Marble Harbor Investment Counsel, LLC
Excerpt from
Third Quarter, 2010 Letter

October 2010

Dear Client:

Over the past 60 years, there have been, on average, only five quarters in each of those decades where the market has risen more than 10%. The market turned in one of those exceptional performances this past quarter, rising almost 11% for the three months ending September 30.

In keeping with the volatile nature of the markets, however, the market also fell almost 12% in the middle of the quarter before staging a strong rally in September. Echoing comments from our recent quarterly letters, volatility seems to be back. It is indicative of the manifold uncertainty in the U.S. and global economy, and given the shifting tax and regulatory environment facing both individuals and corporations, it is understandable. It also reflects the caution being imposed on both capital and consumer markets.

We've discussed the uncertainty faced by individuals, companies and countries. Each is affected in different ways. Yet the confluence of reactions by each group is manifesting in a surprisingly concerted way: A bull market in bonds.

Many investors who previously chased fads in the stock market have been burned. In one form or another, they've resolved not to let what happened to them in stocks over the past 10 years happen again. To fight the last war, they're avoiding stocks and putting money into bonds. Some pundits fear deflation. Regulators of banks, with the horse well out of the barn, are slamming the door shut by implementing new reserve rules making holding risky assets unattractive and holding bonds very attractive. Baby boomers are beginning to retire and want income to supplement their pensions. As each of these players has decided to buy bonds, it has led to falling rates and rising prices.

In selecting appropriate investments that we believe will perform well, we habitually take a reality check on the specific security – stock, bond, or what have you. The range of available options shows a situation we first presented to you last quarter. Today the apparent relative mispricing between stocks of high-quality issuers and bonds seems to be an opportunity for long-term investors.

This year, interest rates have dropped precipitously. Rates are one-half to one-third of the level they were 5 years ago. Have investors simply found a new "Flavor of the Month" in bonds? To see how far this shift in fashion has gone, it's helpful to look at the relative attractiveness of bonds versus stocks. Today, the purchase of a 10-year Government Bond will give us a 2.4% annual return and a guaranteed return of our principal. The purchase of stock in a portfolio of high-quality companies should give us annual income of about 3%, and a reasonable likelihood of capital appreciation of about 5% per year.

What this says is that in exchange for assuming the risk of fluctuating stock prices, we should be able to capture an annual total return that is potentially *three times* as great as the bond. And during that investment period, we receive a higher income to boot!

This leads us to conclude that for a *long-term investor*, the portfolio of higher-quality stocks is significantly more attractive. Long-term investing is a process of getting as many elements of the investment thesis tilted in your favor. Today we see not just one or two companies, but a full portfolio combining the attractive characteristics of valuation, growth, income and financial strength. There is no doubt that there will be a time in the future when bonds once again will pay us a reasonable rate of return. Bonds, especially shorter-term ones, continue to have a role in portfolios as a source of stability. They also provide a place to keep funds needed for current spending. The stock market will continue to be quite volatile – we know that. For investors who share our long time horizon, we see good opportunity today amongst the volatility.

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