October 15, 2018

As we look at the major economic events of the past year – from deregulation to deficits, from tax cuts to tariffs, and even allow for a modicum of Federal Reserve QT (Quantitative Tightening) and ratcheting up interest rates, there's no doubt the seas have changed dramatically. Noticeably, complaints have shifted from getting hurt to getting left behind – a worry consistent with a sharp upturn in the economy. Thus, whether you look at these as nominal or real, short-term aberrations or long-term shifts, the positives have so far dramatically outpaced the abundant but formless negatives and surrounding chaos – by which we refer less to the White House and more to the desultory state of competing foreign markets in general.

The fact is, we can but marvel at how U.S. stocks have comparatively and consistently showered their owners with an abundance of strong returns. The relentless pressure this outperformance exerts on investment managers to participate and buy into an already expensive market increasingly represents a danger of its own. Indeed, the indefatigable advance of share prices over the last quarter – no matter the news – calls to mind Sonny and Cher's "nothing song" that turned into a hit ("The Beat Goes On") back in 1967. For it's in much the same way that this "nothing rally" became a raging Bull. While the song's refrain fits on many levels, more remarkable is its original timing in the midst of the extended top that defined a similar "Buy and Hold Forever" market. Accordingly, the Fed's persistence in raising rates makes some sense if it can cool the potential for an overheated market to flood an economic engine already running on high octane without causing the whole to seize up.

In the meantime, we're reminded that Bull Markets get their name from their propensity to gore their naysayers and detractors – even those like us who are tasked both with managing the current run while seeking to prepare for the next. The effort to manage sustained growth is less one of riding a horse until it falls over, and more one of endeavoring to ride like the Pony Express and leap the gap in switching horses. The gap remains, and the truth is that the leap is more of a surefooted step-down-and-up that manages a switch that keeps the ride. Managing portfolios and switching issues is scarcely different and equally necessary if we're to keep things moving ahead.

At this time, we'd ask you to take a look at your capital gains for the year. Not just the realized gains, but the imbedded, unrealized gains and consider how far we've come off the lows of early 2009, the tests of 2011 and all those in between. As we've seen few dips of more than 5% or 10% in much of this interim, we have no doubt a larger one lies in wait. If you think through our stated goal of 10% to 20% turnover per year and apportion your unrealized, embedded gains on this basis, most of us would see larger gains than we've actually taken in some time. If part of the plan is to also run cyclically with more gains at the beginning and end of long runs, then a time of higher realization is coming, too.

Let us know whether you can do more. And if you want help with the process, feel free to call and discuss your portfolio, your progress and the right level of activity in capital gains for your circumstances. There's a level that's too much, and a level that's too little, and investment consequences for both. Which is right for you may depend on your other resources.

Warmest Regards,

James W. Mersereau, CFA, CIC
President

Daniel A. Kane, CFA, CIC
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.

Market Conditions, Strategy and Activity

Stocks:

As we write, the S&P500 has exhibited both an astounding immunity to headline risks as well as a propensity for long life that would impress any centenarian. No doubt it will sound odd to suggest that while we remain committed to our current exposures, we nevertheless have focused a high degree of attention on preparing for a stock market correction. Yes, we're thrilled with the string of "victories" in winning double-digit returns in a single digit environment. But there's an edge in this that slips easily into disappointment, constraining our better options when the signs are ignored.

This puts us at a hard place with a surging market, a booming economy, and significant emerging risks. Investors are thus highly cognizant of their timing within both market and business cycles and focused not just on the brass ring, but the exits as well. From here, confidence in continued margin and/or price-earnings multiple expansion appears likely to ebb. But the world is full of surprises, and we'll likely see more of the same and instead find that the longer deferred, the greater and more fearsome the ultimate moment when the data turns negative and traders reverse course.

Accordingly, our intention is to remain as fully invested as we can stomach, rebalancing positions within the portfolio without ceding to a more defensive shift in exposure. Though pressing closer toward our 85% invested target will mildly shave allocation, in many cases the effort has up until now focused mainly on issues that have run long and hard to the point where momentum and value have flagged as investors shifted attention elsewhere. With the benefit of good fortune in timing, we might even manage to surrender less than we gain in forward prospects as we simultaneously seek to plant a few small, more temporally attractive new positions.

Evolving exposure in this way serves to play both offense and defense by strengthening the breadth of the portfolio and adapting to the shifts in "favorites". In a sense this represents a stealth rebalancing accomplished while endeavoring to hold over-all exposure constant while emphasizing internal controls. If we're successful and the market holds, we should extend relative out-performance. If the market breaks, we'll have harvested gains near a top and better prepped our defenses.

