INVESTMENT UPDATE

Rounding the corner…

The conflict in the Middle East persists and the Strait or Hormuz is still a mess. The Federal Reserve raised rates by 0.25% in September and signaled further moves are likely in the coming months as they tackle inflation. Yields surged into quarter-end and yet equities managed a modest quarterly gain. This is a brief summation of the third quarter.

As was the case in Q2, those assets that led prior to the conflict in the Middle East struggled to recapture momentum in Q3. Markets were again led by technology (AI and adjacent) along with energy. Meanwhile, industrials (-9.7% for Q3) and utilities (-12.4% in Q3) struggled mightily. The non-US markets struggled to overcome the impact of higher commodity and oil prices, while small caps were hampered by rising costs of capital.

Although a diversified portfolio is always prudent, diversification was not a recipe for success in Q3. The Mega cap tech sector once again regained its leadership "mojo" as investors assess the impacts of the ongoing AI buildout and capital spend. Most other areas lagged. As the quarter wrapped up, the median S&P 500 stock found itself 17% off its highs, despite the index sitting near a record level.

Below is a recap of Q3 and YTD results for the market's largest constituents. Note the performance of the Bloomberg aggregate bond index. As we will discuss later in the newsletter, ***the AGG remains an index we prefer to avoid!***

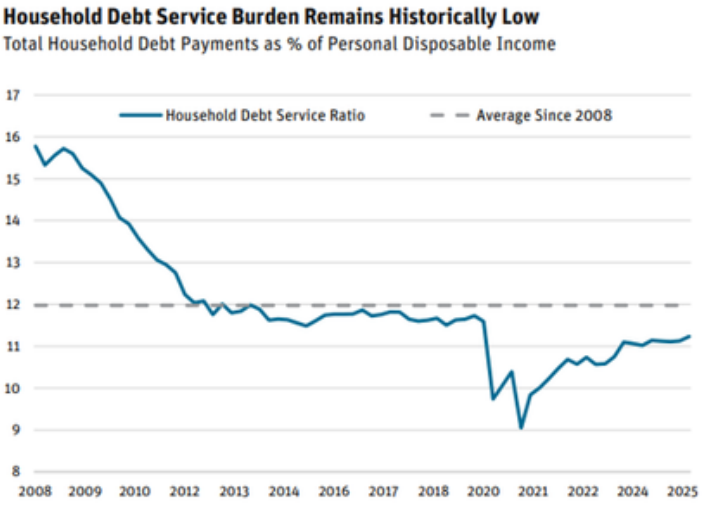


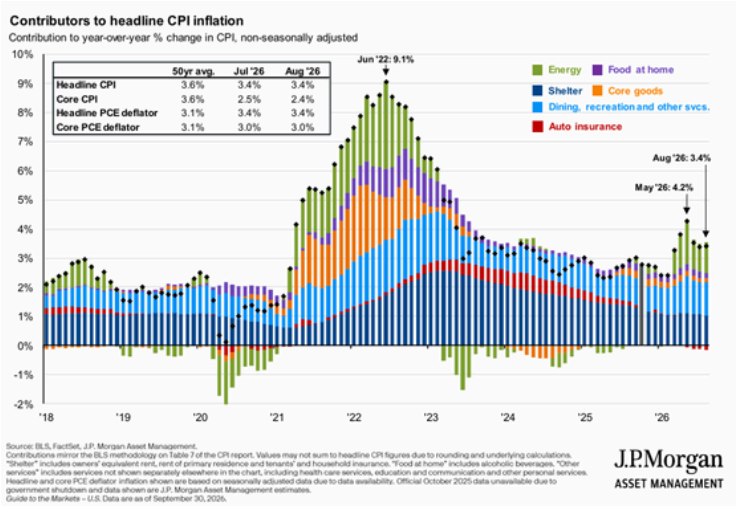
That doesn't imply you should avoid fixed income, just choose more adeptly… ***Our fixed income allocations have outpaced it by over 300bp annually over the last 4 years and held up considerably better than the AGG in Q3!***

