CARDEROCK
CAPITAL® MANAGEMENT, INC.

April 15, 2019

With a strong recovery in prices off December lows pushing the S&P500 index up 13.6% to define the first quarter of 2019, we were gratified to see our own holdings perform even better. But there's always a second act to consider. With valuations now perched high above a spreading landscape of unappealing alternatives, we find ourselves pondering whether our next step is déjà vu or a more appealing breakthrough to new highs.

For this measure, weak economic growth reports coming in for the first quarter look to be noise related to the ill-starred government shutdown, and subsequent readings should affirm a more positive underlying tone. Yet at some point, capacity limits, full employment constraints, and a breath of cyclical inflation lie ahead. If economist Steve Keen is right to suggest today's labor markets will signal wage pressures with a jolt rather than a gentle upward turn, then we could see the ride get a bit bumpy. This in turn could trigger a dose of dissatisfaction as investors long accustomed to smooth sailing find rising volatility and disappointment instead.

Yet in our corner of the market, as much as we like finding so many new investors (increased market support) in our stocks, it is frankly starting to seem a bit crowded. And the odd thing about this crowd isn't that they like high quality growth issues per se, as much as their ability to barbell these as an offset to their other, higher risk holdings. With reports that 80% of the money flowing into new and unprofitable public offerings in 2019 with expectations as "industry disruptors", there's a good probability the only disruption these companies will deliver could be their shareholders' pocketbooks. In turn, these same shareholders could end up covering their losses by selling their winners – our stocks, and thereby make their problems ours. The point is that pure speculations elsewhere can and do ultimately change the character and risks we face in our own sound investments.

Whether or not our long-term stock holdings have morphed into a new "Nifty Fifty" category like those of the early 1970's, we're wondering more broadly whether the markets have initiated an extended topping process akin to that of the same era as well. Three market tops in less than 18 months might not be a coincidence. Keeping in mind that like Dr. Seuss's *Yertle the Turtle*, the appearance that there's always room for one more in a stack holds only until someone else complains or stumbles, wants out and the whole comes tumbling down. And when there's no easy out, vigilance is a right first response.

For now, there's thankfully a difference between micro and macro effects, and a whole that is more than the sum of its parts. Experience counts for something, and if there's one humbling lesson, it's that no matter what happens over the short or longer terms, a generally upbeat economic demeanor feeds more positive outcomes than we're entitled to expect. Given the luxury of time, all our worries, unfavorable metrics, and even adverse valuations fade.

As imprecise as the business of investing may be, it remains generally rational. In our practice, following our disciplines, alternating between tight and loose tolerances, and making incremental changes in part or whole, allows us to follow market trends while maintaining risk exposures that produce consistent results. So for now, there's a measure of satisfaction in seeing a bespoke, active process delivering good results, a path for keeping surprises positive, and a prospect for rational future returns in a world increasingly less so.

With your reports this quarter-end, you'll find our latest filed copy with the Securities and Exchange Commission of our Form ADV for your review. As always, we invite your calls to inquire further regarding your portfolio or to discuss changes in objectives and circumstances and their impact.

Warmest Regards,

Skip | Dan

James W. Mersereau, CFA, CIC | Daniel A. Kane, CFA, CIC
President | Managing Director

In compliance with Rule 204-2(a) of the Investment Advisors Act of 1940, we hereby offer our current Form ADV Part II as filed with the Securities and Exchange Commission through notice of its public posting on our website (www.carderockcapital.com). The Securities Exchange Commission's Investment Adviser Public Disclosure database can be accessed at their website (www.adviserinfo.sec.gov/IAPD/Content/Search/iapd_Search.aspx). With reference to Rule 206(4)-2 Carderock urges you to compare the information on your statement with the statements received from your custodian. Please call if you have any questions.

