CARDEROCK
CAPITAL® MANAGEMENT, INC.

October 9, 2025

The astonishing run up in stocks since "Liberation Day" in April (the day the Trump Administration announced massive worldwide tariffs) continued unabated in the third quarter, as markets continue to be enamored with the advancements in Artificial Intelligence (AI) and the growth of the ecosystem surrounding it. As the Administration takes a softer approach toward China, worries about devastating tariffs imperiling the U.S. Technology sector have been pushed aside, while the advancements in video and text generation, as well as improving technical capabilities of AI models have swallowed the market's attention compared to the rest of the universe of stocks.

Due to the enormity of the committed capital investments ($3 Trillion) by Technology companies over the next three years, what comes to everyone's mind is "are we in a bubble?". With market valuations approaching the highs of the last Technology cycle in the 1990s, the inclination is neither unwarranted nor unexpected. This rings especially true when equity markets appear to be unfazed by any negative developments in trade, global conflicts or a slowdown in the housing market. The bifurcation in forward progress between stocks and the real economy is as wide as it has ever been.

But as the economist John Maynard Keynes noted, "markets can stay irrational longer than you can stay solvent", which is to say a bubble can last longer than we think. While we believe AI technology will certainly bear fruit in its ability to reshape the economy, new technological advancements often take decades to be fully adopted with many early investors in nascent sectors often coming up empty handed.

As Quality Growth investors, the way through this three-year cycle is to keep a close watch on our exposures and stay diversified. Admittedly, broad diversification versus high concentration has not produced the results we would have liked or expected. Our firm's history and experience have shown us that change can happen faster than anyone anticipates. This is why we strongly believe in sticking with our investment discipline in buying quality assets (Stocks and Bonds) that produce consistent growth in profits, have strong balance sheets and will prosper for many future business cycles to come. At historical market highs on many valuation metrics, now is not the time to divert to other asset classes (Gold, Crypto, Real Estate, Private Equity, Commodities and foreign investments) as these alternatives offer little value on a risk/return, transparency and liquidity basis.

As for the rest of the year and moving forward, we expect the following themes to drive our decision making:

- Bottlenecks in AI-related supply (semiconductors, chip-making equipment) can lead to gluts and extended downturns, which we are monitoring closely.
- Productivity enhancements from AI will need to be significant to justify the commitments of multi-trillion-dollar investments.
- Record levels of concentration in stock indices make the viability of AI as a business model critical to future gains.
- Valuations for the S&P 500 market-cap weighted index are in record territory, while the median stock is only mildly above historical levels and smaller capitalized issues are reasonably priced.
- China remains on the cutting edge of new technologies (green energy, electric vehicles) but thoroughly behind the U.S. Technology sector, making a "race to the bottom" in semiconductors unlikely.
- Housing and automobile production continues its sluggish recovery as high interest rates hamper cyclical industries.
- The cancelling of many solar programs/incentives in support for coal and fossil fuels contradicts the economics of solar energy and battery storage as the cheapest and most profitable ways to fuel AI electricity demand.

- Grid investment (brought on by capacity needs for Data Centers) to accompany new electricity demand remains strong, as capacity, transmission and distribution of energy remain key bottlenecks causing utilities to pass prices onto consumers.
- The Federal Reserve is more attuned to risks in labor markets versus inflation at this point, making a more rapid interest rate cut cycle a distinct possibility.

Furthermore, our recent activity can be summarized as follows:

- Selling has outpaced buying so far this year as we have rebalanced portfolios to reduce concentration risk and broaden exposures towards new and undervalued companies.
- Realized Capital gains may be ahead of last year's numbers, so we encourage you to review your results in this report.
- Target cash reserves have been lowered to 10% from 15%, a reflection of continued strong growth in equities.
- We continue to utilize treasury bills as supplements to cash in your portfolio to take advantage of higher yields.

