

Quarterly Client Bulletin

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Registered Investment Advisor

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Third Quarter Recap

Last quarter was a mixed bag as the markets continue to grapple with tighter monetary policy from the Fed in response to higher inflation. The war in Iran has put upward pressure on oil & gas prices and lingering tariffs are also being passed through to consumers. The Fed took action in September by raising short-term rates a ¼ point to a range of 3.75% - 4.0%, and the 10-year Treasury ended the quarter with a yield of 5.3%, up from 4.5% in June. We believe the bulk of the damage has been done to the bond market and expect the Fed to hold rates steady at their October meeting as to avoid any political implications with the mid-term elections coming up. If inflation stays elevated at the 3.7% level, a December hike cannot be ruled out. The higher rate environment put pressure on our longer-term bonds and fixed-income ETF's, but we are maintaining the majority of our positions. We remain constructive but selective on equities as strong earnings growth is the fuel to drive prices higher. In addition, from a seasonality standpoint we are now in the best three-month period of the year for stocks.

“Our strategy to navigate this environment is to maintain our disciplined approach and balanced posture with broad diversification.”

Areas of strength for us last quarter included large cap technology stocks **Apple** and **Microsoft**, health care names **Merck**, **McKesson**, and **Regeneron**, and **Cactus Wellhead** in the oil & gas service sector. Consumer discretionary and interest-sensitive names brought up the rear with **Costco**, **Home Depot**, **Lowe’s** and Booking Holdings leading the decliners. With AI agents now able to plan and book travel, we cut the loss and sold Booking.

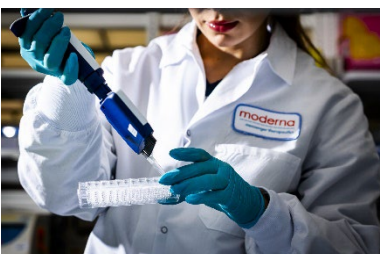
Our strategy to navigate this environment is to maintain our disciplined approach and balanced posture with broad diversification across asset classes and sectors of the market. The total returns will continue to be driven by appreciation and dividends from the equities along with generous income from the fixed-income holdings.

Company News

Apple – The company launched their first dedicated smart home display device called Home View (available in a 7-inch tabletop domed speaker version and a wall-mounted version) powered by Siri AI. Also new is Apple TV 4K, and HomePod mini2, a \$149 smart speaker with Siri AI integration. This follows the September release of the new iPhone Duo, a foldable mobile device.

Microsoft – Call them the come back kid after a chart topping 37.8% return in Q3. After shares had been crushed and in the tank all year, things changed following the strong July 30th earnings announcement. Confidence was restored that its AI spending will generate profitable growth. One of their AI assistants, Microsoft 365 Copilot surpassed 30 million paid seats. It works within Word, Excel, Outlook, PowerPoint, and Teams to draft documents, analyze spreadsheets, summarize emails and meetings, and create presentations.

Merck – Shares popped last quarter following positive phase 3 clinical trials for a cancer vaccine developed in partnership with Moderna. The individualized mRNA treatment is customized to mutations in an individual patient’s tumor, helping the immune system recognize and attack the cancer. The companies share costs and profits equally under their collaboration. It is being studied and tested with Merck’s blockbuster cancer drug Keytruda.



New Equity Buys

Intuitive Surgical – We like to buy stocks that have been hit unjustifiably and catch the rebound. The company's da Vinci machine is the gold standard in robotic surgery and I can personally attest to the fact that it works. Leases are becoming more popular with hospitals. There is a lower upfront cost with a usage-based arrangement where the customer pays a contractual fee for each procedure. In addition, hospitals also buy instruments and accessories that are disposable, so the company typically earns \$900 - \$3,700 per procedure for supplies provided. An installed robot can generate years of repeat revenue for shareholders and save many lives.



Regeneron – We like to keep tabs on companies we've owned in the past and will revisit them after a price decline when we see things turning around. Such was the case with this stock last quarter. Their Eylea franchise for macular degeneration is best in class, and Dupixent, an eczema treatment saw quarterly global sales grow 38% to \$6 billion. An additional catalyst is an expected FDA decision in November on a new drug to treat an autoimmune disease that causes muscle weakness.



GE Vernova – This is a play on the increased power generation that will be required to run data centers. GEV is the former energy business of **General Electric**. It was spun off from GE and became an independent public company on April 2, 2024, but its operations draw on more than 130 years of GE's power and electrical engineering history. Their three principal businesses are:

- **Power:** Gas turbines, steam, nuclear, and hydroelectric equipment and services.
- **Wind:** Onshore and offshore wind turbines.
- **Electrification:** Grid equipment, power conversion, and software that helps move and manage electricity.

The company manufactures and installs new turbines and has an enormous installed base which creates recurring revenue through maintenance and replacement parts.





Corning – Corning is the world's largest maker of optical fiber, and AI data centers need far more of it. Fiber optics provide high-speed connections between racks of servers and between buildings, a job copper increasingly cannot do. What was once viewed as a slower-growth materials company has become an AI infrastructure supplier. Big customers include Meta Platforms, Amazon Web Services, and Nvidia. In addition, the company has supplied a specialized glass to Apple since the iPhone's inception in 2007.



