CARDEROCK
CAPITAL® MANAGEMENT, INC.

January 12, 2026

It was another strong year for the S&P 500 in 2025, and the index continued to be led primarily by a narrow group of large technology companies expected to benefit from the rollout of artificial intelligence ("AI"). Collectively, these firms invested more than $400 billion in AI infrastructure, driven by the belief that AI would transform nearly every sector of the economy and deliver substantial productivity gains and cost savings across corporate America.

Recently, however, cracks have begun to appear in this narrative. Investors are increasingly questioning whether returns on such massive capital investments will justify the spending, raising concerns that the market may be experiencing another speculative cycle reminiscent of the 19th-century railroad boom or the dot-com bubble of the 1990s. Several large technology companies—notably Oracle and Meta—have already seen their stocks decline as markets penalize what is now viewed as excessive spending. History suggests that companies with the highest capital expenditures often underperform over time, and intense, well-funded competition in AI may ultimately limit returns for its developers, even as the technology delivers meaningful benefits to consumers and workers.

As Quality Growth investors, we believe this environment has created opportunities. In our view, many high-quality companies, those with strong balance sheets, low leverage, and high returns on capital—have been overlooked. These stable and profitable businesses have been priced as though they carry significantly more risk than fundamentals suggest. Based on our internal metrics, the highest-quality stocks are now trading at their smallest premium to the S&P 500 in the past five years. Looking ahead, our investment decisions will be guided by several key themes:

- Slowing labor markets and housing activity are likely to shift public focus away from inflation.
- The economic impact of tariffs is likely to be limited as higher prices face resistance from consumers and the courts.
- Strong Baby Boomer spending and elevated savings rates should help mitigate recession risks.
- Continued capital spending by large technology firms favor the smaller companies that supply the foundation tools and services directly to the AI buildout.
- Leadership changes at the Federal Reserve may result in less predictable interest-rate policy in the year ahead.

Recent portfolio activity reflects these views:

- Selling modestly exceeded buying over the past year as we rebalanced toward underappreciated opportunities.
- Cash levels remain near a multi-year low at approximately 10%, reflecting our optimism.
- The shift from an inverted to a positively sloped yield curve has led us to extend duration and further ladder fixed-income portfolios.
- Tight corporate bond spreads and rising leverage among large technology firms warrant more defensive allocations, including increased exposure to government bonds.

Over the past three years, the AI theme captured the market's attention and overwhelmingly rewarded these few companies compared to other areas of the economy. This has tested our list of companies emphasizing quality and diversification. We believe the next phase of the business cycle is just starting and will turn the market's focus towards a broader set of companies with durable growth and strong fundamentals. While volatility is likely as market leadership evolves, we remain prepared to capitalize on these dislocations while maintaining our investment discipline as we look for companies with strong growth and profitability.

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

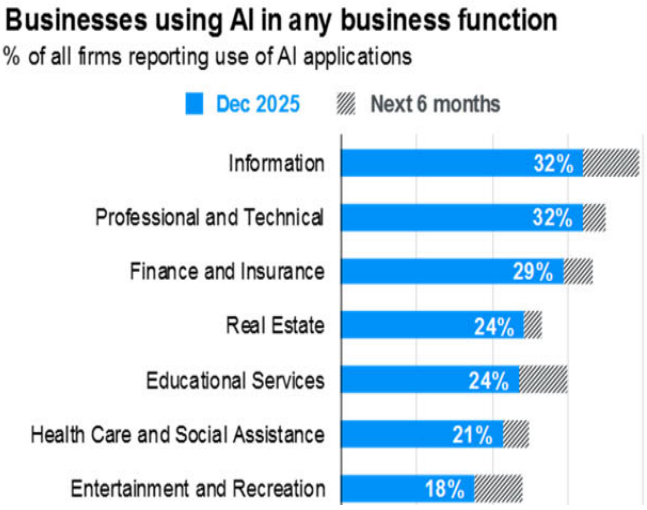
"Mounting concerns about AI's ability to deliver seismic changes on the American economy has turned investor euphoria about the technology into agita. That's driving cash into shares of the 'other' 493 companies, particularly ones that would benefit most if an expected uptick in economic growth comes about. If the economy improves, so too will the prospects for cyclical and growth-oriented sectors, providing ample opportunity for investors looking to move on from the era of Big Tech dominance. Doug Peta of BCA Research notes that 'The most benign outcome for the bull market would be a peaceful transfer of power to a broad coalition of the other 493 S&P 500 constituents. That's not how highly concentrated bull markets typically evolve, however.'" Joel Leon, "AI 'Fatigue' Leaves Investors Focused on S&P's Other 493 Stocks", Bloomberg, January 7th, 2026.

