Marble Harbor Investment Counsel, LLC
Excerpt from
Fourth Quarter, 2018 Letter

We are pleased to send an excerpt from our fourth 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:

"*Anything* can happen *anytime* in markets. And no advisor, economist, or TV commentator – and definitely not Charlie nor I – can tell you when chaos will occur. Market forecasters will fill your ear but will never fill your wallet." - Warren Buffett

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If two years ago, you had taken a nap à la Rip Van Winkle, and woken up today, you would have found the stock market had produced an annualized return of almost 10% while you slumbered and that the economy had performed well, with unemployment at near record lows. What you would have missed is an extraordinarily placid 2017 and a more typically volatile 2018. For all of this recent excitement, the market ended up being slightly down for the entire year, having delivered excellent returns in an almost unbroken string over the past ten.

One question we've heard of late is, "What is going on with this market?" We have spoken in the past about the rise of both index-oriented investing and high-frequency trading. The migration away from actively choosing individual stocks for long-term investment, toward buying a basket of companies in an index has been a dominant theme for the past several years. Long-term investing in good businesses has been less risky, generated a lower tax burden and worked well, as you have personally experienced. However, for many, the promise of always matching the index has been a siren song. While the market went up, this strategy felt good. Many investors are now coming to understand that matching the index means both assuming the risk profile of the index and perfectly matching the index on the way down. This dawning realization has led to significant fund redemptions. Rapid and compressed selling leads to massive stock sales of every company in the index.

On any given day, between 60-90% of all trading on US stock exchanges comes from non-fundamental stock traders. Twenty-five years ago, the percentage would have been negligible. The long-term investing that we engage in for you is now a drop in the bucket when it comes to setting the daily prices of stocks. Who is making all of these trades? The short-answer is The Machines: Quantitative strategies, computer algorithms, high-frequency trading, ETF creation and destruction – these are all driving the moment-to-moment movement in prices. Because much of this activity is driven off of "what has worked," the trading tends to be self-reinforcing and trend-following. The

result is stock price movement that follows Newton's 1st Law: A body in motion tends to stay in motion, in the same direction. Until it doesn't. That's what we saw with the weakness before Christmas and the sharp reversal after the holiday.

These sorts of moves can be striking. While they may not be the largest in terms of *percentages* (which is really all that matters as investors), they are amongst the biggest in terms of *points*. This makes for great headlines, fills airtime and grabs internet page views. Big numbers sound remarkable and consequently stick in our heads. We're wired to notice unusual, striking events and occurrences. That is what kept our ancestors alive and well on the African savannah.

Unfortunately, this cheerleading on good days or rending of garments on bad leads to short-term decisions that are far from constructive for financial well-being. Coming home from work, we are bombarded with a stream of overly emotional commentary that emphasizes the risks all around. This drives selling by individuals in their 401(k)s, which inevitably comes at just the wrong time. Missing the best 10 days of trading in any given year means losing all of the appreciation in the stock market. The massive individual selling that occurred leading up to Christmas suggests that many missed the 5% rise that occurred the next day and the 2% the following day.

More troubling, this understandably leads many to believe that the "Market is rigged," "Capitalism is broken" and "The Little Guy can't win." Is it any wonder that populism has captured the imagination of so many? The media, which is interested in selling ads, not in doing the right thing, is making things worse, not better.

What does this mean for how we approach our investing mission? We are fully in touch with our role as, by far, minority participants in markets. As part of that minority, we look at stocks as pieces of companies. We evaluate your companies based on what's happening in their businesses, not on how their stocks happen to fluctuate on any given day. We also understand that we can use all of this non-fundamental trading to our advantage. Many trades we have made for you this year benefitted from irrational short-term price movements. Given the continued dominance of The Machines in daily trading, we believe that this pattern is with us to stay. We will see periods of placid markets, as we did in 2017, and then dramatic volatility when news or momentum changes direction. Keeping our eyes on the long-term should continue to pay off in terms of long-term appreciation with less volatility than the market. We are certainly not ignoring all the turmoil of geopolitics or the events that effect our companies. However, we don't watch CNBC and the like because it doesn't help our investment process. We hope your New Year's resolution includes swearing off these entertainers and instead enjoying the comfort of knowing you own strong companies in good industries that are working hard for you every day.

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