As was somewhat anticipated given the economic and political backdrop, so far 2026 has brought episodes of volatility and stretches of surprisingly strong performance in unexpected places. Throw in the geopolitical elements, a new Fed chairman championing less transparency and forward guidance, midterm elections in November, and it's reasonable to expect more episodic volatility to continue. Encouragingly, the economy remains resilient (nominal GDP in running at 6.3%) , the average homeowner remains healthy (average mortgage as % of income is at 35-year average levels), and equity valuations (forward P/E) have dropped on the back of remarkable earnings in 2026 from over 21x to ~18x at the end of Q3.

	Q3 Performance
S&P 500	2.3%
Russell 2000	-7.2%
Nasdaq	0.6%
MSCI EAFE	0.8%
Bitcoin ETF	42.2%
Gold ETF	3.4%
Bloomberg Aggregate Bond ETF	-3.5%

	YTD Performance
S&P 500	12.7%
Russell 2000	13.7%
Nasdaq	20.8%
MSCI EAFE	10.3%
Bitcoin ETF	-4.7%
Gold ETF	-3.9%
Bloomberg Aggregate Bond ETF	-2.9%





The chart (above) shows that the average debt service to income ratio sits well below its 2-decade average. None of this suggests an all clear nor a reason for panic. As you will read in the following sections, discipline and active risk management remain hallmarks of our approach.

What can we expect for the remainder of the year?

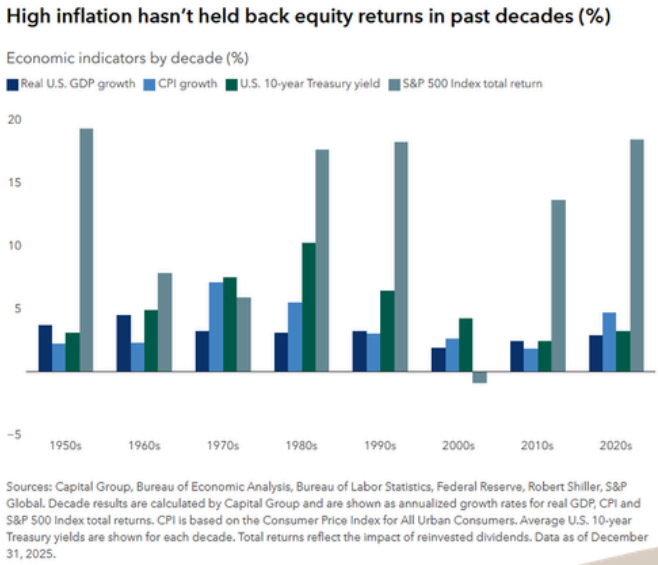
With one eye on 2027 and the other on Q4, below are some of the key items we are monitoring and reacting to as we manage portfolios. What we can say with a high level of confidence is that the fourth quarter is unlikely to be boring!

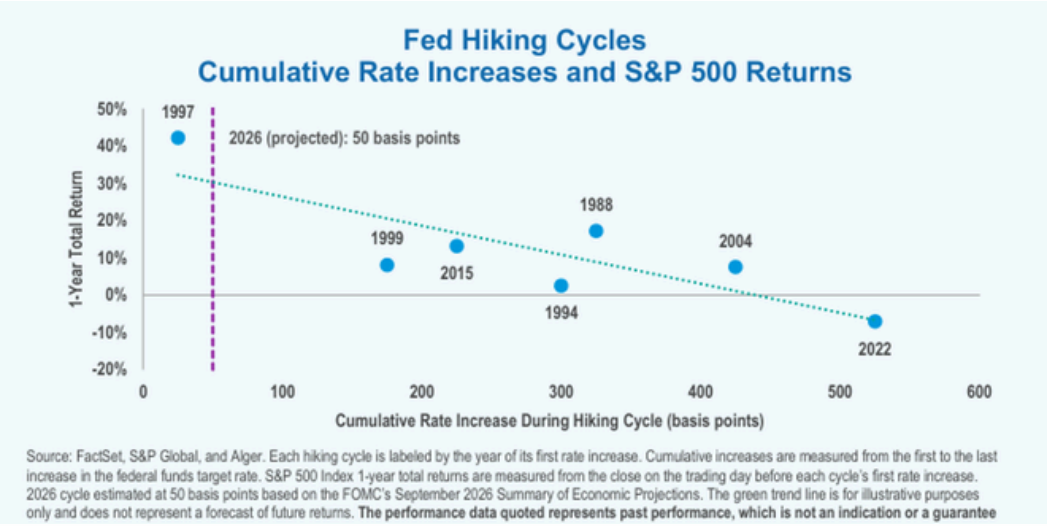
Economics:

