CARDEROCK
CAPITAL® MANAGEMENT, INC.

October 8, 2024

During the 3rd Quarter, the stock market shifted drastically away from Technology companies towards "Everything Else". This welcome change was overdue and expected and as it became evident over the past couple of months that growth was slowing due to historically tight interest rate policy, investors gravitated toward higher Quality issues that can withstand a more stringent economic environment. As a result, Carderock stocks gained 8.1% on average for the quarter, with the S&P 500 market-cap weighted Index up 5.9%.

Up to this point, future growth expectations have been narrowly focused on a few large companies' investments in Artificial Intelligence (AI) hardware, and the implied subsequent productivity gains and transformative effect it will have on the economy. Many parts of the industrial economy that play a role in developing AI have benefited as well, particularly those involved in the maintenance of power distribution networks, datacenters and utility infrastructure that have received tax credits due to recent legislation. In moving forward, we expect the rotation towards Quality companies to continue the 3rd Quarter results into the New Year as the market broadens its view and recognizes these relative opportunities.

Other parts of the economy that have suffered from high interest rates such as Housing and Construction will receive much needed relief from lower rates. The Millennial Generation – the cohort that was born between 1981 and 1996 – is now the largest demographic in the US (72 million), and their housing needs will drive a new cycle that boosts the economy and related Quality Growth issues than what we have seen with higher interest rates over the past 18 months. Growth prospects for companies that service this demographic have only started contributing to a broader-based participation in stocks.

As such, our current and expected activity can be summarized as follows:

- Cash reserve targets currently stand at a multi-year low of 10%, while the strong Stock market has pushed actual cash reserves closer to 5%.
- We will continue to utilize treasury bills to supplement cash reserves in the Stock portfolio, as a substitute for the Money Funds your Custodian uses.
- Our buying has outpaced selling by a ratio of 1.25 to 1 over the past year. We continue to make marginal additions and subtractions to the portfolio when opportunities exist.
- Portfolio turnover (buying and selling) has declined compared to the past two years, as we aim to minimize taxes as the markets have continued to making forward progress.
- With interest rates coming down and the slope of the yield curve normalizing, we will shift toward owning bonds equally across different maturities versus sticking to our recent strategy of only buying shorter maturities (less than 3 years).

For the remainder of the year, we expect the following to drive our investment decision process:

- Inflation continues to decelerate through the end of the year, putting the Fed on a glide path to lower rates.
- Interest-rate sensitive sectors (Housing, Industrials, Construction) will continue to price in a rebound over the next year.
- Valuations are above historical ranges for Quality Growth companies, increasing the likelihood of a "pause" in Stock market gains heading into 2025.
- On average, corporate balance sheets remain strong, making a debt-fueled recession look increasingly unlikely.
- A declining Chinese economy and continued malinvestments in battery technology and renewables will continue to affirm our decision to steer clear of this profitless Energy space.
- Labor markets are "soft" but not showing a total collapse in the making. Overall demand looks to be sufficient to prevent mass layoffs.
- Heightened war in Ukraine and the Middle East and an upcoming political election will drive both volatility in stocks and continued government investment in Defense.

With stocks near all-time highs, it is natural to expect stocks to pull back from its strong year to date performance, particularly with a typically volatile Autumn ahead. But we do believe the underlying trend shown in the 3rd Quarter for Quality Growth issues taking a shine over the rest of the market is still in its early stages. As such, we are optimistic as we head towards the end of the year.

Finally, we are excited to share that we have welcomed a new member to our firm, Jeanne C. Goedecke, who joined us in September in the role of Portfolio Manager. Her experience in Corporate Banking on the capital markets desk and her Relationship Management responsibilities over the past 13 years will bring further depth and knowledge to our firm. She is a graduate of Tulane University's A.B. Freedman School of Business with a bachelor's degree in finance. In addition, she has achieved the coveted CFA designation. We hope you will have a chance to meet her in person over the coming months.

As always, feel free to call us with any questions, concerns or updates you may have regarding your portfolio.