Strategy:

With the stock and bond markets fully factoring in the positives of the broader landscape into current prices, there seems to be clearly a limit to the upside. And while we are expecting decisions by political leaders to postpone negative economic policies as we approach the election cycle, this reflects recognition that less change lies ahead in all cases than advertised. What this likely means is that the Federal Reserve will pause a bit more before ultimately raising rates and lowering its balance sheet holdings; China will continue to underwrite state-sponsored industries; the EU will continue to wield antitrust and other regulations to its advantage; and US leadership will generally "kick the can down the road". While there's a chance that the newsfeed could break positive on any or all of these, we believe the safe bet holds with the status quo. Therefore, our focus will continue on corporate earnings, loan growth and employment that may drive value forward over the coming months.

Stocks:

Notwithstanding these concerns, the year-end decline and the first quarter rebound gave us a green light to lower cash reserves, raise exposure and adjust equity positions. We participated by reducing our cash reserve targets from 22% at the market low in December towards a range from 12% to 15% presently. We also broadened portfolio diversification by trimming overheld issues by adding to others elsewhere. And while this process is never actually "complete" but always a work-in-process, we did accelerate to optimize the rebound during the quarter. Significant additions during the quarter included: Abbott Labs, American Tower, Amgen, Gartner, Intel, Microsoft, Nextera, Phillips 66, and Verizon among others.

Bonds:

For its part, Fixed Income had a healthy counter-trend rally as rates fell from nearly 3% back toward 2% over the past six months. As this dramatically curtailed the range of available yields, we reduced our purchases in the money market range (less than one year) with those in the six- to eight-year range. We felt no rush under these conditions and were content to let a portion of maturities wait for the next rise. As to new purchases in Taxable Bonds, we shifted towards higher quality government paper and less in corporate issues. With Tax-Exempt Municipal Bonds, the tax shield meant that the negatives of the rate environment were largely dampened and purchases less restrained. And though there is buzz about renewed strength to curtail and/or remove certain state and local tax exemptions from federal taxes that would adversely affect the municipal market, odds of any changes remain remote.

Investment Plan Expectations:

As you have seen in our Investment Plans, we have kept return expectations remarkably consistent in recent years. The utility in this facilitated making the case for exposures more heavily slanted toward Stocks as a valid response to record low interest rates. In good measure, this condition still holds.

With equity exposure now ranging between 50% to nearly 70% of household liquid assets depending on the stage of the market cycle, it is always worth revisiting our allocations during peak exposures. At this point, Carderock clients in aggregate target fully invested holdings of Stocks of 65% and Fixed Income at 35%. Yet when looked at from a risk-neutral exposure (using 15% Cash Reserves) the trick is less one of changing allocation targets and more of a matter of doing what we can to keep a lower level of Cash Reserves longer within our discipline.

Therefore, in using the actual returns (the most recent 5-year returns for Bonds and Stocks and the 1-year return for Cash Reserves) as representative of our neutral expectations, this would dictate a 7.4% rate of return projection for "Balanced" benchmark portfolios. But with returns year-to-date and over the last 12-months strongly out-performing this projection (9.5% and 10% respectively), standard mean reversion would have us shave our expectations at this time closer to a 5.8% annual return expectation.

Random Gleanings

"Investors are facing a real dilemma. On one hand, the potential for elevated stock market returns is high over the coming 12 months. On the other, poor valuations will only grow more onerous, and the Fed will ultimately have to tighten policy even more following the on-hold period. Moreover, Chinese policymakers are unlikely to ignore the pressing danger created by misallocating capital for an extended period of time. Consequently, the outlook for long-term returns is deteriorating." **The Bank Credit Analyst,** April, 2019

