

10/1/2026

Brian Regan, Sr. Portfolio Manager

Investment Insights

At the end of September, I made a tactical adjustment to our ETF and mutual fund portfolios. I generally do not make changes before our quarterly webinar and only do so when something meaningful has changed. This quarter, that change was the sharp rise in interest rates, particularly the 10-year Treasury yield and high-yield credit spreads. In our view, higher rates make the stock market, especially growth stocks, less attractive from a valuation standpoint and increase the likelihood of a correction. To help manage that risk, we sold our Nasdaq 100 exposure as tax budgets allowed and moved into an asset with a similar correlation profile but greater downside protection if market volatility increases.

Additionally, on the fixed income side, we further reduced interest-rate risk from what was already a relatively low level. We viewed this as a sensible response to a rapidly changing rate environment, where much of the upward pressure on yields has been driven by geopolitical conflicts with uncertain outcomes.

The move in rates during the quarter was significant. From the end of Q2 through the end of Q3, the 10-year Treasury yield increased by 0.88%. That is a substantial change in the cost of money over a short period of time and has implications for borrowing costs, corporate financing, and asset values across the global economy. Thirty-year mortgage rates, for example, increased by a similar amount.

A key driver of higher rates has been persistent inflation. Ongoing conflicts in Ukraine and the Middle East have contributed to higher energy prices, with gasoline prices rising 14% and diesel prices increasing 28% during the quarter. Higher energy costs eventually work their way into the prices of other goods and services, including food, transportation, and dining. Tariffs have also added modest pressure to goods prices, which is notable given that goods inflation has often been a source of disinflation in recent years.

Higher Treasury yields have also increased pressure on the more heavily indebted parts of the economy. As that pressure has grown, credit spreads have widened. Credit spreads represent the additional interest rate that non-government borrowers must pay above Treasury rates and are often viewed as a measure of perceived default risk.

From an investment perspective, wider credit spreads and higher yields have improved the relative attractiveness of debt investments compared with equities.

I expect credit spreads to continue to be pressured going forward for a few reasons.

- 1) Credit assets are still relatively expensive and have room to cheapen up.
- 2) Private Credit headlines have been rough in 2026, but I expect them to get worse.
- 3) Lack of wages, immigration, and business investment growth will make real economic growth in 2027 more challenging.

The ETF and mutual fund strategies have significantly outperformed the individual stock portfolio in 2026 and understanding why provides some insight into what has been driving the market. Over the last 12 months, 15 of the 20 best-performing stocks in the S&P 500 have come from the technology hardware and semiconductor industries. Four others were energy companies, and one was a pharmaceutical company. These are sectors that have historically been highly cyclical, with earnings that tend to come in waves rather than grow steadily over time.

The current environment has been especially favorable for many of these companies. The AI infrastructure buildout has created extraordinary demand for semiconductor-related businesses, while geopolitical conflicts have supported strong performance in parts of the energy sector. What is perhaps more surprising is that some of the stocks benefiting most are not necessarily the types of companies that fit our individual stock philosophy of owning businesses with highly consistent and predictable growth.

The ETF and mutual fund strategies have participated in these trends through broad exposure, particularly within the semiconductor sector. As a result, they have captured gains from many of the market's biggest winners without having to identify each individual stock in advance.

At the same time, many high-quality companies have had relatively disappointing stock performance despite continuing to execute well. Microsoft (+6.73%), Broadcom (+2.03%), Amazon (+7.94%), Berkshire Hathaway (-0.94%), JPMorgan (+4.12%), and TJX (-13.08%) have all underperformed the S&P 500's 12.74% return. In our view, this suggests that cyclical business performance has been the primary driver of market leadership this year.

That divergence has made me increasingly cautious about the foundation of the market's recent gains. The bullish case remains straightforward: earnings

expectations for the next year are extremely strong. However, earnings expectations are still forecasts, not guarantees. When consensus expectations call for roughly \$400 per share of S&P 500 earnings a year from now, the potential for disappointment increases with historically cyclical companies leading the way.

It is important to remember that our decisions are based on probabilities, not certainties. While we have become more cautious and made adjustments to address rising risks, we also recognize that there are several paths that could support continued market gains. A resolution to current geopolitical conflicts could ease inflation and lower interest rates, earnings growth could continue to exceed expectations, the labor market could remain resilient, and AI-driven productivity gains could meaningfully boost profits.

For that reason, we are not positioning portfolios for an extreme outcome. While we believe the balance of risks has become less favorable at current market prices, it is important to remain humble about what we can and cannot know. As always, thank you for trusting our team with your financial life.

This information is not intended as a recommendation. The opinions are subject to change at any time and no forecasts can be guaranteed. Investment decisions should always be made based on an investor's specific circumstances. Investing involves risk, including possible loss of principal.