Despite the mantra that the bubble will soon pop in equities that is currently being echoed across financial media, we take a constructive view that a good portion of stocks that have been left behind during this cycle are reasonably valued and have bright prospects in a country that will always need healthcare, housing, autos, energy and more. While the spotlight may be shining brightly on AI and the companies most impacted by its potential, the winners from its eventual adoption may exceed those of its early investors, as has often been the case with new technologies throughout time.

As always, feel free to call us with any questions, concerns or changes to your circumstances that you may have.

Warmest Regards,



Daniel A. Kane, CFA
President



Stephen F. Knapp, CFA
Director of Research



Jeanne C. Goedecke
Portfolio Manager

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

"Anyone who invests in the newest thing must answer two questions: First, how much value will this innovation create? And second, who will capture it? Information technology was a revolution whose value was captured by startups and newly rich founders, whereas shipping containerization was a revolution whose value was spread so thin that in the end, it made only a single founder temporarily rich. Is generative AI more like the former or the latter? There are ways to make money investing in the fruits of AI, but they will depend on assuming the latter- that it is once again a less propitious time for inventors and investors, that AI model builders and application companies will eventually compete each other into an oligopoly, and that the gains from AI will accrue not to its builders to but to customers." Jerry Neumann, "AI Will Not Make You Rich", Colossus, September 2025.

"Corporate America is excited about AI, even if CEOs don't know why exactly. Over the past 12 months, 347 management teams discussed AI on earnings calls and 87% of them had good things to say about the technology. However, outside of companies like Caterpillar, Inc. and Freeport-McMoRan, few CEOs could say what AI will do for their bottom line aside from vague hopes for higher productivity. By 2030, tech companies will splash out $500 billion per year in AI-related capital expenditures and will need to generate $2 trillion in incremental sales to make a profit on those investments. The only problem: Bain & Co., Inc. projects that tech companies will fall $800 billion short of that revenue bogey five years from now. This lack of profitability may be why Nvidia is increasingly financing the AI upstarts that buy its chips." Evan Lorenz, "All Cost, No Benefit", Grant's Interest Rate Observer, September 26th, 2025.

"We have written recently about the common if somewhat shapeless worry that if the AI boom were to turn into a bust, it would take the US economy into recession. Economist Jason Furman recently confirmed this, writing 'GDP excluding information processing equipment grew at only a 0.1 per cent annual rate in the first half.' By our math this looks right, with two optimistic counterpoints to the dreary AI bust/recession hypothesis. First, the tax law that takes effect next year allows investment projects to be fully depreciated in the first year which could spark a wider capital boom. Next, the build-up in tech investment as a share of the economy has been more gradual than the upwards bursts in spending during the housing or telecom bubbles. It might be part boom and part permanent secular change." Robert Armstrong, "Does GDP Growth Minus AI Capex Equal Zero?", Financial Times, September 30th, 2025.

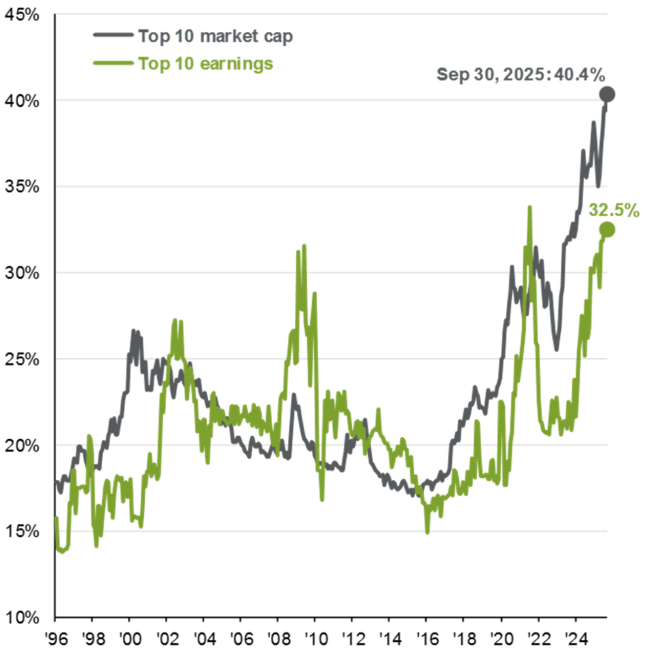
"The Federal Reserve resumed its interest-rate cutting campaign earlier this month in an effort to reverse a stall in the job market. The problem: The hiring drought can't be cured by lower interest rates alone, at least not soon. Lower rates will help by bolstering demand, especially for interest-sensitive purchases such as houses. But many businesses say their problem, rather than demand, is a panoply of issues from high costs and tariffs to tight credit. The usual levers through which lower rates initially boost the economy—rising stock prices and lower mortgage rates—will be less potent than usual." Justin Lahart and Ruth Simon, "Rate Cuts Might Not Cure What Ails the Job Market," The Wall Street Journal, September 28th, 2025.

