Marble Harbor Investment Counsel, LLC
Excerpt from
Third Quarter, 2017 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, L.J. Harrington, Eric Robb and Daniel Rosenblatt

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Dear Client:

Seven years ago, we wrote a *Harbor Light* titled “Where the Values Are” (http://bit.ly/2hFwrmg). It compared the potential return of investing a safe 10-year U.S. Treasury Bond versus the opportunity of investing in a “risky” equity identified as Company A. We thought you might be interested in learning how they have done over the years. The results are an object lesson in long-term investing in quality companies.

When we buy a “safe” bond like a U.S. Treasury, we know what the return will be upfront. Back in 2010, the 10-Year was trading at 2.4%, which is about the same as it is today. We knew that on a $100,000 investment, we would get $2,400 of income each year for ten years, and then we would get our $100,000 in principal back. So far, as expected, we have been paid $16,800 in income ($2,400 x 7 years). We anticipate another $7,200 in income ($2,400 x 3 years), and then we will get our $100,000 back in 2020 when the bond matures. That’s a 2.4% return.

How good is that 2.4% return? Well, it’s sufficient. Inflation has been about 1.7% annually over that time period, so it’s keeping its head above water by about 0.7%.

What about that risky equity? Company A operates in a fairly consistent business. It has some cyclical exposure to the economy, but not a lot. It has an excellent balance sheet with no debt and a buffer of cash. In 2010, it paid a dividend with a 3.2% yield. On our $100,000 investment, that would produce income of $3,200, a third more than our Treasury.

Ten years ago, we thought that Company A had the potential to grow their dividend 5% per year. In fact, they have grown their dividend closer to 8%. Today Company A’s dividend gives us more than a 5% yield on cost. The annual income is now $5,700 – more than double that of the Treasury. Cumulatively, we’ve been paid $16,800 in income from the Treasury, but the income from Company A is nearly double that at $31,000.

That’s the income side, but what about the principal side? What will we get back at the end from Company A? We thought Company A might grow its profits by 5% per year, and if the valuation multiple were to remain the same, it might be worth $163,000 (this is $63,000 more than we would get from the bond). We were not overly cautious on the profit growth – earnings have grown about 7% per year – but we were conservative on the multiple. The P/E has

increased from 14x earnings to about 28x earnings. Consequently, the $100,000 investment in Company A is today worth $320,000.

The principal and income in Company A is now worth $350,000, more than three times that of your bond, which is worth $116,800!

And looking forward? When we made this investment, Company A was trading at a reasonable multiple. Today's multiple is richer. If we reset the clock and invest another $100,000 in both Company A and the Treasury, the math on the bond remains the same. It will produce $23,000 in income, leaving you with $123,000 in ten years. We still believe that Company A will grow its dividend at 5%, producing cumulative income of $25,000, a little more than the bond. We also still believe the company can grow profits 5% per year for the next ten years. This will result in annual profits that are about 60% higher than today. If the P/E were to stay the same, Company A would return about 60% more than the bond. However, the P/E ratio is higher now. Given the higher valuation, we need to be prepared to absorb some contraction in the valuation. The critical takeaway here is that even if Company A's multiple does shrink, it would have to lose a third of its value to have a comparable return to the bond. In any event, we are still likely to receive higher income from Company A than from the bond. Therein lies our margin of safety. Since Company A is, like all of your holdings, a high-quality company in an attractive business, we can have more confidence that they will actually deliver the expected results.

It's clear that Company A was the far superior investment to bonds for the last seven years. Today's valuation is richer, and the case is still strong, but not as clear cut. Bonds are just as expensive as they were in 2010, but equities are no longer cheap, so in *relative* terms, bonds look a bit better than they did. As such, bonds are starting to play a greater role in portfolios. Equity markets trade at 17x next year's earnings. This is above average, but is not close to extreme. Most of your portfolio trades at a multiple closer to the market's than to Company A's.

We have no doubt that we will see both expansion and contraction of multiples over the next ten years. We might be able to buy any number of our companies at lower prices, but we can't predict if, or when. What we can be certain of is the characteristics of our companies, the strength of their balance sheets, how they grow and reinvest cash flows and increase dividends. Over the long run, which is the only way one can invest, these are the qualities that will win out.

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