Marble Harbor Investment Counsel, LLC
Second Quarter, 2022 Letter

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

Sincerely,

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

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"But these sardines are spoiled! I want my money back."
"Son, there's eatin' fish and tradin' fish. Them's what we call tradin' fish."

– Punchline to an old Wall Street joke

Until now, we've shared our thoughts on cryptocurrency one-on-one with many of you, but as its presence and the number of questions around it grow, we thought it would be helpful to address the topic in a letter. We hope that sharing our years of learning about, discussing and debating cryptocurrency in our investment meetings will help shape productive conversations in the future.

While all asset classes have been on a turbulent ride in recent months, cryptocurrency has been amongst the most volatile. Bitcoin is down 70% from its all-time high, Ethereum is down 75%, Dogecoin is down 90%, and poor Terra Luna is down 100%. Bitcoin was supposed to be the new millennium's gold – a stable store of value, divorced from "fiat" currency's inflationary traps, and like gold, with a fixed supply that could never increase, as opposed to central banks' ever-ballooning balance sheets. For years, this seemed like a plausible theory, but theory and practice are often two very different things. Now confronting an inflationary environment for the first time since its birth, cryptocurrency has proven *not* to be the hedge against inflation its champions professed it would be. Instead, it has been quite the opposite, dropping more than any other asset. In fact, the price of Bitcoin is highly correlated to the movement in the Nasdaq – i.e. behaving like other risky, over-inflated trading assets in a rising interest rate environment.

The Origins of Cryptocurrency

Bitcoin was founded during the financial crisis of 2008 as an alternative to central government currencies by an anonymous programmer using the pseudonym Satoshi Nakamoto. He created a digital currency to compete with the dollar, yen and Euro, only with a limited supply, so the currency could not be manipulated by unlimited issuance like the central bankers of the day. The thinking was that Bitcoin would hold its value versus floating "fiat" currencies. Bitcoin itself has a limited supply, but many other cryptocurrencies have since been created, increasing the overall supply of cryptocurrency. Bitcoin is produced or "mined," by computers solving complicated math problems, and the miners are paid for their efforts in Bitcoin. One unintended side effect is that Bitcoin has become a huge carbon polluter, consuming as much energy as the entire country of Norway: This is an environmental calamity.

Is cryptocurrency actually an asset class? Is it investable? To answer those questions, we need to return to first principles of how we invest at Marble Harbor. Let's begin with a Warren Buffet definition. *Intrinsic value can be defined simply: It is the discounted value of the cash that can be taken out of a business during its remaining life.* Over time, investors may pay more or less for that stream of cash based upon the current economic environment, interest rates or what else is available to buy in the marketplace. But at their core, the investments that we make at Marble Harbor for you are based on the intrinsic value of a firm, the foundation of which is the cash flows of the underlying business.

Amongst numerous other forms of investing and speculation is trading in currency and commodities. In the long term, these assets do have some intrinsic value; however, trading them in the short term is a form of guessing based on supply, demand and emotion. Buy copper if you think the economy is booming, and demand is growing faster than it can be mined. Sell copper if you think the economy is slowing or that mines are pumping out too much of the metal. Sell the Yen and buy the Euro if Big Macs cost more in Tokyo than in Berlin. Commodities and currencies are trading assets. If you own commodities all over the world and have superlative information on supply and demand like the world's largest trader, Glencore, you can make a fabulous living selling commodities in one country and buying them in another. We don't have any edge in this high-risk game, so we leave it to others. You may know the story of how George Soros became a billionaire by "breaking" the British pound in 1992. Sam Bankman-Fried, the thirty-year-old founder of crypto exchange FTX, realized that you could arbitrage the difference between Bitcoin prices in Japan and the U.S., and that trade started him on the way to his billions.

Cryptocurrency doesn't create any cash flows for its owners, and there is no underlying value to it as an asset, therefore according to Buffet's valuation framework, it has no intrinsic value. The price of cryptocurrencies, like commodities and currencies, are strictly based on supply, demand and faith. Cryptocurrencies are a great asset to trade because they are highly volatile, there is imperfect information, there are different supply and demand curves across the world, and there are millions of poorly informed individual investors, who are akin to the JV team playing against the Golden State Warriors. Traders need new legions of crypto devotees buying Bitcoin to provide more liquidity for them to trade against. With no cash flows, the only way for crypto to keep going up is to entice new buyers into the ecosystem. You may remember the crypto Super Bowl ads featuring Larry David and Matt Damon that were trying to do just that.

The lack of regulation to date has made cryptocurrencies an even better trading vehicle. There are no laws against insider trading, market manipulation or false advertising, and there is evidence that *all* of these things have been present in crypto-markets. This dearth of oversight is reminiscent of the Wild West of stock trading that preceded the 1929 crash. Following the crash, the banking and investment industries saw the introduction of the 1933 Banking Act, which established the FDIC, the Securities and Exchange Act of 1934 and the Investment Advisers Act of 1940. These important regulations created investor protections and the modern investment industry and laid the groundwork for the United States to become the largest, deepest and richest capital market in the world.

The recent bankruptcy of Celsius Network, where you could lend your bitcoin at rates as high as 18%, feels an awful lot like a plain old run on the bank – a common occurrence in pre-FDIC America. Sadly, hundreds of thousands of depositors may not get their money out. So, the motto here is Caveat Emptor – there is currently no regulator looking out for you in cryptocurrency land. Thus far, Congress has remained hands off, leaving consumers to fend for themselves.

A friend of the firm recently won a World Series of Poker bracelet. His profession is "gambler," but he's essentially a highly rational, attuned trader. He knows the statistics of every hand and has honed his skills over many years. If you're at the table with him, you may win a few hands, but over time, he will win all of your money. If you have the time and dedication to develop yourself into a respectable poker player or trader, we salute you. If you like to dabble in poker or trading, that's fine too. It's okay to go to Vegas with a pre-set limit to enjoy yourself or to buy a little Ethereum, but don't think you're going to beat our friend at poker or become the next Sam Bankman-Fried.

Over time, investing in a broad portfolio of companies will make money, as the underlying companies create cash flow and the economy grows. Of course, there will be periodic downdrafts in the market, as we are experiencing now, and they can be trying. However, trading copper or the Yen/Euro exchange rate is a zero-sum game. You can make money trading it, but you are not making long-term investments. Cryptocurrency is fine to trade in moderation, if you think you have an edge, or if you enjoy the game, but don't confuse speculation with long-term investing.

We are acolytes of cash flow, not traders. We respect people like George Soros and Sam Bankman-Fried, but we don't invest like them, and we only play penny ante against our friend the professional gambler. Cryptocurrencies and their close relations, Non-Fungible Tokens (NFTs), may one day become investable assets with real, intrinsic value, but they aren't today. We continue to follow developments in this corner of the world, but as of now, they remain short-term trading vehicles rather than long-term investments. We will leave the speculating to the speculators and continue to focus our analytical efforts where they will bear the most fruit: finding sustainably profitable businesses that we can invest in for the long term.

Please don't hesitate to contact us if you have any questions.

Sincerely,

Paul, Eric, LJ, Dan and Howie

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