Warmest Regards,

Daniel A. Kane, CFA
President

Stephen F. Knapp, CFA
Director of Research

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

"The speech by Jay Powell at the Jackson Hole Economic Symposium last month was as close to a paean of victory as a sober central banker could utter. Indeed, the success in lowering inflation with only a modest weakening of the real economy is a welcome surprise. However, it is highly likely big supply shocks will happen again. The fact that the big step up in price levels was due to the interaction between post-Covid and Ukraine war-induced bottlenecks in supply and strong demand does not mean that the latter was a huge mistake. Weaker demand would have imposed large economic and social costs, too. The inflation-targeting regime has now survived both Covid and the financial crisis. But more big shocks might come, some of them even quite soon." Martin Wolf, "*Lessons From the Great Inflation*", **Financial Times**, September 3rd, 2024.

"At his presser on Wednesday, Powell delivered the stock market to the Promised Land, where 'strength in the labor market can be maintained in a context of moderate growth and inflation moving sustainably down to 2%'. Investors exuberantly shouted 'Halleluiah!'. The question is whether exuberance is quickly turning from the rational variety to the 1990s irrational version. S&P 500 earnings per share should continue to rise to new record highs, especially if the Fed's aggressive easing heats up the economy. In a meltup scenario, the S&P 500 could soar to above 6000 by the end of this year. While that would be bullish in the near term, it would increase the likelihood of a correction early next year." Ed Yardeni, *"Raising Odds of a Meltup"*, **Yardeni Research**, September 19th, 2024.

"It's a curious feature of this fast and furious tightening cycle that the National Financial Conditions Index of The Federal Reserve Bank of Chicago has never registered a reading of stringency. Sam Wood of Accumulus Capital Management chronicles examples of 'irrational exuberance' in the currently loose environment: hedge funds' 99th percentile exposure to the 'Magnificent Seven'; the cap-weighted S&P 500 outperforming the equal-weighted S&P 500 by the largest amount since the dot-com bubble; the tech sector price-to-sales ratio hitting the highest levels ever at nearly 10x; and the S&P 500 going 356 trading sessions without a 2% decline. A fine time then to be alive and practicing the essential, allied arts of security analysis and risk control." Jim Grant, *"The New Money Needed Something to Buy"*, **Grant's Interest Rate Observer**, August 2nd, 2024.

"Chair Jerome Powell cemented a shift in focus from inflation to employment last week when he said that the Federal Reserve does not seek a further cooling in the labor market. It was a welcome message for those concerned about an economic slowdown. We are currently in a 'low hiring, low firing' labor market regime. Many employers have avoided layoffs by managing costs via attrition and headcount freezes, anticipating a turnaround once the Fed starts cutting interest rates. The tension in the labor market right now is that overall momentum is negative, even though some measures such as jobless claims and layoffs continue to be low and stable. The Fed has enough room to cut interest rates and should be able to reverse that momentum eventually, but the prospects for a pickup in hiring over the next couple of quarters appear dim." Conor Sen, "*Fed Rate Cuts Are No Magic Fix for Anemic Hiring*", **Bloomberg**, August 29th, 2024.

"It is as if America has become one giant emerging market – full of peril and promise but most of all unpredictability. Political leaders overseas know policies may change radically every four years. CEO's understand that subsidies and tax breaks offered today may disappear tomorrow. Investors are considering the premiums that go along with rising debt and more volatile politics. Many governments and businesses are quietly trying to decouple themselves from reliance on the US. And it's not America alone here: The average developed country risk is (also) increasing more rapidly thanks to irregular leadership turnovers, greater policy swings and the economic and financial volatility that comes with it all. We are all emerging markets now." Rana Foroohar, "*An unpredictable America looks more and more like an Emerging Market*", **Financial Times**, October 1, 2024.

S&P 500: Index Concentration and Valuations

CARDEROCK CAPITAL® MANAGEMENT, INC.

