



Sapphire Star Capital Small Cap Strategy Q3 2023

Commentary

In Q3 2023, the Russell 2000 Index experienced a downturn, dropping by 5.13% during this period. This performance reflects the general trend observed in the small-cap sector during Q3 2023. Despite this downturn, it's important to remember that market performances can fluctuate, and should be viewed in the context of long-term investment strategies.

The downturn of Small Cap Stocks can be attributed to several factors including interest rate conditions. Small cap companies can be more sensitive to a higher rate environment and the Russell 2000 has a higher sector weight in financials, making it more leveraged toward interest rate conditions. Secondly lending difficulties make it more often challenging for small-cap companies compared to larger cap companies to negotiate lower lending rates. Thirdly, the economic changes that small cap stocks endure relative to large cap stocks since small cap stocks tend to be smaller younger companies that are more likely to be impacted by changes in the economy. Lastly, the Fed's actions tend to have a higher impact on small cap stocks relative to large cap stocks. Therefore, the market backstop the Fed has previously provided and their reluctance to allow the economy to enter a natural pullback created an environment that did not promote a small cap comeback the way large cap stocks were able to.

Portfolio Review

The Third quarter of 2023 can only be described as a typical soft 3rd quarter which was exacerbated by an overbought situation going into the quarter. Both the Sapphire Star Small Cap Strategy and the small cap market segment in general as measured by the Russell 2000 Growth and the Russell 2000 suffered during the quarter. The Sapphire Star Small Cap Strategy gave up (3.28%) net versus a much larger loss of (7.32%) for the Russell 2000 Growth Index and a significant loss of (5.13%) for the Russell 2000 Index. The three sectors that aided relative portfolio performance the most during the quarter included energy minerals, financials, and health technology. Industrial services, electronic technology, and communications were the three sectors which hindered relative performance the most during the quarter. Both stock selection and sector allocation contributed positively to relative performance for the quarter with sector allocation accounting for 86% of the outperformance. From a holdings perspective Alpha Metallurgical Resources Inc. 58.35%, Permian Resources Corporation 28.40%, and Northern Oil and Gas, Inc. 18.31% were the three stocks that helped absolute performance the most while Novanta Inc. (22.09%), Rambus Inc. (13.06%), and Mueller Industries (13.55%) detracted the most during the quarter. At the end of the quarter, electronic technology, energy minerals and finance sectors were the largest weighted sectors, while utilities, process industries and distribution services were the least weighted sectors represented in the portfolio.

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Looking Forward

Despite the recent performance, the long-term growth potential of small cap stocks remains. Investors willing to accept slightly more risk in exchange for higher potential gains will still find value in including small cap stocks in their portfolios. Investing in small cap companies, those with a market capitalization between \$20 million and \$13.5 billion, as measured by the current market capitalization range of the Russell 2000 Index, can offer significant benefits. Here are some key advantages:

1. **Growth Potential:** Small cap stocks often have higher growth potential compared to larger companies. Many successful large-cap companies, such as Microsoft, Amazon, or Netflix, started as small caps. Investing in these companies at an early stage could lead to substantial returns.
2. **Undervalued Opportunities:** The share price of small-cap stocks is often lower, making the initial investment easier. Moreover, many institutional investors and mutual funds have rules restricting them from buying small-cap stocks, which can lead to these stocks being undervalued.
3. **Merger and Acquisition Activity:** Small-cap companies are often targets for mergers and acquisitions, providing another opportunity for investors.

Although 2023 has proven difficult for small cap investors, as of the end of Q3 2023, the Sapphire Star Capital Small Cap Strategy has returned +7.29% net for our investors versus +5.27% for the Russell 2000 Growth Index and +2.54% for the Russell 2000 Index.

As always, we welcome any questions or concerns and thank you for your continued confidence in the Sapphire Star Small Cap Strategy.

Regards,

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