"AI related stocks have accounted for 75% of S&P 500 returns, 80% of earnings growth and 90% of capital spending growth since ChatGPT launched in November 2022. AI is showing up other places as well. Data centers are eclipsing office construction spending and are coming under increased scrutiny for their impact on power grids and rising electricity prices. Specialized power rates for most data centers aren't enough to cover costs of a new natural gas plant, and in the PJM region, 70% of last year's increased electricity cost was the result of data center demand." Michael Cembalest, "The Blob: Capital, China, Chips, Chicago and Chilliwack", Eye on the Market, September 24th, 2025.
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P/E of top 10 and remaining companies in S&P 500
Next 12 months



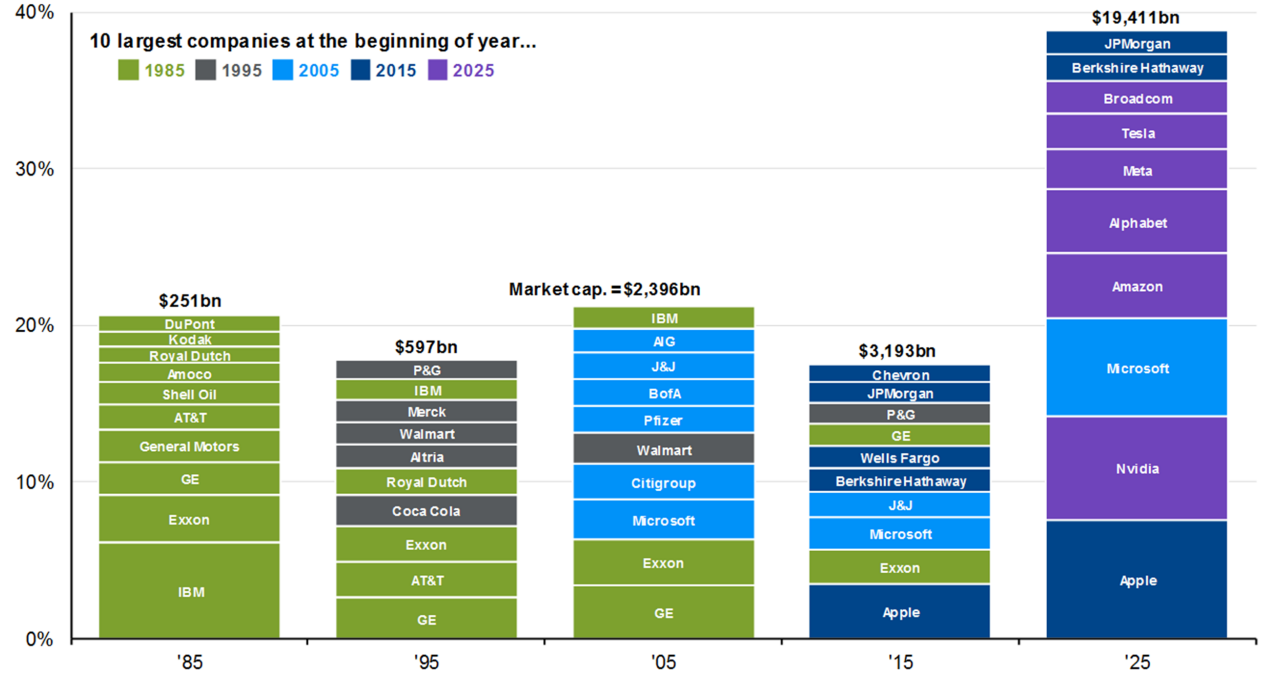
Weight of the top 10 companies in the S&P 500
% of market capitalization, % of last 12 months' earnings



