Marble Harbor Investment Counsel, LLC
First Quarter, 2026 Letter

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

Sincerely,

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The Fall in Software Stocks: Weighing AI Uncertainty Against Opportunity

A friend who has a PhD in electrical engineering from MIT once told us how he learned to program in the 1960s. He worked on an IBM System/360 in the MIT Computer Lab, feeding instructions into the machine using punch cards. One mistake meant starting all over again, and progress came slowly. What he described was something common to many new technologies – a precise, unforgiving language accessible to only the cognoscenti (engineers). IBM reigned at the center of that world. The machines were scarce and expensive, the tools were controlled and obscure, access was limited to a chosen few.

By the time we taught ourselves rudimentary programming in the 70s and 80s, it felt more like learning a complex language such as German with its formal and highly structured syntax. BASIC, COBOL and Pascal required discipline and an understanding of how to express ideas within strict rules. Today, our kids learn Java and Python almost as a default. It's more akin to learning Spanish: intuitive and easier to become proficient. The process of designing software has become progressively simpler over time. However, recently we have had a sea change with AI. Using new LLM models such as Claude Code, programming shifts from writing code to giving instructions based on desired results. These tools allow you to tell the AI what you want, and it builds accordingly. It's less about learning a language and more like speaking in plain English to a team of "digital programmers," or unseen djinnis who weave magical sheaves of code.

AI programming assistants like Microsoft's Copilot, Anthropic's Claude Code and OpenAI's Codex increase productivity, but they also erode the exclusivity of the programmers' guild. The original monopoly on advanced programming, first held by electrical engineers, then by computer scientists, is being broken down again, this time not by regulators, but by the machines themselves.

For years, one of the defining advantages of many software companies was access to talent. The ability to attract and retain skilled engineers created a meaningful edge when building software required deep technical expertise. As the tools improve and the barriers fall, that edge becomes less absolute. Some types of software become easier to build, easier to replicate and harder to defend. What once looked like an insurmountable moat can, over time, prove simply to be a speed bump. This does not diminish the strength of platforms with scale, complexity, mission criticality, data intensity and distribution advantages, but it does change how other parts of the software ecosystem compete. Not all software companies are equally exposed to disruption. Systems of record, platforms that own critical data and software embedded in regulated or risk-averse industries operate under different constraints. When failure is costly, customers are reluctant to leave proven vendors, and those businesses tend to remain defensible. In other cases, where switching costs are lower and functionality can be replicated more easily, competitive pressure can emerge quickly. Imagine the difference between the software that runs a nuclear power plant versus the photo editing function on your phone.

The other side to this coin is that one of the largest expenses for most software companies is salaries for programmers. If programmers become more efficient, then software companies may be able to continue to grow revenue quickly while keeping headcount and expenses relatively flat, which may result in faster profit growth. In a conversation we had last month with a public company CFO, he noted that roughly half of their code is now generated by AI and that their programmers are producing materially more output than in prior years. Productivity is rising and becoming more broadly distributed. That is constructive for the economy, but it also changes how value is created and sustained within software and what skills are most valued.

Software stocks have recently had a rough run, with indices down roughly 30% from recent highs. The repricing reflects not a deterioration in current operating performance, but a shift in what the market assumes those businesses may be worth in the future. There is little evidence of erosion in current fundamentals. Revenues remain durable and customer relationships intact. What has changed is the market's willingness to value those cash flows beyond the near term. In many cases, the market is effectively assuming limited or no value beyond five or ten years.

The debate around the future of software has created opportunity. In periods like this, the market tends to treat all companies the same, even when their businesses are different. That can leave strong businesses trading at prices that don't reflect their durability and offer attractive potential returns.

In 1980 IBM licensed an operating system called MS-DOS from two college dropouts named Paul Allen and Bill Gates, thus inadvertently surrendering dominance of the next wave in the computing industry. However, to this day, IBM still dominates the market for mainframe computers. Many banks, insurance companies and air traffic control systems continue to run on IBM mainframes. Technology can bring great change, but deeply embedded business moats in regulated, mission critical industries can endure for a generation.

This quarter, the software industry was not the only place in the stock market where previous champions faltered. The broad index declined approximately 4%, but the prior front runners, particularly the largest technology companies, fell more meaningfully. The Magnificent Seven declined roughly 14%, with each constituent finishing the period lower. Sector returns told the same story: Information Technology and Communication Services were down double digits, while much of the rest of the market was modestly positive, with Energy a notable positive outlier. As we've discussed at length in previous letters, the inverted pyramid of the market was precariously balanced, and at least for now leadership has shifted away from technology and toward a broader group of businesses.

Sincerely,

Paul, Eric, LJ, Dan and Joe

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