Marble Harbor Investment Counsel, LLC
First Quarter, 2020 Letter

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

Sincerely,

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If you can keep your head when all about you
Are losing theirs and blaming it on you,
If you can trust yourself when all men doubt you,
But make allowance for their doubting too;
…Yours is the Earth and everything that's in it

Excerpted from "If" by Rudyard Kipling

We were first introduced to this poem in 1990 while reading an essay written by the late investment strategist, Barton Biggs. He was both a clear-headed thinker and an excellent writer. Somehow decades of formal education left us unexposed to this poem (and many others, for that matter). Kipling's words resonated then as they do now, because they seem to characterize the challenge of being an investor during stressful times.

Today, "keeping your head" may be helped by viewing the investment world with a longer-term perspective. Our companies make this effort easier because of the long-term approach they take toward their businesses. As well-managed companies in good industries, they are working through the current challenges and planning for how they can emerge in an even stronger relative position than before. Some, in healthcare and software are even thriving because of the present environment.

Let's think back a little more than five years ago, to the beginning of 2015. At that time, we were discussing with you our expectations for modest returns to stocks going forward – perhaps 4 to 6% per year for the next 5 to 7 years. This was based on the valuation of the market, the dividend yield and expected profit growth. At that time, inflation was tame, and this expected modest rate of return would still be faster than inflation (a critical goal of long-term investing), but surely not a get-rich-quick scheme. Relative to bond yields, we expected this to be a pretty good return, as interest rates were already quite low: a 5 Year Treasury bond yielded approximately 1.6%.

The top end of our expectations implied that $100,000 invested would grow to about $135,600 including dividends by March 31, 2020. We were a tad too pessimistic. As it turns out, stocks as measured by the S & P 500 actually delivered compounded returns that came in a bit better than that at 6.26% per year. This is about three times the rate of inflation we have experienced, so stock returns have allowed you to buy more today than five years ago. Had we simply closed our eyes in 2015 and opened them today, we would look back and say, "Not bad." But the roller coaster that got us here can change the perspective to an unhelpful one that ignores the long-term good news.

How does this compare to other alternatives? Well, we know what the return has been for that 5 Year bond – 1.6% per year. And what about for hedge funds, many of which have been reporting losses that are less than the overall stock market for the past three months? During the last five

years, the average multi-strategy hedge fund delivered a return of .81% per year. The price paid for less volatility has been very expensive, indeed.

A look at the past is all well and good, but how should we think about what lies ahead? We'll approach that question in two parts – first the outlook for businesses and second the outlook for stocks.

The extreme volatility in the market of late is likely a reflection of the uncertainty over both the risks to our health and the sudden slowdown we've imposed on economies around the world as we combat the spread of COVID-19. January's lockdowns in China have followed the virus around the Northern Hemisphere. This is creating novel challenges for citizens, businesses, governments and the financial system.

We are likely to have at least a few more weeks of jarring news on the health front, as the numbers of those infected in both the U.S. and the rest of the world rise. That is widely anticipated and, to an extent, is moderately predictable thanks to the work of epidemiologists. We may even see some financial "sighs of relief" as news that matches, or is better-than, expectations is revealed through testing and improved medical care. Last week's spike in the stock market is an example of this phenomenon.

The full economic consequences of tackling this scourge are far less certain. We are earlier in the process of seeing the effects of shutting down large swaths of the economy. We have begun to see the impact on unemployment – millions of Americans have filed for benefits and many millions more will soon do so. Hourly work has been ravaged. Service industries, the so-called Gig Economy and many not-for-profit organizations are struggling to stay afloat as their wages and revenues have plummeted.

Cruise lines, airlines, restaurants, theaters, amusement parks, sports teams and hair salons have had their businesses enter a period of suspended animation. For anyone who has seen a Sci-Fi movie about extended space travel, we know that waking up from this state is never easy, quick or clean. Some don't make it. Some do but are forever changed and others thrive and prosper. We think this is a good analogy for what we will see in the economy. The unprecedented nature of these economic challenges forces us to rethink the way some forms of business are conducted. We'll highlight a few thoughts here and will discuss more on this topic in the future.

The sharp slowdown in so many areas of the economy has elicited truly remarkable policy and fiscal responses from governments around the world in a matter of weeks. The magnitude of these programs should help workers and the economy muddle through this period, until stasis transitions to our new normal. That said, these government programs are designed for the current period. Future "echo" outbreaks between now and when we have widely available treatments and vaccines will require more government stimulus. The pandemic's dual legacies will be immunity and swollen government debts that suggest rising taxes.

Globalization has gotten us to where we are. In the past we have noted the enormous benefits it has bestowed on the world, especially on Emerging Markets and less-developed countries. Health and welfare are far better because of increased globalization over the past three decades. However, embedded in this trend has been a basic set of assumptions that included continuing openness, the free movement of people and goods and a common belief in the concept of free trade. These basic tenets started to come under attack a couple of years ago with the increased tension between the U.S. and China on trade issues. Natural disasters in Thailand and Japan showed that manufacturing

in only one place may not be a good idea. The spread of COVID-19 has now brought into question whether people and goods can even move from their current locations. While elegant and low-cost, today's industrial supply lines have been optimized for a globalized, free-flowing world. They are also quite fragile, as has been brought into sharp relief. Consequently, we believe that businesses of all sorts will begin to build more resilience into their business plans. That may mean actions such as: carrying more inventory, building factories in multiple, even higher-cost locations to hedge the issue of a disruption in one area, reversing the trend of winnowing the number of hospital beds per capita, increasing digital and remote-work capabilities, and building more redundant capacity. These actions may lead to less risk, but lower profitability.

