



October 2026

"Interest rates are to asset prices... sort of like gravity is to the apple."
– Warren Buffett, 2013 Berkshire Hathaway annual meeting

INVESTMENT PERSPECTIVES

Paid to Wait: Starting Yields, Shareholder Returns, and the Paycheck Illusion

The third quarter brought a reminder of how much interest rates matter. Corporate America kept delivering, with S&P 500 companies on track for a third straight quarter of earnings growth above 25%. Yet much of the quarter's attention went to the bond market, where yields climbed to levels not seen in more than two decades and the Federal Reserve raised rates for the first time in three years.

Higher rates are a mixed blessing. They raise borrowing costs for governments, companies, and households, and they weigh on the prices of bonds already outstanding. They also mean that savers are once again being paid well to wait. As Warren Buffett has observed, interest rates act on asset prices the way gravity acts on an apple, and this quarter that pull grew noticeably stronger.

Against this backdrop, this quarter's *Investment Perspectives* explores three themes. First, what is happening in the bond market, why a difficult decade for bonds has created a better starting point, and how we think about owning them. Second, how companies return cash to shareholders, why the S&P 500's dividend yield sits at a record low even as dividend payments set records, and what it means that some of the largest buyers of their own stock became issuers this year. Third, what we call the paycheck illusion: the tendency to treat income as free money, and the better question to ask of any yield.

What ties these themes together is a single question: where does an investor's return actually come from? Income is one part of the return earned by owning productive assets at sensible prices, and this quarter the sources of that return shifted in ways worth understanding.

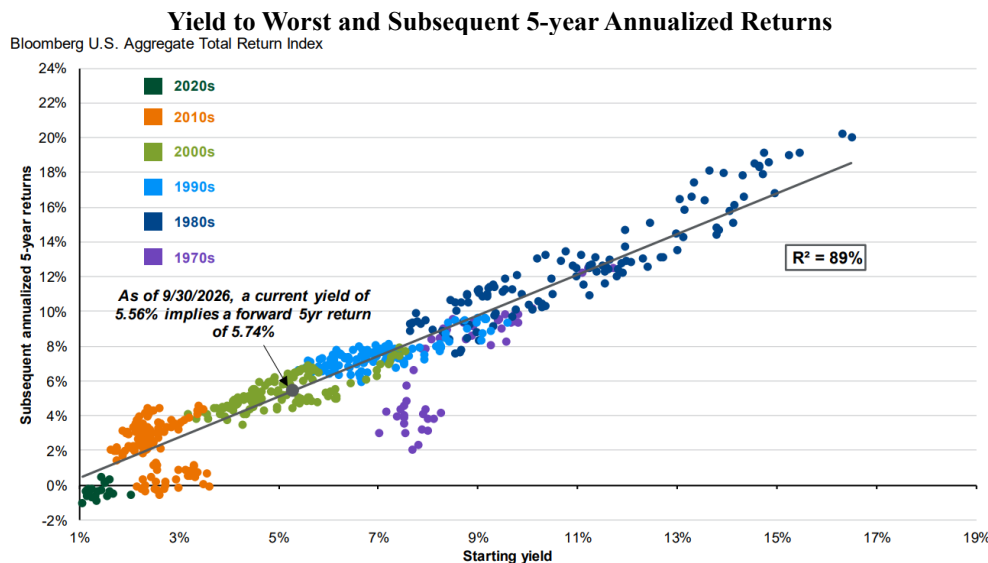
Fixed Income: A Better Starting Point

If you have followed the financial news this fall, you have likely seen headlines about turmoil in the bond market. The 10-year Treasury yield, the benchmark for everything from mortgages to corporate loans, ended September at 5.29%, near its highest level since 2002 and more than a full percentage point above where it began the year. The Federal Reserve raised short-term rates in September for the first time in three years, even as hiring slowed sharply. Rising rates alongside a cooling job market can seem contradictory, so it is worth explaining what is behind them.

Three forces are pushing longer-term rates higher. The first is inflation, which has run above the Fed's 2% target for more than five years and picked up again this year as the conflict with Iran drove energy prices higher, driving consumer prices up 3.4% over the past year. The second is borrowing. The federal government continues to run large deficits, and corporations are issuing debt at a record pace, much of it to fund the buildout of artificial intelligence. The third is that central banks abroad are raising rates as well. When lenders worry about inflation and see a heavy supply of new bonds coming, they demand more interest to lend for longer.

For bond investors, the past decade asked for a great deal of patience. Yields began the period near historic lows, offering little income to work with, and the sharp rise in rates in 2022 took back several years of gains. Over the ten years through this summer, the broad U.S. bond market returned about 1.4% a year, less than the pace of inflation. Even this year, rising yields have trimmed bond prices, leaving the broad market down roughly 2.5% for the year as of late September.

That history helps explain why the outlook is brighter. A bond's starting yield has historically been a strong guide to what it will earn in the years ahead. Research from PIMCO shows that since 1976, the yield on the broad bond market has had roughly a 94% correlation with its return over the following five years. Today that market yields roughly 5.5%, compared with less than 2% for much of 2020 and 2021. Inflation-protected Treasuries now pay about 2.9% above inflation, the highest in nearly two decades. The difficult years reset bond prices lower and yields higher, and new money now starts from a far better position than it has in many years.



