October 13, 2022

As we enter the historically volatile Fall period, it is hard to describe markets as anything but broken. With financial assets squarely in the crosshairs of policymakers looking to revert to 2% inflation, the S&P 500 Index has scored its worst year-to-date performance in twenty years **(-23.9%)**. Carderock Capital's stock portfolios are down on average **(-29%)**, with balanced portfolios weighted 55%-35%-10% (Stocks-Bonds-Cash) on average falling roughly **(-18%)**.

When the dust settles, we will have an abundance of opportunities to buy great growing and profitable companies at much lower prices. As long-term Quality Growth investors, we believe that the fundamentals of our core holdings are still particularly strong, and markets this year have extrapolated a worst-case scenario from the Federal Reserve's interest rate hikes.

How We Have Responded

Activity – On balance, we continued during the 3rd Quarter to be net sellers of stocks to defend portfolio values, rebalance overweight issues and cut positions with unattractive growth prospects.

Capital Gains – We have taken substantial profits in many of your stock holdings that gained nicely since the Great Recession in 2008/2009. Please review your attached statement with your tax advisor to avoid any surprises.

Equity Cash Reserves – We are at 40% as we patiently await more substantial evidence that rallies can be sustained, and the current cycle has bottomed.

Treasury Bill Purchases – We have been active buyers to augment yields on money market cash holdings.

What We Are Watching

Earnings Growth - Carderock holdings show higher earnings growth and returns on invested capital than the typical stock in the S&P 500 Index. And while earnings have been far more resilient for Quality Growth stocks this year, we believe markets have overreacted with prices falling more sharply on a relative basis which portends a catch-up period at some point in the near future.

Inflation - High frequency indicators show inflation is slowing down in major categories (housing, logistics, healthcare) that have yet to show up in headline news. This trend needs to continue for current Fed Policy to change and markets to stabilize.
Federal Reserve Policy – Signs of policy shifting from restrictive to neutral will occur when policymakers believe that the job of fighting inflation is complete. We see no signs of this now going into the New Year.

Our Expectations Going Forward

Supply Chain - Complications should continue to abate, offering stability to prices and compelling buying opportunities in our Quality Growth stock list.

Employment – Workers are still scarce while employment opportunities continue to grow. Companies with balance sheet flexibility will make the necessary capital investments to boost productivity and their prospects during the next recovery cycle.

Capital – With debt issuance, IPOs and Private Equity deals declining precipitously in 2022, we expect capital will be more productive and shift towards proven business models with sustainable profitability.

Fixed Income - We are still focused on the short end of the yield curve in both taxable and tax-exempt bonds, with the average current maturity of our bond portfolio coming in at slightly over 2 years. Short maturing bonds will continue to be favored by the market until inflation subsides and interest rates peak.

While extraordinary events in the form of war and monetary authorities have undoubtedly constrained markets this year, we see few signs that the competitive advantages of our core group of Quality Growth stocks have been upended. Now more than ever is the time to focus on remaining invested to ensure that your patience as a long-term investor is rewarded.

As always, feel free to give us a call to discuss any changes in your goals, circumstances or with any questions you may have.

Warmest Regards,

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President

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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.

Random Gleanings

"Inflation victimizes most businesses, especially the fully staffed and capital-intensive ones. Better, then, to invest in the lightly staffed, asset-lite inflation beneficiaries. 'It's still a thesis', Stahl concedes. 'It must be proven that the companies with the lower labor-cost components can be [inflation] beneficiaries. I don't think the world, in general, is looking at stocks through that lens…So I have this mental construct of the world, and like many times in my life, I think I'm in the minority.'" Evan Lorenz, *"Inflation's Got Legs,"* **Grant's Interest Rate Observer,** August 5th.

"Tech stocks are seen as especially susceptible to rises in interest rates that diminish potential future returns. But rather than trying to second-guess where interest rates might go, they say they are doubling down on trying to understand whether the competitive landscape of their portfolio companies has altered. And they largely reckon the change in the macro landscape has not damaged the long-term potential of many of them." Harriet Agnew, *"After the Tech Sell-Off: Will Growth Investors Keep the Faith?,"* **Financial Times**, September 14th.

"The infamous 'Powell Pivot' of late 2018…fostered the impression that this Fed would turn on a dime. That earlier pivot has made it harder for the Fed to convince markets of its intentions and may well mean that it must hike more than it wishes just to prove itself. There is a final problem with betting on a pivot- higher equity valuations contribute to an easing in financial conditions. The Fed is hoping that it can rein in inflation via the means of tighter financial conditions. So, each little burst of optimism makes it harder for the central bank to move. Bloomberg's own measure shows that US financial conditions are now more than one standard deviation tighter than the mean for the last decade." John Authers, "*The Pivot Mirage Keeps Running Into Macro Reality*", **Bloomberg**, October 10th.

"There has been, in many OECD nations, a decoupling of productivity and wages over the past 40 years, during which time the corporate sector took a larger share of national income gains. But while 55 percent of productivity gains in western Europe still go to labor, American workers must duke it out for a mere 14 percent – and most of that goes to the top third of workers. Deglobalization, which will favor local labor markets in some industries, is starting to shift that dynamic. Aging demographics, which will create a structurally tighter labor market, as well as millions of new onshore jobs in the caring professions, is too." Rana Foroohar, *"Who Will Pay for the Shift from Efficiency to Resiliency,"* **Financial Times**, September 12th.

"And while there remains a lot of uncertainty about the supply chain situation, most companies are now saying that conditions have improved at least modestly. Freight costs, whether by ocean or by truck, continue to fall. Commodity prices have fallen as well, the area where the Federal Reserve's aggressive interest rate increases have had the greatest impact. If freight and commodity costs surge in the months ahead…then all bets are off. Otherwise, these signs that profit margins are returning to normalized levels means we're finally at a place where inflation should start to slow." Conor Sen, *"We Should All Cheer the Return of Company Profits,"* **Bloomberg,** October 4th.