Marble Harbor Investment Counsel, LLC
Excerpt from
Second Quarter, 2014 Letter

Dear Client:

The financial barometer seems high. Global economies, while not overly strong, are generally expanding. Stock market volatility is muted, corporate profits are at high levels, interest rates are at all-time lows, central banks have highly accommodative fiscal policies, inflation remains reasonable and a spate of corporate mergers indicates a fair level of confidence amongst corporate executives. In meteorological terms, the hallmarks of high barometric pressure are clear blue skies and comfortable temperatures. Financial blue skies have led to continued strong stock performance. The S&P 500 has risen an additional 6.1% in this half year, after a strong 2013.

Occasionally clear skies can be indicative of a temperature inversion. This occurs when a layer of warm air high in the atmosphere traps cool air closer to the surface. In the world of finance, we are now seeing increased activity in tax inversions: When a large pile of cool cash is trapped overseas by high tax rates in the United States it can be released through the US company buying a foreign one, using that cash to make the purchase, and permanently locking in the lower tax rates of its new "home." Most often the change of "Home Country" doesn't entail much in the way of jobs or headquarters changing locales. The truly substantive change is that the new corporate form is often meaningfully bigger, has at least 20% ownership by the former owners of the foreign company being acquired and a lower tax rate. We have seen tax-driven changes of corporate domicile in the past, but the US tax law changed and made this maneuver more difficult. Recently, there have been a spate of tax inversion-driven announcements driven by higher tax rates and rising cash balances overseas. Pfizer trying to buy Astra-Zeneca, Medtronic buying Covidien and AbbVie attempting to buy Shire are examples. Each of these mergers actually have good industrial and strategic logic. Doing a transaction makes sense – prices are reasonable, the companies complement each other and the businesses would likely be better performers together than apart. However there is some added benefit in the form of moving the corporation to the low-tax home country of the target corporation – the UK, Switzerland and Ireland are friendly tax havens relative to the US.

Another variation of this tax-saving dance involves using lightly-taxed cash that is "stranded" overseas to make an acquisition without moving tax domicile. This money was accumulated through business activities that occurred outside of the US. If the company wants to "repatriate" the cash, it would have to pay the US corporate tax at a rate of 35%. Rather than give up a third of the money in taxes, companies leave it overseas, use it to invest in their businesses (and jobs) outside of the US and wait for ways to otherwise employ these billions of dollars. Companies that include Apple, Microsoft, GE, eBay and Cisco have all bought small and mid-sized businesses outside of the US in this way. By using this cash, they effectively save a third of the purchase price versus other bidders, while also employing the money much more profitably than having it sit on their balance sheet earning .5% in short-term bonds.

As you might suspect, all of this activity has drawn the scrutiny of the US Congress. There is ample rhetoric that include fire words like "Un-Patriotic" and "Un-American." What is often glossed over are the billions of dollars the US Treasury collects from companies based outside of the US who do business here, as well as the difficult reality that we live in a competitive global economy. Enforcing a high corporate tax rate may no longer be defensible while other countries feel comfortable charging less for the privilege of calling their borders home. So, without meaningful revisions to our tax code, we expect the trend of tax-related transactions to continue. While we may find this as uncomfortable as the diminished manufacturing competitiveness we experienced with China in the 90s or the massive outsourcing of labor to India earlier in the decade, it is a logical product of global capitalism. Simply, developed economies like the US no longer have a monopoly on all things aspirational.

When a temperature inversion reverses to a more normal state – warm air at the surface and cooler air aloft – it often causes unstable weather that can precede another stretch of calm. Companies will continue to engage in mergers while debt is easy, plentiful and cheap and tax policies are unbalanced. The various forms of quantitative easing in Europe, Japan, China and the US continue to encourage risk-taking. And the recent low-volatility in stock markets is not typical. As we have often discussed, none of these factors will persist indefinitely. Like a temperature inversion, when these factors resume more historically typical levels, we can expect turbulence. In those times, better quality businesses will provide a haven in stormy weather.

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