Marble Harbor Investment Counsel, LLC
Excerpt from
First Quarter, 2016 Letter

We are pleased to send an excerpt from our first quarter client letter that discusses our current thinking. We welcome your thoughts.

Sincerely,

Paul Davis, L.J. Harrington, Eric Robb and Daniel Rosenblatt

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Dear Client:

It was the morning
Then afternoon
And then the night came

Until someone told me
"Nothing happened today"

Boomtown Rats, "Nothing Happened Today"

If you closed your eyes on December 31st and opened them again on March 31st, you might think to yourself, "Nothing Happened Today." Stocks returned a total of 1.3% – primarily due to dividends. This is also the case for the past 12 months. But oh, what happened in between. During the quarter, stocks were down as much as 10.3% and up as much as 3%. This volatility is what we have expected and discussed with you over the past several years. The uncertainty in politics, economics, societal safety and even geology and weather has seemingly put a hair-trigger on markets. The result? The undulations we've seen. Your investments are positioned for this environment and performed well, fluctuating much less than the overall market and producing more income.

If we step back a bit, what emerges is a pattern of lots of activity but little progress. The futility of rapid stock trading (aka guessing) and the inherent risks in market timing have come to the fore. Various strategies – both the timeworn and the de rigueur – touted to produce strong, consistent, low-risk returns have not delivered. Hedge funds, portable alpha, tactical asset allocation, managed futures, risk parity strategies and a number of other Baskin-Robbins Flavors of the Month have, on average, all done poorly at exactly the time they were supposed to shine. What has worked has been the discipline of investing in reasonably valued companies that have strong businesses with good long-term prospects. This takes patience, focuses on what can be analyzed and removes much of the emotion from investing. Our priority for you is what lies ahead. We strive to own businesses that are built to endure the inevitable, yet unpredictable, bumps in the road.

We want to emphasize that we aren't blind to the turbulence in the world. You know from frequent prior discussions that we are not. But some of what we observe seems like a scene from an Albert Camus play. For example, 70% of the US economy is driven by consumers. The drop in oil prices has provided a windfall to all those in the US (and worldwide) who drive (even electric cars), heat their homes, or use artificial light. Lately, individuals have been spending this bonanza by paying down debt. Of course this sort of spending does little for the economy today, other than to improve the creditworthiness of banks, credit card companies and consumers. In fact, it's something of a drag on the economy. Cash is not used to buy products and services, but instead is left to "lie fallow" in a savings account, or to pay off borrowings from prior purchases. In the long run, this newfound frugality is great for the sustainability of the growth, though it suggests a muted, slow pace. Perhaps it's a coincidence, but this fits the character of the current economic expansion in the US.

The market, however, has essentially been following the fluctuations in oil prices – oil goes up (bad for those responsible-for-70%-of-the-economy consumers), the market goes up. Oil goes down and, lo and behold, so too does the market. This makes little long-term sense, but there are numerous short-term rationalizations as to why it's true. Similarly China's stock market turmoil has traded in line with oil. This is even less logical given China's dependency on foreign oil and gas – especially since declining oil prices seem more driven by excess supply than weak demand. One thing we do know about oil, and markets in general, is that every industry and market sector will go through cycles of strength and weakness, coming into favor and eventually going out of fashion. Our job is to avoid being over-exposed when things are too expensive (no matter how great a business it is) and ease into investments when they look attractively valued. We have been able to do that during our time working with you.

We remain comfortable that over the long-term, your companies can provide fair returns – in the range of 5-7% per year on average, which should be modestly better than inflation. Based on your current investments, we expect about half of those returns to come from dividends, which means we anticipate changes in stock prices to contribute only a few percentage points each year. Given the expected future growth in profits from your companies and current valuations, this is not a high hurdle. That said, we are less comfortable with the idea that the overall stock market will be able to achieve this rate of return. Business prospects and earnings growth for the average company look much less certain to us. The market's dividend yield and the growth of those dividends is lower than yours, and valuations of certain sectors and companies seem stretched. As we have emphasized in the past, there is much less resiliency in the system, so we strive to build it into your investments through strong companies with good balance sheets.

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