"Starting a trade war, at the same time growth is slowing for other reasons, is more than a little unwise. Agricultural tariffs have already ripped through U.S. farm country to devastating effects, leaving losses some farmers may never recover. The president's tariff threats had other impacts as well. Companies raced to import foreign-supplied components and inventory before the tariffs took effect. This jammed ports and highways last year, not with new demand but future demand shifted forward in time. At some point, all this has to stop. Carrying inventory is expensive and will eventually outweigh the benefit of avoiding tariffs. Then the boom will come to a screeching halt. Imports will fall as companies work down inventory. This combined with other cyclical factors and high debt loads everywhere, could easily add up to a recession. Exactly when is hard to say. Recessions usually get pronounced in hindsight, so there's some possibility we are in one right now. But I still think we'll avoid it this year. Getting into this box took a long time and so will getting out of it." John Maudlin, *"Recession Signs Everywhere",* **Maudlin Economics**, March 30, 2019

"Recession risk is higher today than at any time in this recovery if for no other reason than the expansion will soon become the oldest in U.S. history. This calendar-old recovery currently embroiled in an economic slowdown is already raising recession anxieties and consensus fears seem likely to intensify further in the months ahead. Recession fears are enough to create volatility in the stock market, but the primary issue facing equity investors is whether an actual recession is imminent. Some signs are now pointing more prominently to a recession include a calendar-old recovery, a flattish yield curve, and a U.S. leading economic indicator which peaked last September. However, private-sector balance sheets, often at the epicenter of most recessions, remain remarkably healthy. Therefore, investors may do best by betting against calls for an imminent recession." Jim Paulsen, "*Balance Sheet Recession Risk*?", **LeutholdGroup,** February 28, 2019.

"Martin Wolfe, the Financial Times' economics writer, contended this past week that monetary policy has run its course having done all it can to fight secular stagnation, the state of persistent inadequate demand. Persistently low interest rates aren't artificially depressed by central banks but by the low level of real rates needed by the economy, Wolf continues. The total amount of negative-yielding bonds hit $10.2 trillion, JP Morgan reported this past week, the highest amount since December 2017. Many argue the expansion of debt encouraged by low interest rates now exerts a drag on the economy, as companies and households have to pay off those obligations rather than expand. General Electric, an extreme example, has had to prioritize shoring up its balance sheet over growth. Wolf contends because monetary policy has reached this apparent cul-de-sac, fiscal measures are needed to counter insufficient demand. Taken a step further, this argument extends to adopting Modern Monetary Theory, which essentially argues a nation that can borrow in its own currency is not limited by the size of the debt. Forty years ago this October, the Fed embarked on a major, single-minded policy assault on double-digit inflation, even at the cost of severe, back-to-back recessions. Now, it would appear the focus of debate under way is directed at maintaining the economic expansion that, despite being on the way to be the longest on record, has been more successful in boosting asset values than household income. "*The Federal Reserve Faces a Reckoning*" Barron's, March 18, 2019.

"Longview Economics has crunched the numbers and the average equity rally that retraces losses amounts to 67 percent. The Fibonacci 'golden ratio' is 61.8% retracement. But beyond technical, there are looming macro challenges that will test the stomach of investors. Clearly trade is a big deal and the outlook for the US economy another question." Mike Mackenzie, "*FT Market Forces: A Relief Rally Must Pass a Test"*, **Financial Times** January 18, 2019.

"The sell signals the market generated during the correction, the subsequent bottoming process and the initial stages of the rally taken together are a forecast for a bull market of at least moderate proportions and perhaps much more, and that we ought to participate in it to the limit of our comfort. Cash Reserves that were as high as 37.5% of US Equity and lowered to 25% last week should now be lowered to 12.5% going forward." John Bollinger, **Bollinger Bands Letter**, January 25, 2019.

"2019 may be a relatively flat year: The big question that needs to be asked is whether the current rebound is a bear market rally, or the start of another up leg that resumes the major bull market. It is quite possible that 2019 may be more of a sideways year with major stock indexes trading between their September 2018 highs and their post-Christmas lows. One factor in the market's favor is that stocks usually gain ground in the year after midterm elections. One factor working against the market is that it will hit its tenth anniversary next month, making it the first bull market in history to reach that advanced age. That might argue against another up leg, which could leave the market trending somewhere between these two bearish and bullish scenarios. Some longer ranges charts suggest this as part of a major topping process." John Murphy and Arthur Hill, **The Stockcharts.com Market Message**, February 5, 2019.

