Marble Harbor Investment Counsel, LLC
First Quarter, 2024 Letter

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

Sincerely,

Paul Davis, L.J. Harrington, Eric Robb, Daniel Rosenblatt and Howie Cowan

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Why are large American companies trading at near record valuations compared to their counterparts in the the rest of the world, and even compared to their own history? We think that their business models are substantially better than both those of their forebearers and of their foreign competitors. This is "not your mother's or your father's stock market."

Much of the strength in the market in 2023 came from the larger tech companies – specifically the Magnificent Seven – and this resulted in a more concentrated market. In fact, this is the most concentrated it has been in recent memory. But looking further into history, from the 1920s through to the early 1960s, the market was considerably *more* concentrated. Companies like AT&T, General Motors and Exxon ruled the roost, and the top seven stocks made up about 30% of the market, versus 25% today for today's tech giants like Apple and Microsoft.

For decades, if you wanted to make a phone call in the U.S., it was going over AT&T copper, for which you paid them a substantial toll. The industrial revolution that started in the late 19th century required a physical buildout. The companies that built the infrastructure of this country had huge capital expenditure needs. For AT&T, it took decades and millions of miles of wire to enable an end-to-end telephone network in the United States. For U.S. Steel, it was a network of mills. For GM it was dozens of factories, and for IBM it was "big iron" computer hardware and software that could only be leased. These huge, protective moats lasted for a couple of generations. Some great things came out of these physical fortresses. For example, Bell Labs invented the transistor and the first practical photovoltaic cell, a precursor to the solar panel. Eventually the monopolies of these highly capital intensive companies were broken up either by the government or by the creative destruction of competition, which diminished their stranglehold on both the economy and the market.

From the 1960s forward, the government took antitrust action against IBM, deregulated the airlines and broke up AT&T. Dismantling these powerhouse franchises played a role in decreasing the stock market's concentration – it began falling in 1960, and by 2015, the top ten stocks only made up about 15% of the market.

Over the past two decades, power in much of business has shifted to the development of virtual franchises that exist in the ether, in the cloud. Traditional modes of competition and business-building have put incumbent competitors and regulators on their back foot. The result? A new generation of behemoths. Microsoft is the long dominant figure in operating and productivity software. Apple wrings out nearly all of the profit in the cell phone industry. Automatic Data Processing dominates payroll processing. That said, a few important factors separate these tech franchises from their 20th century forebears, namely capital intensity, market scope and resulting cash flow margins.

AT&T had to lay wire all across the country in order to have a network. Apple, on the other hand, designs iPhones in Cupertino, California and then outsources their assembly to Foxconn in China. Apple spends billions on research and very little on capital expenditures. When AT&T wanted to enter a new region, they needed to string new wire. All Apple needs to do is order more phones and watch the profits flow back to the mothership.

Where are these "motherships"? While most are domiciled in the United States, their monopolies are *global*. As they have developed, size has created huge barriers to entry. They generate free cash flow so enormous in scope that it can't all be spent on capital expenditures and must accrete to shareholders. Who are their international peers? There are shockingly few.

Seen through this lens, it's not so crazy that large U.S. companies are trading at higher valuations than their counterparts in other areas of the world. Looking back at the history of the early twentieth century, it's clear that monopolies can maintain their market dominance for sustained periods of time.

When we look at historical valuations, we are implicitly comparing today's tech giants to AT&T, GM and their kin. Looking back to 2000, the largest companies included Microsoft, General Electric, Cisco Systems and Exxon. Today's largest companies are, on average, simply much better businesses that use less capital and produce more profit (even Satya Nadella's Microsoft of today is a better business than Bill Gates' Microsoft of 2000). In 2000, the top large companies had a free cash flow margin of 11%, today's are almost double that at 21%! The hand-wringing over "crazy" valuations ignores the foundational fact that the composition of today's market is entirely different from that of the market of several decades ago.

That said, a couple of things could bring this party to an end. Companies are vulnerable to competition and creative destruction. A new disruptive technology could displace the old regime. Alternatively, governments could break up the monopolies through regulatory fiat.

Today, AI could be that disruptive technology, and the market's recent behavior seems to suggest that many businesses will be disrupted imminently. We have little doubt that AI will cause enormous changes througout the economy and in how humans interact. These changes will be both pervasive and profound. But, as Rudi Dornbusch famously said, "In economics, things take longer to happen than you think they will, and then they happen faster than you thought they could." AI, as with most transformative change, is likely to hew to this pattern.

Governments have been trying to dismantle big tech franchises for years, and their attempts have been ham handed. Witness the European GDPR regulations (Thanks for the "Click here if you accept cookies" button on every website) that entrench the incumbents, who have armies of lawyers to help them comply with regulations, while startups with vastly fewer resources find themselves at a deep disadvantage. The FTC has rung up a string of losses as they attempt to go well beyond the law to forward other agendas. That said, they will undoubtedly continue their efforts.

Today's strong franchises are better businesses than both their predescessors and their foreign counterparts. Thus, they will continue to play a large role in your portfolio. While we keep in mind their promise, we also take note of the cross currents of near-term opportunism, valuations, government regulation, potentially disruptive technologies and the constant churn of a dynamic economy.

Sincerely,

Paul, Eric, LJ, Dan and Howie

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