Source: FactSet, Standard & Poor's, J.P. Morgan Asset Management.

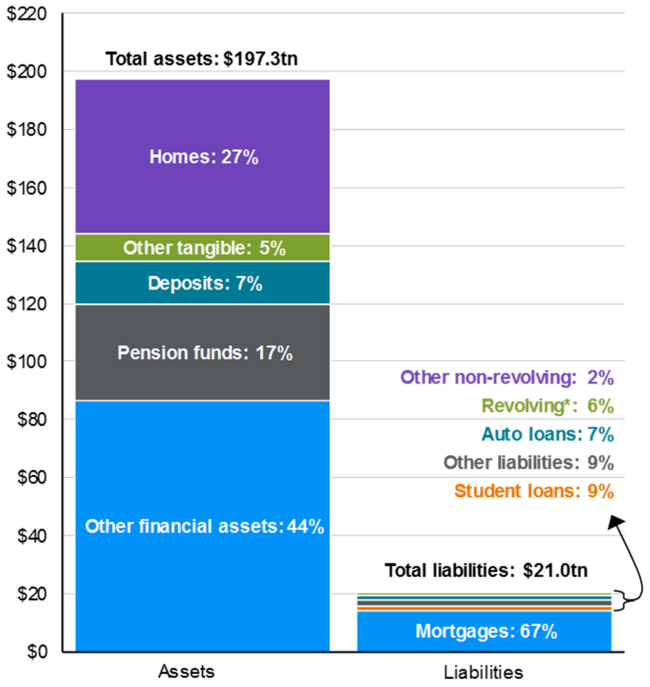
Forward P/E ratio is the most recent price divided by consensus estimates for earnings in the next 12 months, provided by IBES since January 1996 and FactSet since January 2022. The remaining stocks represent the rest of the 490 companies in the S&P 500, and their P/E ratio is calculated by backing out the nominal earnings and market cap of the top 10 from that of the S&P 500.

Top 10 S&P 500 companies by market capitalization
Percent of S&P 500 market capitalization as of the first day of the indicated year

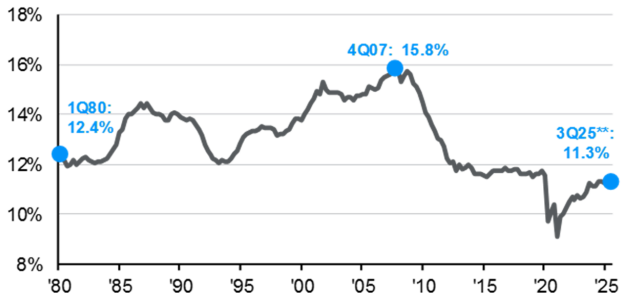


Source: Bloomberg, Standard & Poor's, J.P. Morgan Asset Management.

