October 5, 2022

Dear clients and friends of Sapphire,

Interest rates continued to climb dramatically during the third quarter of 2022 and contributed to a negative 14.6% year-to-date total return for the U.S. Aggregate bond index. Bond prices and prevailing interest rates have an inverse relationship. The Fed has implemented multiple rate hikes and has used other means of quantitative tightening during 2022 with the goal of reducing inflation that has been fueled by factors including government stimulus/largesse, COVID-related supply chain disruptions, and ironically, Fed policy. Prime rate, which is relevant to many consumers and businesses, has increased from 3.25% to 6.25% during 2022 and may continue to increase in tandem with anticipated increases in the Fed funds target rate. While interest rates in the United States are not particularly elevated by historical standards, the speed at which the Fed has moved away from its "zero interest rate policy" has stunned investors who have counted on bonds to provide modest, but positive nominal returns.

As we wrote earlier this 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." Higher interest rates, slower expected earnings growth, the prospect of recession, and the escalating war in Ukraine have continued to put pressure on stock prices. On a year-to-date basis through September 30, 2022, the S&P 500 index delivered a total return of negative 23.9%. Over the same time period, international equities, as represented by the MSCI ACWI ex-US index, produced a negative 15.8% total return in local currency and a negative 26.2% total return from the perspective of domestic investors as the result of a strengthening US dollar.

While there has been "no place to hide" in recent months, there is a silver lining. Investment grade corporate bonds have recently offered yields approaching 5.7% and the valuation of "the market" as measured by the forward price-to-earnings ratio of the S&P 500 index is slightly below its twenty-five-year average of 16.8x.

Although headline-grabbing price volatility and perpetual noise from sources such as CNBC may tempt investors to react with immediate and frequent action, we remind ourselves of sage advice from Charlie Munger: "Don't just do something. Sit there." The future is unknowable, but we believe that investors will be rewarded for owning securities issued by high-quality companies – companies that feature proven management teams, produce durable cash flows, and exhibit financial strength. We believe that investors who adhere to a tailored investment policy and implement a rational investment philosophy will be well-compensated for demonstrating patience. We work with clients to develop and maintain a shared understanding of their anticipated cash flows, tax considerations, long-term objectives, and willingness *and* ability to take risk. These are essential considerations – and they change over time.

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

Paul Stropkay, CFA

Sources

- J.P. Morgan Asset Management *Guide to the Markets®* 4Q 2022 as of 09/30/22

SAPPHIRE FIDUCIARY ADVISORS

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