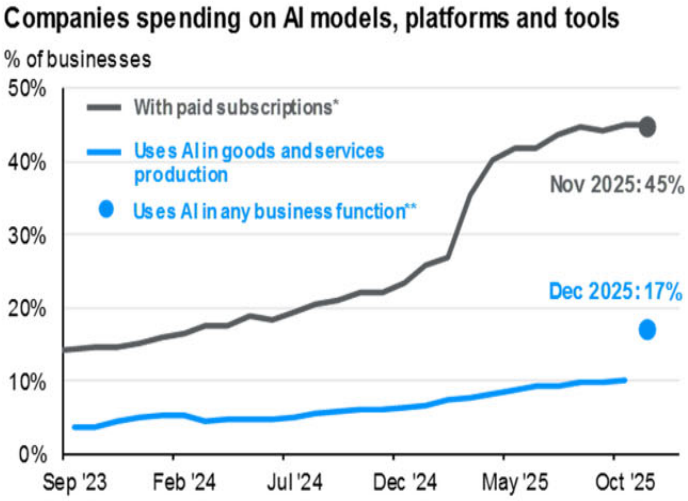
"The inflation report was part of a deluge of data released this week that also showed unemployment rising to a four-year high and earnings growth slowing. People have a nagging feeling that the economy isn't working for them, and part of the equation is the security of their income and that's where the job market comes in. Wages are up just 3.5% a year, the lowest since 2019 and artificial intelligence remains a headwind even as tariff effects fade. The conventional wisdom in Washington is that costs will be the dominant issue heading into the midterm elections, but the latest trends on AI and job security hint that the conventional wisdom may have to change." Greg Ip, "Jobs Could Soon Replace Prices as Focus of Anxiety", The Wall Street Journal, December 19th, 2025.

"Investors are the most bullish since the everything bubbled three-and-a-half years ago, according to the latest BofA Global Fund Manager survey. There are good reasons for that rose-tinted outlook. Tax cuts in the OBBA are expected to boost GDP growth by 0.9 percent in 2026, and consumers may get lower prices if the Supreme Court rules against Trump's tariffs. On top of that, investors have priced in at least two rate cuts next year. Of course, the problem when investors are all-in is, who will be the incremental buyer? The top 10% of households account for 49% of spending, and the other 90% of shoppers are paring back. If a stock market correction causes wealthy Americans to do likewise, the S&P 500 will not boost earnings by double digits in 2026." Evan Lorenz, "So Good It Can't Get Better", Grant's Interest Rate Observer, December 19th, 2025.

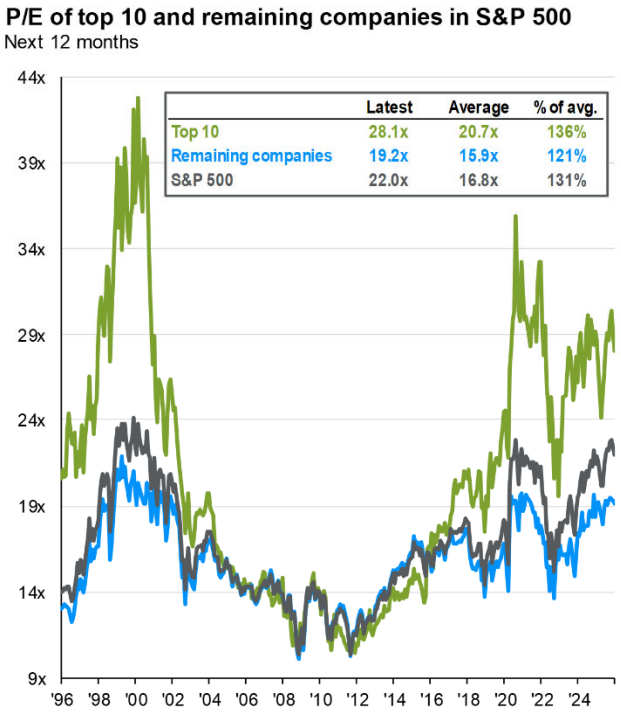
"Casting an eye across the outlooks from all the major investment banks and big asset managers, it is close to impossible to find a naysayer. US policy on trade and interference in central banking remains a clear and present danger to every portfolio, but the astonishing market resilience of 2025 makes it very difficult to justify whining from the sidelines. Corporate earnings have done all the heavy lifting on asset prices in the US, but this optimism sits alongside a widespread suspicion that stocks are in a bubble- even masters of the tech industry universe freely acknowledge that excessive exuberance has set in. It is cool to be pessimistic. But now more than ever, it's hard to justify that stance." Katie Martin, "Why the Melt-Up is Still On", Financial Times, January 4th, 2026.

"On AI, China is behind the US, but not by years. There's no question that American reasoning models are more sophisticated than the likes of DeepSeek. But the Chinese efforts are doggedly in pursuit, sometimes a bit closer to US models, sometimes a bit further. By virtue of being open-source (or at least open-weight), the Chinese models have found receptive customers overseas, sometimes with American tech companies. If US labs achieve superintelligence, the Chinese labs are probably on a good footing to follow closely. Unless the DSA is decisive immediately, it's not obvious that the US will have a monopoly on this technology, just as it could not keep it over the bomb." Dan Wang, "2025 Letter", The Secure Transport of Light, January 1st, 2026.





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.

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