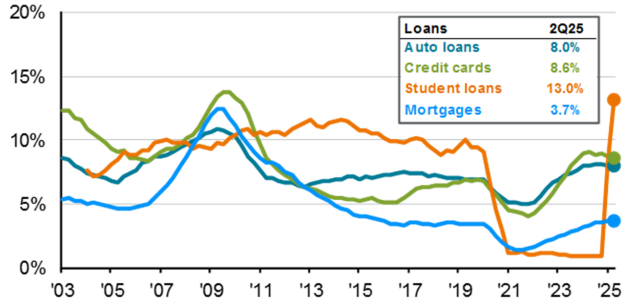
Consumer balance sheet
2Q25, USD trillions, not seasonally adjusted



Household debt service ratio
Debt payments as % of disposable personal income, SA

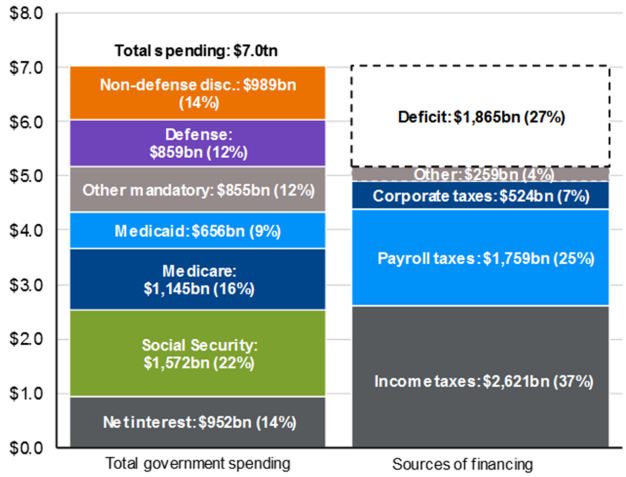


Flows into early delinquencies
% of balance delinquent 30+ days



Source: FactSet, FRB, J.P. Morgan Asset Management; (Top and bottom right) BEA.

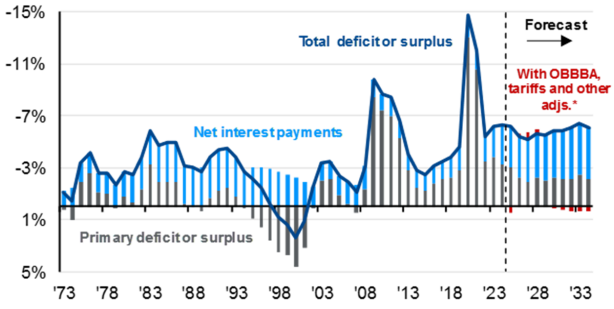
The 2025 federal budget
USD trillions



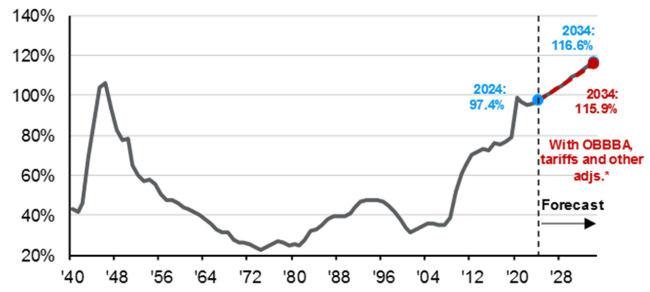
CBO's Baseline economic assumptions

	2025	'26-'27	'28-'29	'30-'35
Real GDP growth	2.2%	1.8%	1.8%	1.8%
10-year Treasury	4.1%	3.9%	3.9%	3.8%
Headline inflation (CPI)	2.3%	2.4%	2.3%	2.2%
Unemployment	4.2%	4.4%	4.4%	4.4%

Federal deficit and net interest payments
% of GDP, 1973 - 2034, CBO Baseline Forecast



Federal net debt (accumulated deficits)
% of GDP, 1940 - 2034, CBO Baseline Forecast, end of fiscal year



Source: CBO, J.P. Morgan Asset Management; (Left) Numbers may not sum to 100% due to rounding; (Top and bottom right) BEA, Treasury Department.