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

We are pleased to send an excerpt from our second 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:

Looking at the current economic environment, it's easy to feel a bit disoriented, as if we've stepped through the looking glass and found ourselves, like Alice, in a world where down is up and backward is forward. In Europe and Japan, $11 trillion of sovereign debt and even some corporate debt has a negative yield, subverting the traditional relationship between lender and borrower, with investors *paying* bond issuers for the privilege of using their money. Likewise, the conventional logic concerning the role fixed income and equities play in a portfolio is also turned on its head. Customarily, one would look to the fixed income portion of the portfolio to provide stability and income. If more income were the goal, then you could allocate more to bonds. But in today's Jabberwockian setting, if we sell equities and buy bonds, chances are income will actually decrease. To successfully invest in the Red Queen's world, we must accept our new surroundings and adapt accordingly.

At this writing, the S&P 500 dividend yield is 2.1% and ten year bonds are yielding 1.7%. To increase income, we face three choices: Lend out money for a very long time, lend to much riskier borrowers or add to holdings of stocks. Each of these options carries its own special risks.

Ten years ago, equities and bonds were behaving in a less curious manner. The ten year bond was yielding 4.7% and the S&P 500 dividend yield was 1.7%. To increase income, the decision was quite clear. For every dollar of equities moved into fixed income, income would increase by 2 ¾ x. Today for every dollar of income moved from equities into bonds, income *decreases* by 20%!

When buying a bond, we know exactly what your income (and total return) will be. A ten year, $1,000,000 bond yields 1.7% and will pay $17,000 per year in income for 10 years, $170,000 in total income, at which point you'll receive your original $1,000,000 back.

On the other hand, if you were to invest $1,000,000 in stocks, yielding 2.1%, in the first year you would receive $21,000. Unlike a fixed rate bond, with an equity the income has growth potential. We expect the typical company you own to raise its dividend about 3.5% per year (which is faster than inflation). Over the course of ten years this suggests you would likely receive on the order of $250,000 in income from equities, *almost fifty percent more income than from bonds.*

Not only do equities provide the opportunity for more, and faster growing income, they also have the potential for capital appreciation. Since 1930, dividends have provided about 40% of the return of the S&P 500. This ratio has varied over time, but using the long-term average and the current S&P dividend yield of 2.1%, you could see a total return of about 5%. If the companies are able to grow their dividends, total returns might be a little higher, perhaps 6% or 7%. Compare this to the diminutive 1.7% annual return we know we'll receive from a ten year bond.

The price we pay for the higher total return of 5-7% per year in stocks is the day-to-day and month-to-month volatility we will *no doubt* experience versus the guaranteed return of the Treasury bond.

The greatest investment risk is permanent loss of capital. That can come in two basic forms. First, investing in something that permanently drops in value or where you're forced to sell an investment while it's temporarily at a loss. The second is the silent killer of investing – inflation. Stocks certainly pose the first risk, but over long periods of time, we have managed to significantly mitigate that threat for you by paying attention to business valuation and balance sheet risk for the companies you own. Buying a 10 year Treasury bond at 1.7% today seems to us to *guarantee* that you will lose to inflation.

It's true that with equities come more volatility, and riding those waves can test even the most steely of temperaments. In the long term, however, volatility, while unsettling, is not risk. Bonds can still mute some of that choppiness, but in today's world, we need to look down more than one rabbit hole to help protect your portfolio against the erosive effect of inflation. Once you've slipped through the looking glass to the land of negative interest rates, getting where you want to go may call for a departure from the traditional. As Alice discovered, in Wonderland, steadfastly sticking to conventional wisdom leads you precisely where you *don't* want to be.

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