Marble Harbor Investment Counsel, LLC
Second Quarter, 2020 Letter

We are pleased to send our second quarter client letter that discusses our current thinking. We welcome your thoughts.

Sincerely,

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

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"It was the best of times, it was the worst of times, it was the age of wisdom, it was the age of foolishness...we had everything before us, we had nothing before us, we were all going direct to Heaven, we were all going direct the other way..."

Charles Dickens, *A Tale of Two Cities*

As was the case during the French and Industrial Revolutions, we are seeing a great deal of turbulence in society, health and the stock market. With fear, greed, uncertainty and speculation all running rampant, there have been some extraordinary gyrations in stocks over the past several months. In fact, in a record four months, we have gone through a full bear/bull market cycle. Today we have something akin to a do-over: Stocks are more or less back to where they were at the beginning of the year. The initial plunge in stocks was broad-based. Few companies emerged unscathed. From the end of March, however, there has been more differentiation. It has been the Best of Times for a select few Work from Home beneficiaries like Zoom Technologies and for Digital Darlings like Amazon that help us to all shelter in place. These stocks have risen to truly breath-taking valuations in a matter of months. At the same time, the royalty of the last age of retailing was led to the tumbrels, with J.Crew, Neiman Marcus and J.C. Penney all declaring bankruptcy and numerous other fading glories poised on the precipice.

COVID-19 has accelerated the migration toward digitization of nearly everything. Business trends that otherwise would have taken years have been compressed into a matter of months. Every company has had to digitally transform its business. Companies like Microsoft that have enabled this conversion have been richly rewarded by the market. Many companies already had been digitizing their businesses, and this has paid off in increased flexibility during the crisis. Ecolab has been able to remotely monitor its clients, allowing it to continue to service them efficiently and help them to sanitize their facilities to keep their customers and employees safe. Digital transformation has changed buying behavior as more people shop online and fewer people want to touch "dirty" cash. PayPal was ready for this transformation, and adoption that they thought would occur over five to ten years is taking place now.

Alongside tech, the other big winner has been healthcare. Diagnostics, a sector long out of favor, is back in vogue as investors contemplate billions of serology tests. Abbott Labs recently hit an all-time high. With more than 80 vaccine candidates, most of the big Pharma and Biotechs have a hand in the game. Six months ago, the only new stories one heard about pharmaceutical companies were the evils of drug pricing, liability for alleged past misdeeds and how Medicare for all will take an axe to profits. Telehealth, always a great unreimbursed dream for the industry, was accorded emergency reimbursement, literally overnight. The relationships we have with our doctors are now going to be quite different, even after fears over COVID-19 fade into the past. Dexcom's continuous glucose monitors can send information to doctors, patients and relatives. Why settle for a once-yearly blood test when continuous, inexpensive monitoring is increasingly an option?

As growth has been hard to come by, the winners have been richly rewarded. The fastest growers – profitable or not – have been accorded a premium valuation to the market seen only once in history: December of 1999. With that in mind, we have been trimming some of your most richly valued companies – businesses we've liked for many years, but for which the market has a newfound exuberance. You will see the details on your appraisal at the end of the quarter.

So, technology and healthcare are the new revolutionaries. Who are the Ancien Régime, swept away by the new? Some of the indicators of weak performance in this crisis regardless of sector have been the perceived relative proportion of physical versus digital business model, the speed of sales growth and current cash flow. Does the company have a recurring revenue stream of frequently-repurchased products or services? Excellent. On the flip side, is it a restaurant, a department store or a cruise ship line? Look out below. Overleveraged companies have been treated even more harshly, as investors asses their ability to pay interest and borrow more money to stay in business. We have always preached the importance of a strong balance sheet. Never has that prudence been so clear as today.

In January we wrote to you that stocks were fairly valued, but not at extreme highs. Today, the economic environment has worsened dramatically, but stock prices are about the same as they were at that time. Now, however, valuations on the most expensive stocks are extended, and this has created a "narrow" market. What this means is that the extremely high valuation of a relative handful of companies is responsible for most of the strength in the stock market. The other 85% of the market is either at a reasonable or even cheap valuation, relative to current economic conditions. This has the potential to make the markets even more volatile than normal. Think of a pyramid standing on its wide base versus balancing on its tip. We look at the Pyramids of Giza standing against millennia, immovable, stable and solid. A stone gets worn away, but the structure stands. That describes a market where most stocks have valuations that are in a fairly modest range. Today we have a market that is more like the Great Pyramid resting on its nose. A small proportion of the market is very highly valued. Remove only a few key blocks and that pyramid will tumble. That said, it doesn't necessarily mean that every stock will fall. On some of the strongest recent days in the stock market, the Zooms, Amazons and Abbotts were actually *down,* while the great unwashed masses of those left-behind companies rallied strongly.

Are bonds or cash a good alternative? Yes and no. Income is scarce, with ten-year Treasury bonds yielding 0.70% and municipal and corporate bonds yielding not much more. At best you will get your principal back. Cash yields about .01% (that's not a typo). For short periods of time, this allows you the comfort of sitting out the volatility that goes along with stock market. In the longer-term, however, money is most definitely being lost to the silent killer: inflation, which will almost certainly be more than 0.70% over the next ten years. At this point, with vanishingly-slight yields that are 50 to 80% less than the yield on a stock portfolio, we view fixed income as a place holder to mute volatility.

If we were forced to guess – and please forgive this step back from professionalism, but this is only a guess – the stock market roller coaster ride is likely to continue, especially if the virus reemerges and its consequences on the real economy become longer-lasting and/or more profound. While this is an uncomfortable time to be in the market, investing through times like these is the reason that stock returns have outpaced bonds over the years. Looking at any truly long-term stock market chart shows the most profoundly painful periods – depressions, wars, pandemics – to be mere blips. But as we are all living the experience right now, this doesn't feel like a blip. It feels real, and sometimes it's hard to see any of the good through the haze of fear and the crisis of the moment. Looking back over the past few months, though, the U.S. and the world have proven remarkably resilient. Things are not all wine and roses, but nor are we fated to blight and misery. Humans are remarkable creatures. Three months ago, there was only one vaccine candidate, now there are dozens. As we write this, a study has just been published showing that mortality in the most severe cases can be cut by 30 to 50% through the use of a 60-year-old generic steroid. Your companies have predictable business models, recurring revenues and strong balance sheets that will allow them to withstand the turbulence of COVID. We expect them to pick up market share from weaker companies and come out stronger – even through this accelerated revolution.

Thank you again for your continued support. We wish you all good health.

Sincerely,

Paul, Eric, LJ, Dan and Darcy

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