"Wall Street banks are offloading leveraged loans at discounted prices and demanding that borrowers accept less advantageous terms, as they move to protect themselves from rapidly weakening demand in a previously hot corner of the credit market. The development reflects mounting concern from investors about the quality of loans used to finance private equity buyouts follow
ing a series of warnings from central bankers this year as the leveraged loan market ballooned over the past two years and risk-management practices weakened. Notably, leveraged buyout activity in the US has surged to its highest level since the financial crisis with more in the works." Jon Rennison and Colby Smith, *Debt Machine: Are the Risks Piling Up in Leveraged Loans?*" **Financial Times**, January 21, 2019.

"James Carville's endlessly repeated witticism about wanting to come back to earth as the bond market because the bond market bosses everybody around is a sdated today as the Clinton presidency. It's the stock market that a politically ambitious person would choose to become in a second life." James Grant, **Grant's Interest Rate Observer**, January 11, 2019.

"The Wall Street Journal reported that $11 trillion worth of bonds worldwide are priced to yield less than zero. As a share of global debt outstanding, the negative yield cohort represents 22.6%. The trouble with investing in the 21st century is that you become blasé' about the quirks of the age. Before you know it you start to think, well, negative yielding debt isn't so bad. Someone's buying it. What's crazy? Bond-market-destroying negative interest rates enforced by central banks would be one candidate; asset-price levitating and society polarizing QE another." James Grant, **Grant's Interest Rate Observer**, February 22, 2019.

CARDEROCK CAPITAL MANAGEMENT, INC.

SHORT TAKES
March 31, 2019

RESULTS

The **S&P 500 index** rose **13.6%** for the 1st Quarter and **9.5%** for the last 12 Months.

Stocks:

Size: – Mid-Cap Stocks outperformed both Large and Small Stock Indices during the 1st Quarter.
S&P 400 Mid-Cap 14.5%, S&P 500 Large-Cap 13.6%, S&P 600 Small-Cap 11.6%

U.S. Economic Sectors: – 1st Qtr. S&P 500 Index Sectors with Ranges from: –
S&P **Technology** rising **19.9%** to S&P **Basic Materials** stocks gaining **10.3%**

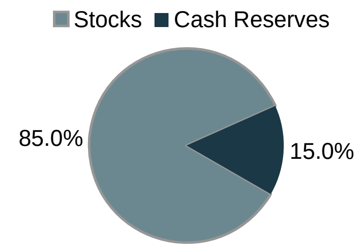
Bonds – Fixed Income returns were strong on the upside; Longer-term Tax-Exempt Bonds outpaced shorter, higher Quality issues as the Interest Rate Yield curve flattened during the period.

1st Qtr. 2019 Returns:

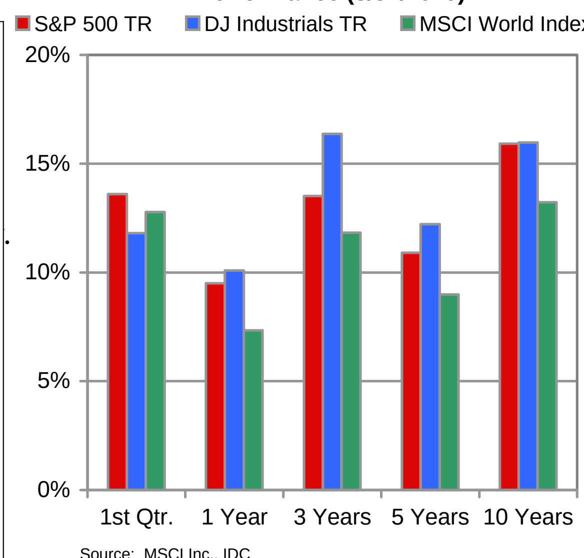
- Lipper Short-Int. U.S. Govt. Index: **1.2%**
- Lipper Short-Int. Municipals Index: **1.7%**
- iShares iBoxx **(LQD)** Inv. Grade Corp. Bond Index: **6.8%**
- iShares iBoxx **(HYG)** High Yield Corp. Index: **7.6%**