The key focus items in the economy surround inflation and the consumer. The Fed will likely focus squarely on bringing inflation toward their 2% target until they believe employment or another part of the consumer complex is beginning to falter. We agree with others who argue the Fed's main tool (the Fed funds rate) cannot accomplish the goal (i.e. that raising short-end rates cannot create refining capacity to bring fuel costs down, nor will it slow spending by the hyperscalers).

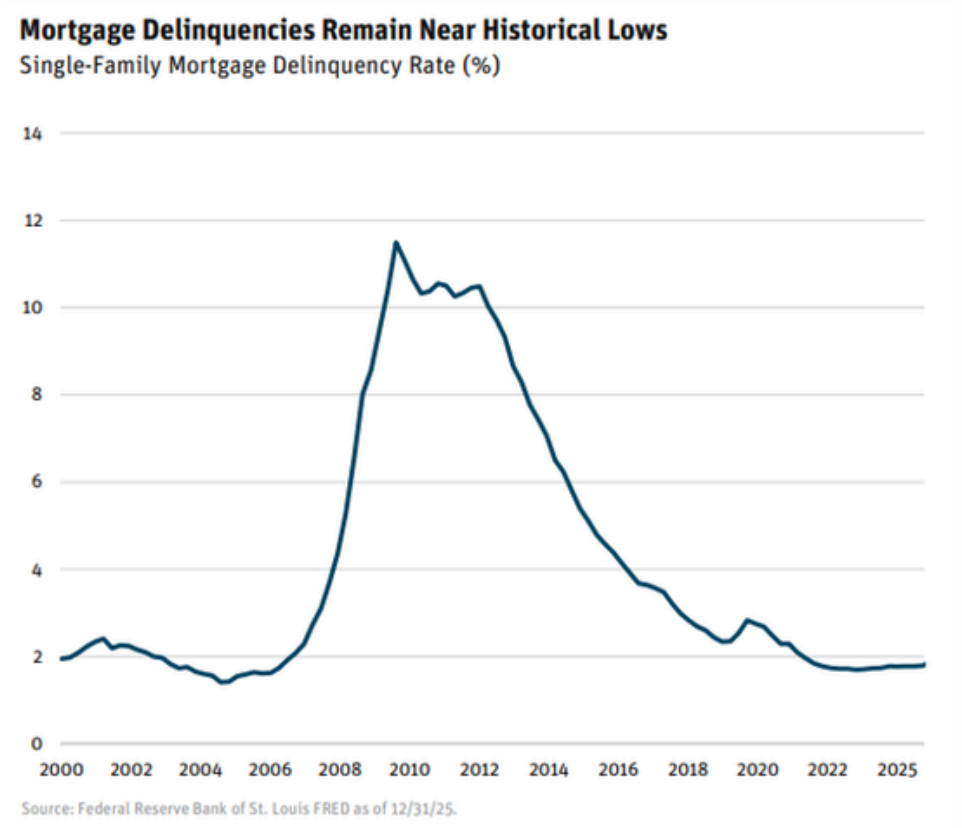
As the chart below illustrates, today's levels are in-line with the 50-year averages and largely driven by the recent oil price surge. Note the reduced impact of housing in the chart!