P/E ratio of the top 10 and remaining stocks in the S&P 500

Next 12 months, 1996 - present

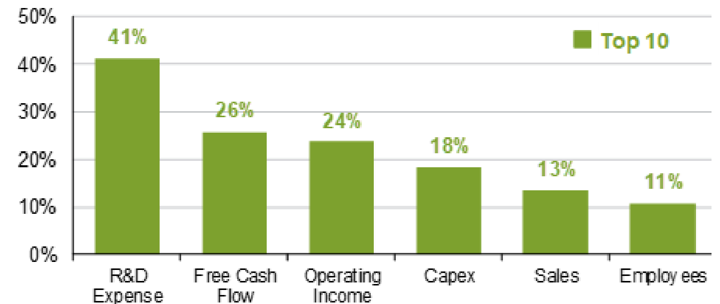
	Current	Average	% of avg.
Top 10	30.5x	20.5x	149%
Remaining stocks	18.4x	15.7x	117%
S&P 500	21.5x	16.6x	130%

Weight of the top 10 stocks in the S&P 500

% of market capitalization of the S&P 500

Economic concentration in the S&P 500

% of S&P 500 metric, 2Q24



Magnificent 7 performance and earnings dynamics

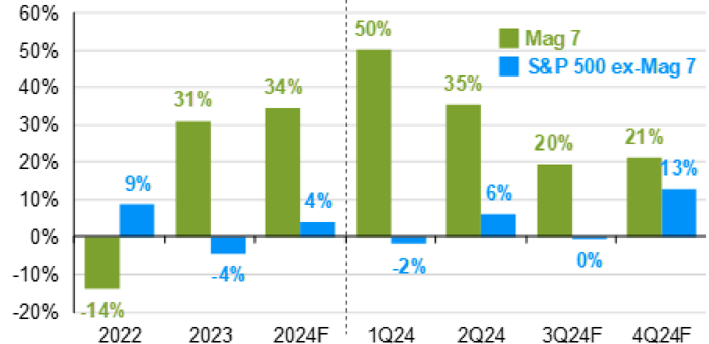
Performance of "Magnificent 7" stocks in S&P 500*

Indexed to 100 on 1/1/2021, price return

Returns	'21	'22	'23	YTD '24
S&P 500	27%	-19%	24%	21%
S&P 500 ex-Mag 7	17%	-8%	8%	11%
Magnificent 7	40%	-40%	76%	35%
*Share of returns***	*33%*	*56%*	*63%*	*45%*

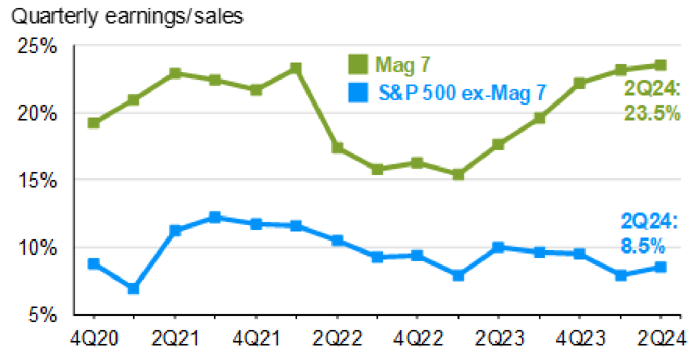
Earnings growth

Pro-forma EPS, y/y



Profit margins

Quarterly earnings/sales



Source: FactSet, Standard & Poor's, J.P. Morgan Asset Management. The top 10 S&P 500 companies are based on the 10 largest index constituents at the beginning of each month. As of 9/30/2024, the top 10 companies in the index were AAPL (7.1%), MSFT (6.5%), NVDA (6.1%), AMZN (3.6%), GOOGL/GOOG (3.6%), META (2.5%), BRK.B (1.7%), AVGO (1.7%), TSLA (1.5%) and LLY (1.4%). The remaining stocks represent the rest of the 492 companies in the S&P 500. *Magnificent 7 includes AAPL, AMZN, GOOG, GOOGL, META, MSFT, NVDA, and TSLA. Earnings estimates for 2024 are forecasts based on consensus analyst expectations. Share of returns represent how much each group contributed to the overall return. Numbers are always positive despite negative performance in 2022. *J.P.Morgan Asset Management - Guide to the Markets – U.S.* Data are as of *September 30, 2024*.