Marble Harbor Investment Counsel, LLC
Excerpt from
Third Quarter, 2015 Letter

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

Sincerely,

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

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Dear Client:

This past quarter has proven to be a volatile one. While the total return for the quarter showed a modest drop of 6.4%, bringing the total return for the year to -5.3%, we saw fluctuations during the period that ranged as much as 15%, including one day where the market fluctuated more than 6.5%. For all this excitement, if we look over a longer timeframe, we see a stock market that is up 42% over the last 3 years, 87% over the last 5 years and 93% over the past 10 years (which includes the financial crisis). And as we write this, the market has rallied and erased the year's losses. A good question is whether the fundamentals of the companies and the economy merit these gyrations as we look forward. Another excellent question is why so much volatility, both up and down?

As we've discussed over time, we seem to be experiencing a slow-motion economic expansion. The US has enjoyed a slightly stronger version, while the rest of the world has experienced choppier growth. In terms of corporate profits, most companies are growing on the order of 8 to 10%. The exceptions are energy companies who are dealing with the sharp drop in oil and gas prices. Of course this fall in the price of energy benefits just about every other sector of the global economy. Also temporarily weighing on US multinationals is the strong dollar, which does not flatter their overseas sales and earnings. That effect should work its way through the system in a few more quarters. Consequently, as we look at the underlying business conditions, we see a largely supportive environment, albeit one that is growing slowly.

Economically, the world is more knit together than it once was. Thirty years ago, had Greece suffered a budget crisis or China's growth slowed, it likely would have been little more than a curiosity or a reason to make that country your next vacation spot because it had become inexpensive. Today, Greece's trouble can cause meaningful ripples throughout the world. Things that happen in other countries matter more and so we pay attention to them. And in this more complex, integrated setting, people have a tougher time predicting the myriad consequences an event might have. This leads to one form of uncertainty. The primitive part of our brain is predisposed to interpret the unknown as a threat. As investors cogitate on each new so-called crisis or event (as filtered through an often sensationalist media), they buy or sell – shoot first, ask questions later – with unprecedented speed, if not with considered reason.

This rapid reaction cycle significantly drives market movement in and of itself; however, the evolution of the actual market infrastructure further contributes to the speed, frequency and magnitude of the volatility. Decades ago, things played out relatively slowly. There were certain players who traded rapidly and in high volume, but largely speaking, the markets moved with some degree of contemplation. Occasionally we got a taste of what computers and new participants might do in the future, for example the 1987 crash, but those were rare.

Today, however, we have market movements occurring several times in a single year that some analysts have suggested shouldn't take place more than once in 100 or 1,000 years. We assert that this is due to a change in market structure that has systematically substituted pro-cyclical forces for counter-cyclical ones. Markets are being driven in the direction that they are already moving, until they aren't. Then they boomerang with the same vigorous momentum.

We've written about High Frequency traders (HFT) in the past. They are very much pro-cyclical. Their algorithms try to determine which direction individual stocks are headed based on preferential access to trade-order data. HFTs claim that their activity adds liquidity (ease of buying and selling for other investors). Perhaps. If they do, it's a poor substitute for the more benign role that Specialists once played on the floor of the NY Stock Exchange. When their roles were greater, Specialists often (though not always) acted as a shock absorber, buying stocks when they were dropping, and selling on the way up. They took stock onto their balance sheets and held it there for a time. In much the same way, brokers traded for their own accounts alongside (and often against) their customers. While this was generally a very profitable practice for the brokers, it occasionally lost a lot of money in a given period due to market volatility. This was due to the counter-cyclical trading in which many of the brokers engaged. However, in the wake of the financial crisis, new rules require banks and brokers to hold higher reserves against this sort of activity, so they have largely stopped. The intent of the regulation is a good one – take risk off of the balance sheets of brokers so that taxpayers won't have to bail them out. The unintended effect has been to open up a liquidity gap into which HFTs have stepped.

Hedge funds have also had a hand here. Years ago, most of them actually hedged – both buying securities they wanted to own and selling short (hedging) securities they thought would fall in value. This approach is far more rare today. Instead, many so-called hedge funds make "directional bets" on various asset classes and trends. Over the last 5 to10 years, these bets have proven to be all too similar in nature from one fund to the next. The effect has been a lot of capital sloshing around in one direction or another, again reinforcing increased volatility.

With the emergence of these players, investment banks and brokers have developed products for them to use. There is an arms dealer in every war. Amongst them are Exchange Traded Funds (ETFs). Originally developed as a way for investors to inexpensively invest in various stock indexes, ETFs have morphed into a group of infinitely sliced and diced portions of the market that can be used to speculate. Want to make a bet that oil prices will rise over the next 30 days? Buy an ETF that makes a 4x bet on changes in the price of a barrel of oil. Think smaller companies in Europe are going down? Then short an ETF that owns them or buy a 2x ETF that shorts them. You can even buy ETFs that make a bet on how volatile the stock market will be on a given day. This reminds us of the dentist who hands out lollipops after each visit.

The ETFs allow hedge funds and other traders to make rapid and large bets and theoretically get rid of a bet if it doesn't work. However, ETFs rely on sophisticated computer networks and software to ensure smooth operation. But machines are only as good as the people who designed them and who run them. So if there's a storm of information that causes a strong directional movement in stocks, and simultaneously there's a glitch in the software that administers the ETFs, we get problems. And how are they resolved? Humans step in and try to synthesize an enormous amount of data about a complex system in a short time span. Being human, they interpret the situation as a threat and so implement risk-averse policies to try to protect themselves. This is what happened in late August, leading to extreme market fluctuations in the span of a few hours.

We hope this hasn't been too much Inside Baseball (despite it being October). Each of the factors mentioned here – developments around the world, integration of the global economy, HFTs, hedge funds, ETFs, and most of all human nature are not likely to change anytime soon. So we need to accept volatility as a part of investing. Our strategy is to focus on better businesses that can be analyzed, understand them well, invest at reasonable valuations and hold these businesses for a long time. We know that each and every one of our companies will experience significant ebbs and flows in their stock price over our holding period. In aggregate we have seen, and expect to see, less volatility overall and better performance from this discipline. We can't guess where the market will go tomorrow or nine months from now, though we do know it will fluctuate a lot. We will, however, remain for you a long-term investor.

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