Marble Harbor Investment Counsel, LLC
Excerpt from
Fourth Quarter, 2019 Letter

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

Sincerely,

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

****

Dear Client:

2018's Fourth Quarter lump of coal set the scene for the S&P 500's 31% return in 2019. Our advisory board member, Brad Perry, counsels us to never look at performance trough-to-peak, rather view it from peak to peak and trough-to-trough. If we look back to the prior peak in October of 2018, we find that the market has risen 14%. We think this is a much more relevant discussion point than the 31% that is being trumpeted in the media. Your performance over this short, dramatic roller-coaster ride has been very good.

The 2010s were kind to stock investors. Equity returns averaged 13.5% per year. How is it that they performed so well? As with 2019's performance, we need to look back in time to the lost years between 2000 and 2010 that returned -1.2% annually. We started that decade with the tech bubble and ended it with the traumatic 47% drawdown of the financial crisis. While we started the 2010s at a low point, almost all of the rise in stock prices came from growth in company profits. There were other factors as well that drove the market to such good returns in this decade. The question of the hour is will they persist? You could answer this with a PhD thesis, but let's discuss the few most important factors.

During the financial crisis, governments around the world turned to unorthodox means to combat the recession. The Federal Reserve Bank, the European Central Bank, the Japanese Central Bank and the Chinese Central bank embarked on an unprecedented era of quantitative easing ("QE"), injecting trillions of dollars into the world economy. The goal was to lower short-term interest rates and cajole consumers and companies to invest and stimulate the economy. Interest rates did indeed fall. Before the financial crisis, the one-year Treasury was 5%. After QE, it fell to almost zero. As we discussed last quarter, many European and Japanese bonds are carrying negative yields. Savers have been driven to invest in riskier assets in order to obtain an attractive rate of return. Equities, venture capital, private equity and real estate have all been major destinations for these investments.

Though QE has ceased in the United States, it continues elsewhere. That said, it's era seems to be coming to a close. We are instead faced with the prospect of quantitative *tightening* over the next decade. While QE was a boon for stocks in the 2010s, it's effect will likely be much less significant, and possibly even negative in the 2020s.

Warren Buffet described the 2017 tax cuts creatively. The U.S. government "owns" a special class of all U.S. stocks. Prior to 2017, the U.S. government received "dividends" (taxes) of 35% of profits from U.S. corporations. After 2017, the "dividend" was only 21%, leaving more profit for owners. This increased the intrinsic value of all stocks and the stock market. While it's possible that there could be a further corporate tax cut in a second Trump administration, it's also possible that there would be tax hikes in a Democratic administration. Tax rates were a positive for stocks in the 2010s, and will likely be neutral, at least in the early 2020s.

Over the last decade, U.S. companies have been able to keep more of every dollar of revenues. In accounting terms, operating margins have expanded from about 10% to 12%. This might not seem like a lot, but it means companies are now keeping 20% more of every dollar they make. This process has been going on for a while. In fact, margins have doubled since the 90s. There are a lot of reasons for this expansion. Business models are better than they were ten years ago and undoubtedly better than they were thirty years ago. Technology has allowed companies to make more money with less capital investment. Globalization and free trade have allowed companies to outsource manufacturing to low cost countries, the resulting reduction in labor costs has increased corporate profits. Most importantly, the businesses that comprise the U.S. economy are meaningfully different than those of 30 years ago. The current crop of companies simply operate in more attractive industries and sell more services. Low margin manufacturing businesses have been exported to Chinese and Malaysian factories, while selling "Software as a Service" has been reserved for our domestic economy.

While Microsoft will continue to be a better business than Union Carbide or U.S. Steel, globalization is on the retreat and protectionism is on the rise. These are new, real costs to businesses that could weigh on results. Just as in the 1920s and 30s, the rise of populism worldwide, on both the left and the right, indicates that people are dissatisfied with their lot. In response, companies may need to share some of their margin gains with workers. This is already happening through higher wages. It may also mean higher taxes or tariffs, both of which will weigh on the U.S. and global economy. While margin expansion meant increased value for shareholders in the 2010s, it is unlikely to push profits up in the 2020s.

The past ten years were good for equities. They grew out of the depths of the financial crisis with some encouragement from quantitative easing, globalization and lower tax rates. In the coming years, those tailwinds may taper off. We should expect more modest returns coupled with more volatility. As always, we will continue to look for better business models that can stand on their own, regardless of the economic environment. We look forward to serving you and shepherding your capital through the next decade.

On a final note, we want to share some exciting news about Marble Harbor's growth. At the beginning of the year, Darcy Morris joined us as a Counselor. Darcy is a native of the North Shore of Boston who has been working in the finance and investing world for the past 15 years, most recently with another investment advisory firm here in Boston. Her path from Dartmouth College to Marble Harbor took her first through San Francisco, and fortunately for us, the draw of icy ski slopes, family and changing seasons were enough to bring her back east from the beauty of the Bay Area 10 years ago. Darcy will primarily be working with clients and taking on some research responsibilities. She is most of the way through the Trust School curriculum and is enrolled to study for her Certified Financial Planner certification. We are excited for the energy and skills Darcy brings to our firm toward being able to better serve you. We know you will enjoy working with her.

* * * *

The views expressed in this sample quarterly letter are those of Marble Harbor Investment Counsel ("MHIC"), are subject to change at any time, and MHIC disclaims any responsibility to update such views. None of the information contained herein is intended as investment advice or securities recommendations. Past performance is not a guarantee of future results.