes you can find great virgin powder and surreal quiet and beauty off-piste, there is often a cost in terms of hidden rocks, unstable terrain, the risk of avalanche or at the least, no ski patrol if something goes wrong. The advantage of these dark pools is that they carry lower transaction costs for brokers and HFT traders. The downside is that it creates a set of private, unregulated "exchanges" where certain players have superior trading information. This creates situations where for *short-term* traders, the terrain can get very treacherous.

We've been following this activity for years. The flash crash of several years ago and some of the remarkable intraday market volatility we see is arguably related to increased HFT and dark pool activity. Meaningless short-term paper-pushing doesn't really serve a higher purpose in the pursuit of allocating capital to the most deserving companies in a capitalist system. To be momentarily selfish, is this bad or good *for you*? We'd posit that it is marginally positive.

Many speculators choose to compete with these traders. We don't follow them off-piste. Let them glean the fields of those who falsely believe they have a short-term trading advantage in the market. We know that it is an illusion unless you are participating in the arms-race for data and computing power to win the short-term trading game. As investors, we instead focus on the true value of the companies we own (or want to own) and make purchases and sales when prices make sense relative to a company's fundamentals. None of the values of the companies in your portfolio change because a computer trading algorithm determines that it can harvest $.003 per share on a trade by selling the stock in New York and buying the futures in Chicago. With this mindset, outsized volatility creates opportunities for us to own businesses at prices that make sense.

We agree with Paul Volcker, that this activity erodes confidence in the markets. From that standpoint, HFT and Dark Pools are bad. But as long as there have been markets, there have been speculators who endeavored to exploit inefficiencies, loopholes if you will, in the system. We remain cognizant of this dynamic and keep a watchful eye for whatever new form market manipulation may take. Whether global events or market speculation, our focus remains on how we can leverage the inevitable short-term bias of others to your best advantage.

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