Inflation is headed lower on its own (Brian Wesbury of First Trust expects a 2.5% CPI in 6 months) as housing, insurance, and a few other components "calm." Housing is negatively impacted by higher rates, but unlike 2 decades ago, over 90% of all US mortgages are fixed with most well under 4.5%. Higher rates make borrowing costs an even greater headwind while tight supply and locked-in rates keep prices from falling very far. Also impacted by higher rates are small businesses who need to borrow for operations, research, and growth. While the Fed doesn't directly impact the long end of the curve, it often moves in sympathy.





As you see (above) inflation and a Fed hiking cycle have not proven to be the "death nail" of equity markets.



(Above) Homeowners are still paying on time as they have been since the post-Covid reopening.

Elections:

While there is good reason to pay attention to the upcoming midterm elections, the results' impact on markets is more likely a rounding error than something that moves the needle quickly. Granted, Congress controls the nation's purse strings and sets priorities, but today's Congress is almost certain to keep spending, even if slight shifts to where occur.

While history is only as good as what you take away from it, the 9 months following midterms have resulted in gains every election since WW II and we see a backdrop that likely continues that trend. Expect volatility to surround the rhetoric and immediate outcomes, but to dampen as the likelihood of gridlock sinks in for investors.

Equities:

The Fed raising rates could logically be considered a headwind for equities. Nevertheless, it doesn't necessarily mean negative outcomes historically when the economy remains healthy. There are multiple instances of the Fed raising rates as the market presses higher. Nevertheless, a less accommodative Fed is NOT a tailwind for equities and places a heavier burden on earnings to come through. Should earnings start to falter, equities could see meaningful repricing lower. We are keying on earnings!

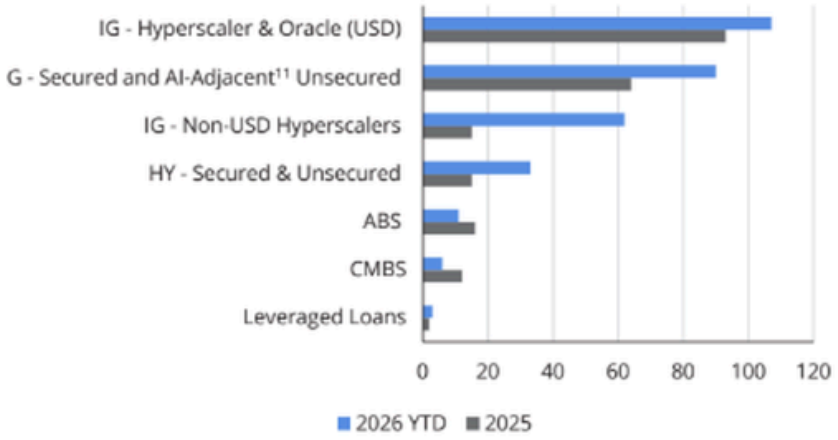
Herein lies the discipline element of equity investing. In a goldilocks scenario hyperscalers keep spending, Wall Street absorbs all the debt required without issue, and AI adjacent companies reap the rewards. That could be what lies ahead and it would likely resemble the last 3+ years in equities. If, however, the conflict in the Middle East rages on, oil and yields press higher, and earnings disappoint we could see market behavior more akin to this March or Liberation Day in 2025.

Our approach is to be prudently optimistic and positioned accordingly. We've shared that we have been sleeping with one eye open a lot lately. A properly allocated equity portfolio, in our opinion, should not only succeed in a goldilocks scenario. Therein lies the reason we advocate buffered, covered, and non-traditional equity solutions as a part of one's overall exposure. These strategies (each in their own ways) help insulate the portfolio during an array of market volatility "moments." Should one of these "moments" evolve into a sustained drawdown, we would expect these strategies to be among our best equity performers. That resilience can directly translate into opportunity to capitalize on lower prices.

Fixed Income:

Among the most challenging arenas to "play in" has been fixed income. A Fed committed to raising rates presents an obvious headwind to bond owners, especially those with long duration exposure. Our positioning, however, continues to emphasize responsible ownership of credit with a duration significantly lower than the index. While we are not immune to bond price volatility, we have a cash flow advantage of more than 2% vs the AGG and a duration ~1/2 that of the index. Although we have raised our portfolio duration from its 2022 lows (from ~2.2 years to 3.5 years) we are actively considering the benefits of lowering it once again to preserve maximum flexibility and liquidity.

