Talbot Financial – Third Quarter 2021

Please find attached your Talbot Financial third quarter 2021 portfolio review to supplement your monthly account statements available from Schwab. The report provides a performance summary of your investment portfolio compared to the S&P 500 Total Return Index ("Index"), Talbot Financial's benchmark, and lists your investment portfolio holdings by industry sector.

Investment Review

The Index returned 0.6% for the third quarter, representing the fifth consecutive quarter of positive performance since last spring's pandemic lows. The quarter started off strong as supportive Federal Reserve policy, slowing Covid cases, and strong quarterly earnings reports drove the index up nearly 6% through July and August. Much of this gain was given back in September as government funding and shutdown concerns dominated the news headlines.

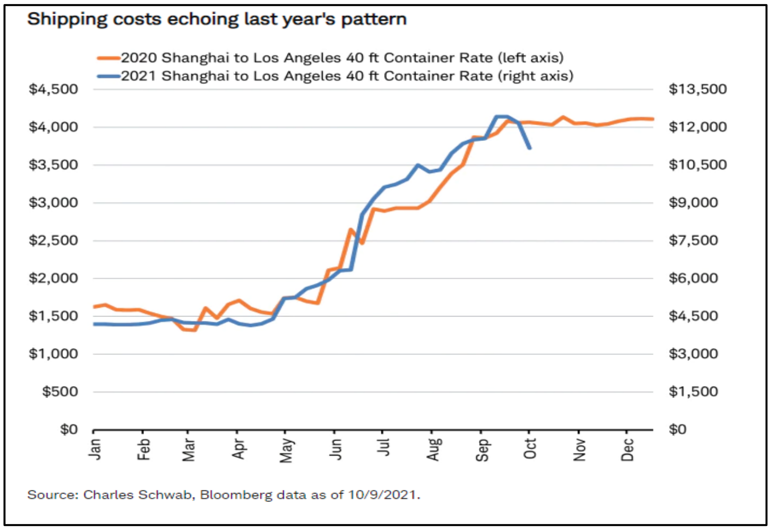
Our investment approach is to cut through the background noise and focus on financial results and financial outlooks as we believe a company's value is best measured by revenue and earnings. Both metrics were exceptional during the third quarter, with over 90% of the Index, and closer to 95% of Talbot Financial portfolio companies, reporting revenue and earnings ahead of consensus expectations. By comparison, both figures historically average closer to 65% for the Index, substantiating both the quality and the strength of businesses of large U.S. based companies, and in particular those companies owned in your portfolio.

As we all know firsthand, supply chain constraints continue to serve as a temporary drag on the economy. Historically, when the economy goes into a recession, businesses decrease their demand and suppliers scale back production. The cutbacks from both tend to follow the perceived magnitude of the pending recession. If a deep recession is expected, then cutbacks are significant. When coming out of recession demand and supply are often mismatched, leading to bottlenecks. This is what happened during the Covid-19 recession, and subsequent economic recovery.

The pandemic represented unchartered territory, so both demand and supply were scaled back dramatically. When the recession was short-lived at only one-month in duration, demand quickly rebounded and has remained robust ever since. Given the scale of supplier cutbacks at the front end of the recession, the supply chain has been playing "catch up" ever since. The imbalance created shortages across a wide-ranging number of products, including lumber, toilet paper, farm commodities, appliances, semiconductors, automobiles, and countless other consumer and industrial products.

One primary bottleneck has been at U.S. shipping ports, where cargo vessels remain idle while waiting to unload their goods. Two recent data points suggest shipping problems may have peaked. First, recent Purchasing Managers Surveys show that supplier delivery times have flattened and are no longer worsening. Second, the most recent data from the Marine Exchange of Southern California shows the cost of shipping a container on a downward trend.

The chart below depicts the cost of shipping a 40-foot container from Shanghai to Los Angeles (the world's busiest shipping route). The historic trend remains the same, i.e., shipping rates rise into the fall due to holiday shipping demand. However, the most recent cost of shipping (the blue line) showed a decline in the last couple of weeks.



If both trends hold true, then one major component of the supply chain may be opening back up and throughput of goods should begin to improve.

The relevance of the current supply-demand issues to your investment portfolio is both directly and indirectly connected to the semiconductor industry.

Chips, as semiconductors are often referred to, are the brains to electronic devices. In recent years, the use of chips has proliferated as they have become essential components to literally every industry, including communications, computing, healthcare, transportation, energy, and the military. It is highly likely that semiconductor chips are part of every electronic device you own, be it smartphones, gaming consoles, 5G modems, washing machines, electric toothbrushes, and refrigerators. In fact, every company in your investment portfolio leverages semiconductors in some fashion to either improve their product or enhance the efficiency of their underlying business.

As the Covid-19 crisis mounted, businesses from almost every industry pulled back on orders as they were unsure about the magnitude of the crisis. In turn, semiconductor manufacturers dramatically scaled back production and supply. Supply was further curtailed as natural disasters took two additional manufacturers offline late last year.

As the supply side contracted, two demand forces gathered momentum. First, with consumers working from home and going out less, there was a boom in demand for computers, gaming devices, streaming services, and e-commerce shopping. These devices, as well as the servers and distribution centers fulfilling e-commerce shopping, all rely on semiconductors. Second, the world-wide economy turned around much quicker than expected and demand for chips rebounded almost immediately.

The current circumstance is that supply is not able to meet high demand for chips. Importantly, in the case of many products such as an Apple iPhone, a shortage of chips does not mean a lost sale, but simply a deferred sale. Over the coming months as manufacturers retool, expand current capacity and build out new facilities, supply will catch up to demand and the shortage will self-correct. Importantly, for both semiconductors and the broader economy, many of the shortfalls in supply are due to overwhelming demand. Demand is there and remains robust.

Lastly, we encourage you to utilize several financial planning calculators available on our website, including retirement savings, home budgeting, and net worth calculators. The link to the calculators is: Talbot Financial | Calculators.

Our office in Bellevue is fully open and we would welcome the opportunity to review your portfolio in person, by phone or on a Zoom conference. Please contact us for a review, or to answer any questions you may have about your portfolio.

Sincerely,

Talbot Financial, LLC

www.talbotfinancial.com