July 7, 2023

Dear clients and friends of Sapphire,

The post-COVID period has proven to be a particularly intriguing time, with massive monetary intervention, uncertainty, and unintended consequences reminiscent of the Great Financial Crisis of 2008-2009.

Signals are mixed. Home affordability remains low, yet there is significant demand for housing. The inverted yield curve, often seen as an anticipation of a recession, contrasts with the current strength of corporate earnings and employment indicators. Additionally, while federal finances in the United States continue to deteriorate, the US dollar retains its position as the world's reserve currency. Furthermore, interest rates are rising, but US-based growth companies continue to trade at price-to-earnings multiples well above their 20-year averages.*

Currently, many money market funds yield roughly 5%, while long-term Treasury bonds (maturing in ten years or later) offer yields around 4%, which will scarcely preserve purchasing power if inflation doesn't continue to decline. Through June 30th, the S&P 500 index has demonstrated a remarkable year-to-date advancement of 16.9%. However, this performance was primarily driven by a handful of outliers, and without the contribution of these few large cap technology stocks, the index would have remained relatively flat. Internationally, despite ongoing challenges such as war in eastern Europe, restrictive central bank policies, and slowing growth in China, the EAFE index (Europe Australasia Far East) posted a return of 12.1% when measured in US dollars during the first half of 2023.

While we maintain awareness of the macroeconomic and investment environments, we acknowledge that these dynamics are beyond our control. As such, we focus on manager selection, security selection, asset allocation, and yield curve positioning to manage investment portfolios that address our clients' unique financial and personal circumstances.

Behavioral finance studies consistently highlight the human tendency to experience the pain of loss more intensely than the pleasure of gain. While *ability* refers to an investor's financial capacity to withstand market fluctuations, *willingness* pertains to psychological and emotional disposition towards risk. Investors may have the financial ability to absorb temporary or even permanent losses, but emotional responses to price volatility may make them more inclined to pursue a conservative investment approach. Listening closely to clients and developing an understanding of their objectives, our shared expectations, and our investment results are essential to our portfolio management process.

Sapphire views loss aversion as a useful psychological bias. We believe that avoiding permanent loss is an essential goal. A related consideration that guides our capital allocation discussions with clients is their investment *time horizon*. The question we consider no less than annually in some manner is, “When (if ever) will these assets need to be turned into cash?” Longer-term investment horizons can better accommodate price volatility, while shorter-term horizons are more susceptible to its effects. For clients with longer time horizons, a significant allocation to equities may be appropriate despite inherent price volatility. At this time, short- and intermediate-term US Treasury securities with relatively attractive yields can be used to meet the known cash needs of clients with shorter time horizons.

During our initial and ongoing discussions with clients, we explore personal factors that inform investment decisions. These factors may include the volatility of earned income, concentrations resulting from appreciated holdings in taxable accounts, real assets, financial leverage, private business interests, liquid and illiquid net worth, and the probability of significant unforeseen expenses.

A quote attributed to Benjamin Graham, who is known as “The Father of Value Investing” and who was Warren Buffett’s professor at Columbia Business School, serves as a useful reminder during periods of economic uncertainty and price volatility: “In the short run, the market is a voting machine but in the long run, it is a weighing machine.” With this in mind, we seek to avoid permanent loss by investing in what we believe to be heavyweights that exhibit sustainable competitive advantages and have the potential to compound value over the long run.

Please contact Sapphire at any time if you would like to discuss your portfolio or to learn more about how we can be of service to you.

Respectfully,

Paul Stropkay, CFA

* As we wrote last year, "In a rising interest rate environment, equity analysts using discounted-cash-flow valuation models increase the discount rate, which results in a lower estimated, present value of future cash flows – what Warren Buffett calls the intrinsic value of the security. When analysts publish a lower target price based on this type of analysis, downward pressure on the market price of the stock often follows."

Sources

- J.P. Morgan Asset Management *Guide to the Markets®* U.S. 3Q 2023 as of June 30, 2023

Disclosures

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