FIGURE 1
The Rapid Rise of Data Center-Related Debt Issuance
AI-Related Fixed-Income Issuance ($, in billions)



2026 data as of 5/23/26. IG=Investment Grade; HY=High Yield; ABS=Asset-Backed Securities;[12] CMBS=Commercial Mortgage-Backed Securities.[13] Sources: Intex, Bloomberg, CreditFlow, Trepp, PitchBook, Morgan Stanley Research, and Hartford Funds, 9/26.

The chart above illustrates the newest big issuer of debt (tied to the AI data center buildout) and the scale of debt growth. This debt is directly competing for dollars from some institutional investors who would otherwise be buying Treasuries.

Furthermore, today's math for bonds is far better than it was in 2022. Today's starting yields are meaningfully higher and most bonds trade at a discount to par. The most fringe views put 3-4 more Fed hikes in the picture over the next 15 months and a 10-year Treasury approaching 6%. That outcome would signal an economy that remains healthy (at least in the eyes of the Fed) and would likely not traumatize equities. While those levels would pressure bond prices, our fixed income portfolios are positioned for a modestly positive outcome in that scenario. Our fixed income portfolios are designed to withstand bond volatility and preserve principal with higher cash flow. Nevertheless, if losses occur, we have the ability to capture them to help offset taxable gains while repositioning.

A more common view is that we see another 2-3 moves by the Fed and a 10-year Treasury that trades between 4.75% and 5.5%. Such an outcome would allow us to both capture yield and potentially some accretion toward par on our bonds. This too would signal an economy that is likely moving along at a decent pace of growth.

If the Middle East situation improves and yields retreat toward 4.5%, we stand to post meaningfully positive returns in fixed income.While we cannot guarantee returns nor predict economic outcomes, we still believe the income offered by fixed income serves our clients well as a source of resilience and as a means of hedging against a solely consensus view of what lies ahead. We continue to trim certain exposures in fixed income and to reconfigure as we see opportunities presented (as do the managers we have hired who have added meaningfully to floating rate strategies in the last few months).

Other:

Many of our exposures are not reliant on an upwardly moving market. That's by design! Such is true of our in-the-money covered call writing, put writing, and alternative strategies. Over time markets go up far more often than they go down. The intention of these strategies is to own enough assets that can be durable when others are losing that one can capitalize on a selloff. That same concept can hold with short duration fixed income as well.

Consider this example:

- Portfolio A is comprised of 60% equities and 40% bonds entering a 25% correction in equities and a 2.5% hit to bonds. A $100K allocation that started as $60K/$40K becomes $45K/$39K (-16%)

- Portfolio B is comprised of 60% equities and 40% bonds entering a 25% correction in equities and a 2.5% hit to bonds. This portfolio, however, only feels a 10% equity correction and posts a 5% gain in fixed income. A $100K allocation that started as $60K/$40K becomes $54K/$42K (-4%)

While only a streamlined illustration, it's easy to see that reallocating additional dollars to equities during that drawdown is far easier for the owner of portfolio B! Our emphasis on cash flow and structural protection are components that should serve us well!

This is why we take the approach that we do and why we are positioned as we are today.

Today's markets often move fast, too far, and reverse courses before even the most basic analysis can be done. Chasing such trends is called trading, not investing! Predicting the direction of the next quarter has proven a fool's errand. Avoid the temptation to chase trends, stay disciplined, and stay attune to what could change quickly.

Final Words

Recency bias is real. We believe 70 years of experience gives us an edge in both avoiding temptations of the market and maintaining discipline when others lose focus. We are committed to using our full suite of tools to navigate the fast moving and ever-uncertain investment landscape. We will remain focused and disciplined in the face of whatever markets "throw" our way.Thank you for your trust in us!





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