Marble Harbor Investment Counsel, LLC
Excerpt from
Third Quarter, 2013 Letter

Dear Client:

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That's a cute little Tapir. It may be about as close to a Taper as we will get for the near future. Though there was much hand-wringing during the summer over the Federal Reserve tapering its program of Quantitative Easing (QE), most observers now guess that based on both pronouncements from Fed governors, and the tone and pace of economic activity in the United States, this won't be happening soon. The dust-up over the government shutdown and the debt ceiling doesn't suggest an end to QE either. Given what we hear from our companies, this makes sense. The bigger question is does it make a meaningful difference to your investments?

Year to date, the stock market has appreciated over 20% – your less volatile equity holdings have generally risen a bit less than that. At the same time, bonds have delivered negative total returns, though your fixed income has given you a positive return. Much of the explanation for the strong equity and poor fixed income returns are due to QE. The analogy we've made in the past is that QE is akin to a temporary sugar-induced high. It gives you energy, gets you going and can even spur you to do things you otherwise might not have done. But inevitably the short-term, artificial stimulus goes away, and you are left tired and perhaps regretting what you did under the influence.

Through massive purchases of Treasury securities, QE has depressed interest rates. This has had a broad effect on markets. It has pushed the price of bonds up and their yields down to unsustainably low levels. Money that is searching for yield / income has been taken out of the bond market and gone into stocks that have, in many cases, provided superior income and the prospect for growth. This has driven up stocks. The money that has come into stocks has gone toward two polar ends of the spectrum – high-yielding companies and speculative / smaller companies. High-yielding companies such as utilities, have been driven to valuations that are rarely seen. Utilities make up little to no part of our client portfolios. Over the past 18-24 months, the smaller, more speculative and lower-quality a company is, the better its stock has done in the stock market. You will note that those three characteristics are not part of our criteria for choosing your investments.

When looking at these events, we are pleased that your companies have continued to perform well in their businesses. They are growing, a record number of them are raising dividends (some at a rapid rate), and they are reinvesting for the future, all while throwing off a great deal of cash that is either piling up on their balance sheets or being returned to us. And unlike the overall market, your companies have consistently grown their profits and have prospects to continue to grow even when the Fed decides to taper QE. This is critical, because while this sugar high is causing certain sectors and companies to experience strong market returns, we fear the complacency that many investors seem to be bringing to their investments. When the candy gets taken away, it will be the less indulgent who will be in much better shape. As for bonds, even a rumor of tapering earlier this year decimated most bonds. When tapering does occur (and it will), interest rates will rise and bond prices will fall, hence our conservative stance toward fixed income.

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