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Third Quarter 2025 Commentary

Dear Clients,

Please find enclosed your Third Quarter 2025 Investment Reports. Global indexes were up across the board for the quarter ending September 30, 2025. U.S. Large Cap Stocks and Emerging Market Stocks led the way again this quarter, up +8.8% and +10.6% respectively. US Mid Cap Stocks, US Small Cap Stocks, and Developed International Stocks produced positive quarterly total returns of +5.3%, +7.5%, and +4.8% respectively. U.S. Bonds returned a bit more than their coupon, with a +2.0% return for the quarter, while Global Bonds were a bit weaker at +0.6%. Annualized five-year total returns for all stock indexes except Emerging Market Stocks are now in double digits, while bond indexes have experienced negative total returns over the same time period because of rising interest rates. Consider, for example, that the 10-year US treasury yield has risen from 0.68% five years ago to 4.15% today.

Benchmark Returns

	Last Quarter	Last Twelve Months	Last Five Years (annualized)
U.S. Large Cap Stocks	8.8%	19.5%	16.9%
U.S. Mid Cap Stocks	5.3%	13.1%	12.5%
U.S. Small Cap Stocks	7.5%	8.7%	12.2%
Developed International Stocks	4.8%	15.0%	11.2%
Emerging Market Stocks	10.6%	17.3%	7.0%
U.S. Bonds	2.0%	2.9%	-0.4%
Global Bonds	0.6%	2.4%	-1.6%

Data source: YCharts (get.ycharts.com/disclosure/). Past performance does not guarantee future results. It is not possible to invest directly in an index. Last five years data is annualized. Indexes in table are:
US Large Cap Stocks: CRSP US Mega Cap TR
US Mid Cap Stocks: CRSP US Mid Cap TR
US Small Cap Stocks: CRSP US Small Cap TR
Developed International Stocks: MSCI EAFE NTR
Emerging Market Stocks: MSCI Emerging Markets NTR
US Bonds: Bloomberg US Aggregate TR
Global Bonds: Bloomberg Global Aggregate TR

In 2025's first quarter commentary, we discussed two primary forces that drive stock returns: economic fundamentals and investor sentiment. Given the disparity between the five-year historical performance gap between stocks and bonds, this quarter we will reflect upon some forces that drive bond returns.

We will simplify our discussion by focusing on traditional stocks and bonds (hybrid financial instruments have characteristics of both). One of the key differences between stocks and bonds is this: if you own a stock, the amount and timing of repayment was unknown when you purchased it, whereas if you own a bond, the promised amount and timing of repayment was known when you purchased it.

Consider conditions five years ago, in the fall of 2020, which was six months after the first global effects of Covid. Economic uncertainty was elevated, reflected by the fact that U.S. unemployment had just spiked to an all-time modern era high. Amidst the uncertainty, investors could choose (for example) a bond with known repayment, a U.S. 5-year U.S. treasury that was offering 0.28% of annualized return, or stocks with unknown repayments. If you needed your money in five years, and held that U.S. treasury until now, you earned 0.28% (annualized). The key point: the bond performed as it was expected to do so. However, the economy did much better than *expected*, so other assets (stocks) enjoyed that *unexpected* upside that ultimately materialized.

Knowing what you expect to get back, and when you expect to get it back, is a core reason why bonds are often considered safer investments than stocks; bonds allow you to plan for your known future needs more easily.

However, bonds are not risk free. Just because you are promised a specific future cash flow does not mean it will materialize. The promising borrower may cease to have the means to pay. For this reason, we say that bonds

have "credit" risk. Credit risk is the risk that the borrower will default on the timing and / or amount of promised repayment.

One of the reasons the U.S. government is in a unique position when it comes to borrowing is that it can create the cash that it has promised to pay borrowers. In this sense, the U.S. government is often considered "[credit] risk free". Of course, the government could, for political reasons, still decide not to repay an obligation on time, but there is no structural reason why it cannot repay all its debts by simply creating more money.

This brings us to another risk with bonds: inflation. For a generation of bond investors, inflation risk was a mostly latent concern, but that risk has come back to the forefront. Annualized inflation in the United States has now been above the Federal Reserve's stated target of 2% for nineteen straight quarters (almost the full five years in our table). Inflation eats away at the purchasing power of the future returns of bondholders. You get back your promised cash, but you can purchase fewer goods and services with it than you expected.

After periods of high inflation, investors reacclimate to this risk and force new arrangements. For example, after the U.S. Civil War, investors began to demand that debt contracts, both public and private, include a gold clause allowing for repayment in cash, or if the lender chose, gold of a fixed quantity. Bondholders wanted to protect themselves from inflation (the kind of inflation they experienced in wartime). However, governments have historically struggled politically when they have no ability to create inflation because governments typically aim to stimulate demand when the economy is in a recession and unemployment is high (the populations who keep governments in power change their support when unemployment is high). As a result, on June 5, 1933, in an effort to escape the Great Depression, the United States government nullified the gold clauses that protected U.S. bondholders from inflation.

Some of the modern mechanisms to protect government bondholders from inflation come in the form of Treasury Inflation Protected Securities (commonly referred to as TIPS). TIPS were first issued by the U.S. government in 1997, though the idea for such instruments has been around for longer. For example, the U.K. government issued its first such bond in 1981, while the Massachusetts Bay Company issued such bonds in 1780. Modern U.S. TIPS can be a useful addition to an investor that has known cash needs in the future but does not want exposure to inflation risk.

Beyond inflation risk, bond prices also reflect current market expectations as they relate to future economic growth. Bonds ask you, the investor (as lender), to give up purchasing power today for purchasing power tomorrow. Humans are risk adverse and prefer a bird in the hand to two in the bush. To provide an incentive to forgo the cash today and take on the risk that the borrower might not repay, bonds must in theory offer a positive rate of return. That rate of return, or interest, reflects prevailing expectations about future economic conditions. When you purchase a bond, you know what rate of return you will receive (assuming the borrower stays solvent). Can you get a better rate of return if you wait another month to lend your money? It depends largely on how economic expectations shift over that next month.

Do bonds still have a place in a portfolio? Absolutely. The 5-year U.S. treasury rate today offers about 3.74% annualized, much higher than the 0.28% that was offered five years ago. You could also buy a 5-Year TIP that will pay you 1.37% plus realized inflation per year. (If future inflation averages 2.37% over the next five years, you would be indifferent between these two bond choices.) Either way, bonds remain the most straightforward way to provide for known future cash flow needs.

Today, U.S. stocks are priced as if future earnings growth will be as strong as it has ever been in the modern era. If you buy stocks, you agree that this thesis is true (or better). If you buy bonds, you do not have to make that prediction. If you mix stocks and bonds, you take a middle ground as far as future economic expectations.

As always, we thank you for your continued trust in us.

Leavell Investment Management, Inc.