Bonds:

Fixed income is a simpler but darker story. With the spring back toward more normal interest rates, many investments that made sense only in a zero-rate environment will slide in value, causing real pain. While we count ourselves fortunate for sidestepping that problem, the aftermath weighs on all, and avoiding getting caught in a deeper bear trend for bonds becomes harder the longer rates continue to rise. Some already suggest we have in fact entered a 30-year secular bear market for bonds, but most think this is premature. But the fact that rates are simply rising as they return to normal levels – encouraging as that is doesn't change the negative math; nor does it improve the record of Federal Reserve for killing recoveries and expansions by hyperactively raising rates.

For our part, we hold that secular changes are clear only in hindsight, requiring a series of cyclical rate rises – with each peak higher than the last. Accordingly, our more reserved estimation allows an effort to put a toe in the eight to ten-year range that we eschewed over the last decade as an anchor for building a more normal, broader maturity ladder. As it stands, we're mostly pleased with the prospect of higher yields and greater income, and in many respects consider that the Federal Reserve's mis-estimation of the inflection point will afford future opportunities as well. The good news is that bonds should return to a normal part of most portfolios in their function. And providing that the Federal Reserve does not lose control, many who avoided bonds and sought substitutes in recent years may return as buyers. This would be an overall positive.

Random Gleanings

"The latest relief rally reflects mounting confidence that Trump's trade war won't escalate into one that depresses the economy and corporate earnings, which continue to soar. In addition, there is less fear lately that the Fed's policy normalization will trip up the bull market. So what will it take to snare the bull in the bear traps? It will take a recession. That's all there is to it. I have argued that there was a growth recession during 2015 caused by the collapse in Commodity prices. Credit quality yield spreads widened dramatically, especially in the junk bond market. Yet here we are at a record high in the S&P 500. Arguably, there has been an emerging markets crisis this year, yet here we are at a record high in the S&P 500." Ed Yardeni, **Ed Yardeni Research,** October 1,2018.

"On a trailing earnings basis, the S&P 500 has been highly-priced above a 20x PE multiple (or below a 5% earnings yield) for most of the last two years. What does this suggest about future return potential, and perhaps more importantly, about the potential for negative returns? Although the absolute valuation of the stock market does impact future return potential, it has not been particularly useful in assessing the chance of losing money in the stock market. However, valuation metrics are not typically good timing tools. "Valuation" can ground one's impressions formed by a multitude of short-term indicators, but the essential risk faced by investors today is not excessive overvaluation. Rather, the primary risk is recession. Nearly 85% of the bull markets since 1945 ended (associated mostly with recessions) when the real EY was in the 1st or 2nd quartile. And currently, the real EY sits directly in the middle of this range!" Jim Paulsen, "*Let's Get Real*", **The Leuthold Group**, July 23, 2018.

"The fallacy of today's tariff war with China is that it is meant to save jobs. But it ends up destroying better ones. By now, it feels like every Chinese import save iPhones are subject to tariffs under Section 301. As President Trump said in February, "I want to bring the steel industry back into our country. If that takes tariffs, let it take tariffs, OK? Maybe it will cost a little bit more, but we'll have jobs." But not all jobs are equally desirable. It's profits, not sales, that create wealth. Jobs for jobs' sake destroys wealth. Many of the products subject to the tariffs shouldn't be made in the U.S. anyway. Mercantilism has failed again and again, from British Corn Laws to Japanese chips. Show me the margin. That's where jobs will be created." Andy Kessler, "*Lessons from an 80's Trade War*", **The Wall Street Journal,** October 8, 2018.

"There's an old proverb that says 'If you want to go fast, go alone. If you want to far, go together.' That is the principle the United States has followed for decades and why the world is as peaceful and prosperous as it is." James D. Melville, Jr. "*Why I Stepped Down as an Ambassador*", **The Washington Post**, October 4, 2018.

"Defaults have occurred with and without a gold standard, with and without 'too-big-to-fail' banks, with and without such modern innovations as credit default swaps, securitized debt, waterfall debt tranches, the Bloomberg terminal, CNBC and floating-rate securities. Democracies, autocracies, juntas and empires have cheated their creditors. Low interest rates, by fostering a demand for high-yield investments are the time-tested source of trouble. Low British gilt yields drove income-seeking capital into dubious overseas investment in the 1820s and 1870s. Walter Bagehot, editor of the Economist in the mid-1800's famously warned against the mischief that a 2% bank rate stirs up. 'People won't take 2 percent. They won't bear a loss of income. Instead of that dreadful event, they invest their careful savings in something impossible…Still less do they settle for zero percent, or minus 1%." James Grant, **Grant's Interest Rate Observer**, September 7, 2018.