Caterpillar – Caterpillar is no longer just a construction and mining company. Its engines, turbines and generator sets are being installed as primary power plants at data centers that cannot wait years for grid connections. Second-quarter revenue exceeded \$20 billion for the first time, sales of power generation equipment to end users jumped 72%, and the order backlog reached a record \$72 billion. Recurring parts and service revenue on a growing installed base adds a steadier layer to the story.

Please Note: Your holdings may not include all securities discussed due to different client inception dates and manager discretion. Client performance is based upon your objectives, risk tolerance, and portfolio structure, and may materially differ from average client returns. Any reference to an index return is for informational purposes only and is not intended to be a benchmark comparison. Past performance is no guarantee of future returns.

Bonds & Fixed Income Investments

On September 16, the Federal Open Market Committee chaired by Kevin Warsh voted unanimously to lift short-term interest rates by 0.25%, following a hot August inflation report.

The higher rate environment put downward pressure on bond prices and core ETFs during the quarter. We view this as a temporary setback and are maintaining most of our existing positions believing that the majority of the disruption has already been absorbed. Bond yields are now near their highest level in the past 25 years and we believe the Fed vigilance will serve to contain further damage at the long end of the yield curve. Given the stronger than expected September CPI and PPI inflation reports, and the bond market closing higher after the news, it appears we may have hit a ceiling for long-term rates. With all these securities, the interest and dividend income keeps coming so we are exercising patience, while maintaining vigilance over interest rates and the credit markets.

We continue to favor a ladder barbell structure with plenty of short maturity bonds for extra safety. Our short-term TIP's (Treasury Inflation-Protected Securities) are working out well and the T-bill's and short-term Treasury notes have been a safe harbor. We were a bit premature in picking up a couple of high-quality longer-maturity holdings like the 5% 2045 U.S. Treasury bond and the **Vanguard Long-Term Corporate Bond ETF**, but we believe prices are too oversold at this point to bail out and better days are ahead.

Holding bonds across the yield curve allows us to collect attractive income today, blending stability at the short end and the potential for price recovery at the long end, without having to guess exactly when the turn will come. While recent price drops in the market can be unsettling, they have also driven ETF yields up to levels we have not seen in years. Right now, the **JP Morgan Income ETF** and **Invesco Variable Rate Preferred ETF** are yielding 5.8%, while our **Vanguard** corporate bond ETFs are both producing a 6%+ annualized yield based on the most recent monthly dividend.

Our tax-exempt municipal bonds also experienced some price weakness. We plan to hold the individual bonds to maturity, while we did some tax-loss harvesting with the iShares CA Muni Bond ETF, and bought more of the Vanguard CA Tax-Exempt Bond ETF. For our higher income clients with a 41% combined marginal tax bracket, a 3.75% tax-free yield works out to a 6.36% taxable equivalent yield.

Tax & Financial Planning

- **Social Security COLA** – The social security administration has announced that recipients will be receiving a 3.6% COLA (Cost of Living Adjustment) beginning in January. This is up from 2.8% last year.
- **Charitable contribution deduction** – For 2026, taxpayers who take the standard deduction may now deduct up to \$1,000 of cash gifts to qualifying charities (\$2,000 for married couples filing jointly).
- **Qualified Charitable Deduction (QCD)** – For those age 70 ½ or older, you have the ability to give directly from your IRA to a qualified charity and you do not have to recognize the income. The limit is \$111,000 per person and can satisfy all or part of your RMD (required minimum distribution).
- **Estate and gift thresholds** – The federal estate and gift tax exemption is now \$15 million per person, indexed for inflation. The annual gift tax exclusion remains \$19,000 per recipient for 2026, with no tax consequence to the donor or donee.

- **Retirement limits and the new Roth catch-up rule** – The 401(k) deferral limit is \$24,500 for 2026, plus a \$8,000 catch-up for workers age 50 and older (\$11,250 at ages 60–63). The IRA limit is \$7,500, with an extra \$1,100 at age 50. New this year, workers whose prior-year wages from their employer exceeded \$145,000 must make 401(k) catch-up contributions as after-tax Roth contributions.

Minimizing income tax is an integral part of our wealth management process. We are happy to engage with you and your CPA for a year-end tax projection to avoid any surprises down the road.

Pledged Asset Line

If you have any large cash needs but don't have the funds handy, this borrowing tool might be of interest. It comes with a variable interest rate that's currently lower than traditional mortgage rates, no fees or prepayment penalty, and interest only monthly payments. You pledge securities in your brokerage account (non-IRA) as collateral for a loan from Schwab Bank. Your interest rate depends on the size of your overall relationship with Schwab, and you can borrow approximately 70% of the value of your account. This can be an effective strategy for a real estate purchase without having to sell securities and realize capital gains. For more information, check out the following link: <https://www.schwab.com/pledged-asset-line> or give us a call.



Year-End Review Meeting

If it's been a while since we've talked, we will be reaching out over the next few weeks to catch up and see if you would like to schedule a meeting (phone, video, or in-person) to discuss your portfolio along with any other pertinent financial or personal matters.

We are a Fee-Only Independent Registered Investment Advisory firm. In addition, Warren, Nick, and I are licensed as CFP® professionals and held to the highest standards of conduct. We have a fiduciary duty to always act in your best interest. It is a privilege to serve as your advisory firm and we appreciate the opportunity to be of assistance in building and protecting your hard-earned dollars. Please let us know if you have any comments or questions.

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