The rapid spread of COVID-19 itself is certainly a consequence of globalization. Viruses such as these have been appearing and vanishing in various localities for millennia. In the past, with limited mobility, they did their damage, then inevitably created their own immunity in the local population and disappeared. The rest of the world rarely knew of them. Today, with effortless transportation and instant communications, we both share, and are aware of, happenings from all over the world. Building resiliency into our healthcare system to deal with this sort of threat is no longer an interesting concept proposed by some virologists. We are experiencing the extreme consequences of failing to take that ounce of prevention.

This leads us to some initial thoughts: We are likely to see a headwind to corporate profitability and eventually higher taxes to pay for the massive economic support packages that each government is, in turn implementing. In the short term, we may see an uptick in building, and a spike in demand as recovery begins to take shape inside of business and government, to say nothing of within households. Over time, however, it suggests a system, a world, that is both more resilient and a bit more expensive to operate each day.

Generally, we believe this experience has helped to force people and companies to more readily adopt remote and digital technologies. While few of us love to learn a new language or embrace big changes, we are now *all* learning to operate at a distance. Whether that means firm-wide video Town Halls, or Video Cocktails with friends, we aren't going to emerge from this as we went in. Digital businesses will likely gain more ground, the plumbing of the internet will need to be made more robust (and redundant) and health practices will integrate new scenarios for which to plan. Vaccine makers and diagnostic companies should continue to thrive, as will those who make the everyday conveniences of life, including disinfectants. Also, strong will be those service providers who allow business and families to go about life with less trouble, less friction. These stronger businesses comprise much of your portfolio. While we had no sense that there would be a pandemic, the inherent attractiveness of your companies' industries is what attracted us to them in the first place. These characteristics are coming to the forefront today.

As for specific industries, we can point to a few with some likely changes. You'll note that in general these are **not** widely represented in your portfolio. They are less attractive businesses to be in, and the stresses of the pandemic are only making things harder. We expect restaurants to eventually re-open, but with fewer tables. Airlines will see renewed air traffic. In fact, we may see a temporary spike as cabin fever creates an appetite for vacation travel and businesspeople want to see customers and remote work sites. After that initial rush, though, we wonder whether this forced training in the ways of remote communication and work may change long-term behavior. Perhaps a weekly videoconference with that manager in rural Ohio can substitute for some of the monthly on-site visits. All of the airlines' profitability comes from business travel. If this structurally declines, what will that do to an already challenged industry? And for leisure time, are people going to be

rushing to go to a movie theater, take a cruise or visit a busy foreign city anytime soon? Before widely available tests and vaccines are available, "Business as Usual" is unlikely.

Looking at stocks, our expectations are resetting. With so much in flux, it would be misleading at best, and dangerous at worst, to jump to significant long-term conclusions about what may happen in the stock market over the coming years. Patterns from the past though, may give us clues to what lies ahead.

First, with the stock market having dropped a bit, it may mean that from these lower levels, the returns over the *next* 5 to 7 years may be a little *higher* than what we had expected recently. That of course depends on how rapidly investors discount challenges in the world and push stocks up in the short term. We'll patiently reserve judgment about future returns until we have a better sense for what the economy may do and where stocks sort out over the coming months.

Second, we know from looking at stock market history how expensive it can be to try to time the market. For the 15 years through the end of 2019, the stock market delivered a compounded annual return of 9% per year. However, if an investor missed only the *10 best trading days* that return shrunk to 4.13%. Miss the 20 best days, and the return withered to 1.17% - worse than buying a series of short-term Treasury Notes or leaving your money in cash. And what if you missed the best 30 days – one month of days out of 180 months of investing? Well that was a disaster which delivered a return of -1.35% per year. Stuffing the money in your mattress or in a coffee tin in the backyard was a better strategy.

Volatility has certainly been breathtaking in recent weeks. Responding to some good health news and the huge government stimulus, last week was the best for stocks in 46 years. A couple of weeks ago we had a series of days that implied that the entire value of corporate America increased or decreased in value by 5 or 10% over the course of 24 hours. While this movement can be nerve-wracking, we can't let it be destructive. On any given day, as much as 90% of all trading is driven not by fundamental issues affecting individual companies, but by macro factors, high-frequency trading, computer algorithms and technical issues surrounding derivatives and Exchange Traded Funds (ETFs). This means that on a given day, the prices of many stocks don't really reflect a company's long-term value, but rather the short-term supply and demand for the shares of stock.

With this knowledge we still don't have an answer that tells us "When?" But that is not the right question. We aren't looking for *the* right time to buy or sell, rather we are looking for companies to buy or sell when opportunity presents itself. With a view to the next 5, 10, 15 years, we want to own good businesses, and the current turmoil allows us to do so at reasonable values. We do know the market will continue to churn in the short-term; however, we also know that the stocks of good companies will give us fair returns over the long-term.

Much will change for all of us in the years ahead, but certain things have not altered. Twelve months ago, pundits found little that could go wrong in the economy. Today it may feel as if it's hard to find things that will go right. Neither of those views is correct, because of some enduring truths: We are all striving for a better world and for a better life in that world. People who have less will apply creativity and hard work toward improving their and their family's lives. More children will be born, increasing the population and long-term consumption. Inflation will slowly, but steadily eat away at the purchasing power of money. And good businesses will be able to prosper over time.

We are all trying to stay safe and get through a difficult and challenging period. Health and safety come first, and then we will tackle the economic consequences. You own a portfolio of good businesses. The volatility we are seeing as we move through this period of economic uncertainty will give us opportunities to change some of your holdings and add to others. Eventually the crisis phase will pass, and we will discover what lies ahead. No one knows what that is, but we believe that the enduring capabilities of your portfolio companies will generate good investment returns and that as in past crises, we will emerge stronger, smarter, more thoughtful and yes, changed.

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