"'Post-truth' is a malediction coined for politics, but Wall Street had the idea before lexicographers sanctioned the word. With the coming of artificially low interest rates, dubious cash-flow metrics and conceptual marks of business value, objective investment truth has gone out the window. Into the resulting vacuum has flown private equity. Now in progress is a critical survey of the $3 trillion industry that will supposedly save the bacon of the country's underfunded pension plans and income-starved endowments. In preview, we judge that it won't. Paying high valuations and employing heavy leverage, it couldn't. The disappointment will ripple far and wide." James Grant, **Grant's Interest Rate Observer**, August 10, 2018.

"Unless you have been living in a cave for the past week, you are probably aware that it is now a decade since Lehman Brothers declared bankruptcy, ushering in a banking panic and the scariest phase of the credit crisis that had started in 2007. If there is one presiding emotion from all the retrospective, it is a pervasive belief that the post-crisis period could and should have been better handled. Ten years ago many of us, thought a rerun of the Great Depression was very likely, and some of the actions taken in desperation during the crisis hold up slightly better than might have been expected. But long waves of monetary ease, fiscal austerity and legal leniency for the guilty did not need to follow from this, and have left the bulk of the populace angry and embittered. I do not know what people hoped for 10 years ago, but the world is an angrier and less trustful place now – and that makes life worse for all of us." John Authers, *Authers' Note: Too Big to Fail: Too Much to Read"*, **Financial Times**, September 17, 2018.

"Tobacco, asbestos, DDT and other human harmful products ultimately were held to account through legal liability. Today's software not only lacks any warranty, it even clearly states 'use at your own risk'. We have yet to legally hold any software producer accountable for negligence in software development except for a few isolated cases where there have been penalties for failure to protect personal information at the management level." Michael Ayres, "*The Web Was Not Built as a Transactional Platform*", **Financial Times**, September 12, 2018.

Cyberattacks are a systemic threat. Almost all software is insecure because it is not seen as an engineering product that needs scientific foundations. Most vulnerabilities that cyberattacks exploit can be traced to errors in software design and programming. Such errors are pandemic because programming has evolved not as an engineering profession but as a branch of creative writing – even worse, one where plagiarism is strongly encouraged." Martyn Thomas, "*Thinking Like an Engineer Will Make Software Safer*", **Financial Times**, September 10, 2018.

"Airbus thought it was about to make aviation history when the company's battery-powered E-Fan aircraft lifted into the air with barely a sound on a summer day in 2015, and a cheer went up from those on the ground in southern England. Except, it was outsmarted. After hearing of the Airbus plan, a French stunt pilot had taken off in his own small aerobatic e-plane a few hours earlier and crossed the channel from the other direction. Aviation is on the brink of the biggest revolution since Frank Whittle invented the jet engine in 1937 with electrically-powered aircraft." Peggy Holinger, "*How the Promise of Electric Power Could Transform Aviation*", **Financial Times**, September 18,2018.

CARDEROCK
CAPITAL® MANAGEMENT, INC.

SHORT TAKES
September 30, 2018

RESULTS

The **S&P 500 index** rose **7.71%** for the 3rd Quarter and **17.91%** for the last 12 Months.

Stocks:

Size: – Large Cap outperformed both Mid and Small Stock Indices during the 3rd Quarter.
S&P 500 Large Cap 7.7%, S&P 600 Small Cap 4.7%, S&P 400 Mid-Cap 3.9%

U.S. Economic Sectors: – 3rd Qtr. S&P 500 Index Sectors Winners and Losers –
S&P **Healthcare** – **14.0%**; S&P **Materials** stocks fell **(-0.14%)**

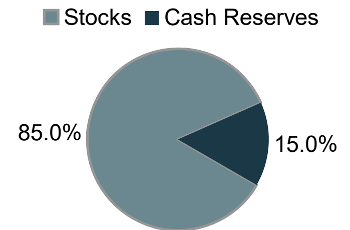
Bonds – Fixed Income returns were mixed; Longer term Taxable Bonds outpaced shorter, higher Quality issues during the period.

3rd Qtr. 2018 Returns:

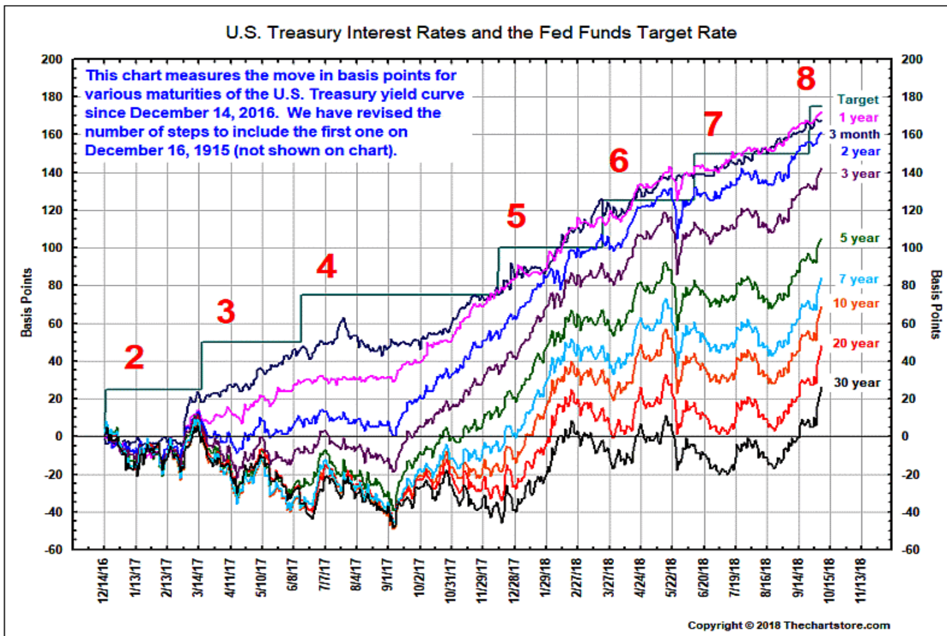
- Lipper Short-Int. U.S. Govt. Index: **(-0.02%)**
- Lipper Short-Int. Municipals Index: **(-0.02%)**
- iShares iBoxx **(LQD)** Inv. Grade Corp. Bond Index: **1.22%**
- iShares iBoxx **(HYG)** High Yield Corp. Index: **2.93%**

Source: Lipper, FactSet and Blackrock

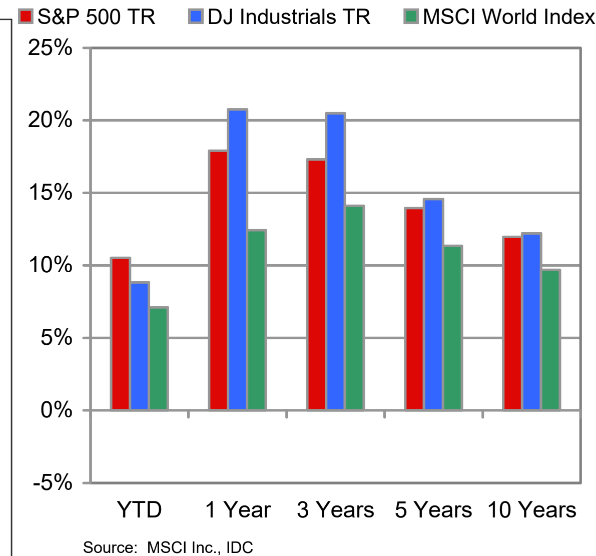
Carderock Equity Target Allocation



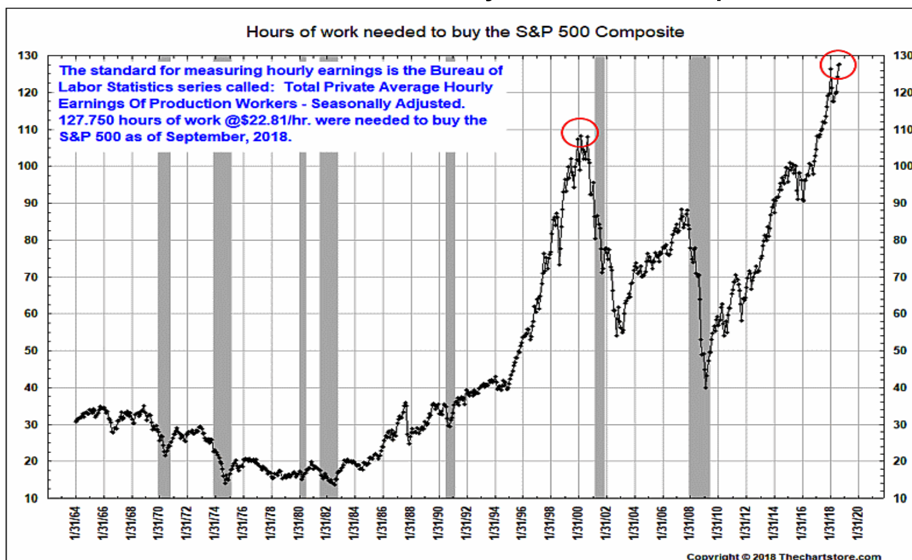
U.S. Treasury Interest Rate Change vs. Fed Funds Target Rate



Global Stock Market Annualized Performance (9/30/2018)



Hours of Work Needed to Buy the S&P 500 Composite



Growth vs. Value Style Annualized Performance (9/30/2018)