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

Dear Client:

The Butterfly Effect: Is Cyprus Europe's Butterfly*?

Many seem to think so.   As with other crisis focal points in the past, Cyprus is small. Their GDP, at $24.7 billion is the equivalent of Vermont's. The magnitude of what's necessary to "fix" their banks is similarly small. However, we all seek to find patterns in our world. As many so painfully learned in the wake of the Asian Crisis in 1998, the Internet Bubble in 2000, the Mortgage Crisis in 2008 and the ongoing Greek Crisis, small triggers seem to lead to bigger problems.

In this case, the first proposed solution to Cyprus' undercapitalized banks was to tax all deposits as a way of recouping some of the cost of a bailout. Putting aside the penalty inflicted on small savers, this proposal, floated over a weekend by other European Union members, stimulated both a potential run on Cypriot banks, but also a run on banks in other, larger and more crucial banking systems.

As we remember from "It's a Wonderful Life," runs on the bank start when depositors lose faith: "You're thinking of this place all wrong. As if I had the money back in a safe. The money's not here. Your money's in Joe's house...right next to yours. And in the Kennedy house, and Mrs. Macklin's house, and a hundred others. Why, you're lending them the money to build, and then, they're going to pay it back to you as best they can. Now what are you going to do? Foreclose on them?" Banks are entirely dependent on confidence. If the EU could confiscate savers' money in Cyprus, then why not in Spain? As we write this, it appears that a new plan, which is less confiscatory, will save the banks. Perhaps Cyprus will avoid being a butterfly for the moment.

The irony of this concern over the bailout tax is that it ignores the annual confiscation from savers that has been happening for decades – inflation. As our dollars, Euros, and Reales lose 2 or 3 or 5% of their purchasing power every year, we are in no different position than if the government taxed our savings at that same rate. Where does this inflationary "tax" go? To borrowers. Right now, the biggest net borrowers are governments like our own US Treasury. Inflation allows these governments effectively to shave a few percent a year off their debts. The proposed tax that caused rioting in Cyprus would have raised about $7.4 billion in *one-time* taxes; the "inflation tax" that devalues cash held in the US by about $160 billion *each year* stimulates little comment, or even raised voices.

We can't stand idly by and allow this phantom tax to sap away the value of your investments. With inflation currently running at about 2%, we see that as a critical hurdle for your investment returns. The first order of business is to grow your investments at a long-term rate that is greater than the inflation rate, while taking the least risk. As we look across the investment horizon, we see precious few “easy” ways of doing so. One that remains attractive, as we have so tirelessly repeated, are the stocks of higher quality companies. These remain relatively well valued, provide ample dividends and present a prospect for growth at a rate faster than inflation. Over time, the share price will follow the profitability upward. Other investors seem to be recognizing this: Low interest rates and a few encouraging economic data points seem to be driving more people to commit money to the stock market. While there remains a huge amount of cash on the sidelines, we have started to see inflows to stocks for the first time in a while. This may partially explain the strong performance of stocks, and your portfolio, in the first quarter of 2013.

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*The “Butterfly Effect” derives from a science fiction horror story where a traveler goes back in time, and by accidentally killing a butterfly, inadvertently, and disastrously, changes history.

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