Source: Lipper, FactSet and Blackrock

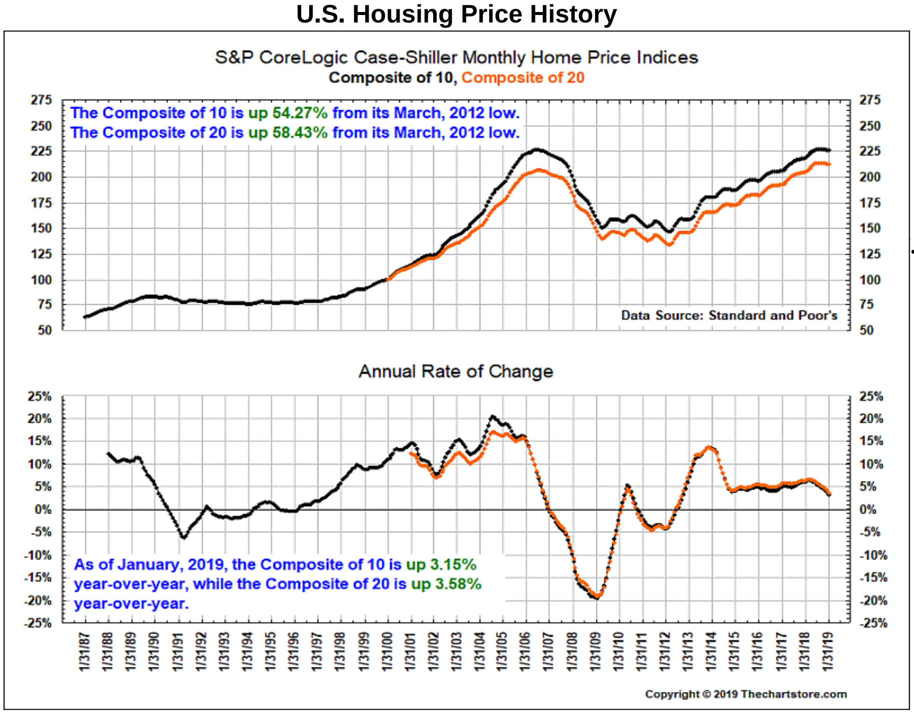
Carderock Equity Target Allocation



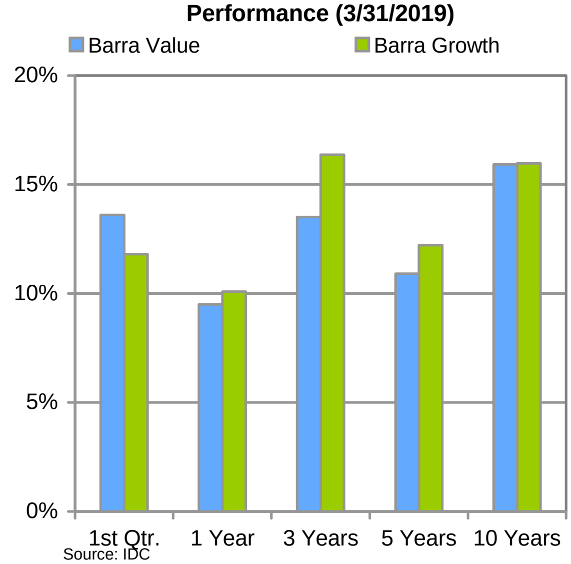
Global Stock Market Annualized Performance (3/31/2019)



U.S. Housing Price History



Growth vs. Value Style Annualized Performance (3/31/2019)



Seasonal Pattern S&P 500 Composite Index