Returns are 60 -month annualized total returns, measured monthly, beginning 1/31/1976. R^2 represents the percent of total variation in total returns that can be explained by yields at the start of each period.

We approach this opportunity with a few firm principles. We do not try to predict the direction of interest rates. Instead, we build portfolios of individual bonds as ladders, with a portion maturing each year. As each bond matures, the proceeds can be reinvested at the far end of the ladder, keeping its structure intact and putting that money to work at prevailing rates, or they can be used to supplement income. Because part of the portfolio comes due on schedule, the strategy does not depend on correctly forecasting rates.

Our first priority is preserving principal, and we do not chase yield. We buy only investment-grade bonds, and we evaluate each issuer ourselves rather than relying on its credit rating alone. We continue to monitor credit quality after we buy and will sell a bond if its quality declines. Today that discipline costs very little in forgone yield. The extra yield investors earn for taking corporate credit risk sits well below its long-run average, while high-quality bonds pay well on their own.

Bonds also play two practical roles in a portfolio: stability and liquidity. An individual bond held to maturity returns its face value, barring default, regardless of where rates move in between. That gives a client a known sum of money on a known date. This predictability allows a bond ladder to fund planned spending. When stock prices fall, we can draw on maturing bonds rather than sell stocks at depressed prices, and we can use bond proceeds to rebalance into stocks when prices are attractive. Cash has a role as well, and money market funds now hold nearly \$8 trillion, but cash yields reset quickly whenever the Fed changes course. Bonds can lock in yields for years.

What matters to our clients is the yield they keep. Depending on each client's tax bracket, we choose between taxable and tax-exempt bonds based on which offers the higher yield after taxes. For a California resident in the top bracket, combined federal, state, and investment income taxes can exceed 50%, making the tax exemption on qualifying California municipal bonds particularly valuable. Treasury interest, meanwhile, is exempt from state income tax, and for clients in lower brackets, Treasuries or high-quality corporate bonds may come out ahead. As we assess the most appropriate bonds for each client, we analyze which bonds deliver the best after-tax yield in the current market environment.

Where the Cash Goes: Dividends, Buybacks, and Big Buyers Turning Issuers

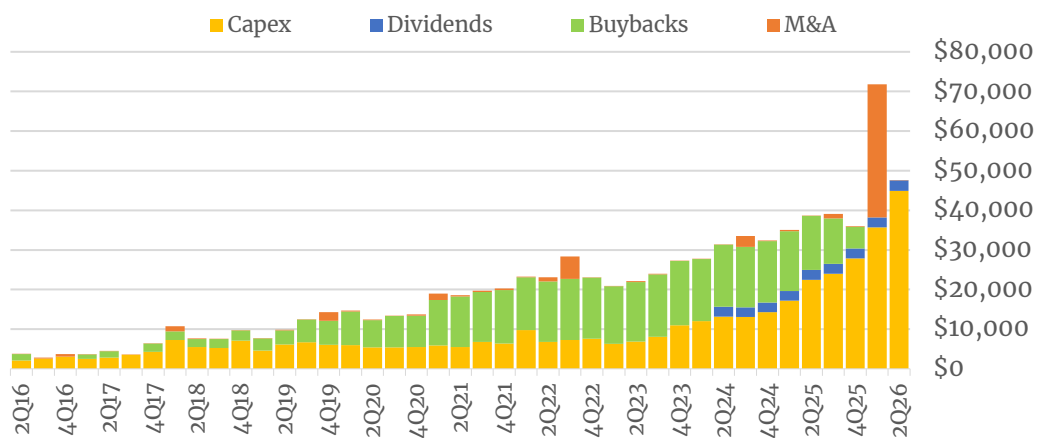
Higher bond yields change the math for stock investors too and nowhere is that clearer than in how companies return cash to shareholders. The S&P 500's dividend yield has fallen to about 1.04%, the lowest on record and below even the 1.11% reached in September 2000. That might suggest dividends are disappearing. They are not. Dividends per share reached a record \$78.92 in 2025, up 5.5% from the year before.

The yield is low for two reasons. Stock prices have risen faster than dividends, and companies now send more of their cash back through share buybacks. In the twelve months through September 2025, S&P 500 companies spent a record \$1.02 trillion repurchasing their own shares, compared with \$665 billion in dividends, so roughly 61% of the cash returned to shareholders came through buybacks. The two tools serve different purposes. A dividend is a commitment that boards are reluctant to cut. A buyback is flexible and can be paused whenever a company needs the cash for something else.

It helps to keep a basic principle in mind. A dollar paid out as a dividend is a dollar that leaves the company, and the share price adjusts accordingly, all else equal. What creates value for shareholders is what a company earns on the dollars it keeps and, for buybacks, whether the company pays less for its shares than they are worth.

This year, companies used that flexibility. In the first quarter, buybacks across the S&P 500 grew about 1% while capital spending rose 38%, as the largest technology companies redirected cash toward data centers for artificial intelligence. Alphabet repurchased no stock in the first half of 2026, compared with \$28.3 billion a year earlier, and in June it raised \$49.6 billion of new equity along with \$20.3 billion of new debt. Together, the five largest technology spenders issued about \$220 billion of bonds through August. Some of the market's most generous returners of cash have become, at least for now, raisers of it.

Alphabet (GOOGL) Capital Allocation



Source: FactSet

Whether that is good news depends on the returns those investments earn. The early evidence is encouraging in places: Google Cloud revenue grew 82% in the second quarter, and its operating income roughly tripled. Our test is the same one we apply to every holding: new capital must earn well above its cost. With a Treasury bond now paying more than 5%, that hurdle is higher than it has been in years.

This is why we look at shareholder yield, the combination of dividends and net buybacks, alongside the growth a company funds by reinvesting at high returns. The companies we favor tend to pay modest dividends that rise over time, reduce their share counts gradually, and reinvest the rest at attractive rates. Berkshire Hathaway, one of our holdings, pays no dividend at all, reflecting its preference for allocating capital within the business. Today the S&P 500's earnings yield, about 5.3%, is roughly equal to the 10-year Treasury yield. Although the two measures are not directly equivalent, the comparison underscores how much the case for stocks depends on future growth. That raises the importance of owning businesses that can compound earnings over time.

The Paycheck Illusion

Many investors think of dividends and other income as a paycheck: money that arrives regularly and leaves the underlying investment untouched. Research suggests that view can be costly. In a study published in the *Journal of Finance* in 2019, Samuel Hartzmark and David Solomon found that investors tend to treat dividends as a separate stream of income and overlook that each payment comes out of the share price. They called this the free dividends fallacy, and they found that demand for dividends rises most when interest rates are low and other sources of income are scarce.

The financial industry is very good at meeting the demand for income. Funds that sell options on the stocks they own may distribute 8% to 11% a year, but those payments come with trade-offs. Selling options gives away part of the portfolio's potential future gains, and the tax treatment of distributions depends on the fund's structure and the source of the payment. Private credit funds offered steady distributions for years, until this year, when many limited withdrawals to 5% of assets per quarter as investors asked for their money back. One of the largest has now done so for three straight quarters.

Every yield comes from somewhere. It may be payment for lending money over time, taking credit risk, accepting that an investment cannot be sold quickly, or giving up future upside. Sometimes a distribution is simply your own capital being handed back to you. The useful question to ask of any income stream is who is paying it and what you are giving up to receive it.

For clients who rely on their portfolios, we believe there is a better approach than chasing yield. We plan spending around total return, the combination of income and growth across the whole portfolio. In practice, that means holding three to five years of planned withdrawals in a high-quality bond ladder, the same structure described earlier. This reserve reduces the need to sell stocks during a downturn to meet spending needs and gives the equity portfolio time to recover and compound. At today's yields, bonds can contribute more income toward those withdrawals than they could just a few years ago.

Looking Ahead

Interest rates act on investments the way gravity acts on objects, and this year that pull grew stronger. Higher rates have been uncomfortable for borrowers and for owners of bonds bought when yields were low. For investors with new money and a long horizon, they also create an opportunity: high-quality bonds offer more income, and companies face a higher hurdle for the capital they invest.

Three ideas guide us this quarter. Bonds offer income and predictable cash flows, and we own them with a focus on quality, structure, and after-tax results. We judge companies by how well they allocate capital among dividends, buybacks, and reinvestment. And we examine the source of every yield, so that the income our clients receive rests on a sound foundation.

Our approach remains the same: we own durable businesses at sensible prices, build bond portfolios for safety and dependable cash flow, and make decisions with the long term in mind.

Thank you for your continued trust. As always, we welcome your questions about markets, your portfolio, or how these themes apply to your own situation.

DISCLOSURES:

As of September 30, 2026, the following were the ten largest holdings of HCM:

Name of Issuer	% of Equity Portfolio	09/30/2026 Closing Price
Apple Inc	7.23%	\$333.02
Microsoft Corp	6.20%	\$512.90
Berkshire Hathaway Inc Class B	6.10%	\$497.95
Alphabet Inc Class A	5.25%	\$344.08
Exxon Mobil Corporation	3.85%	\$162.75
Progressive Corp	3.57%	\$207.31
Waters Corp	3.47%	\$439.39
Dimensional US High Profitability ETF	3.26%	\$41.91
Jacobs Solutions Inc	3.25%	\$135.27
Amazon.com Inc	3.17%	\$249.15

HCM's investment decision making process involves a number of different factors, not just those discussed in this document. The views expressed in this material are subject to ongoing evaluation and could change at any time.

Past performance is not indicative of future results, which may vary. The value of investments and the income derived from investments can go down as well as up. It shall not be assumed that recommendations made in the future will be profitable or will equal the performance of the securities mentioned here. While HCM seeks to design a portfolio which reflects appropriate risk and return features, portfolio characteristics may deviate from those of the benchmark.

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