January 2017

CYPRESS
CAPITAL MANAGEMENT

Dear Client,

Portfolio Review – January 2017

Despite the negative move early in the year, 2016 proved to be a reasonable year for equity markets globally.

Bonds generated essentially flat returns for the year.

2016 in Review

2016 started very poorly for equity markets. In the first 3 weeks of the year, global equity markets, including the Canadian market, were down over 8%. Despite the negative move early in the year, 2016 proved to be a reasonable year for equity markets globally and a particularly strong year for the market in Canada. After being down 8.3% in 2015, the TSX Composite returned 21.1% in 2016, primarily driven by significant gains in the Energy, Materials and Precious Metals sectors. In Canadian dollar terms, the S&P 500 returned 8.8% for the year and Developed Markets outside of North America were down a modest 1.5%. The past few years have highlighted just how skewed the Canadian market is to Energy and Resources compared to other developed markets globally.

After several years of positive returns, on the back of falling rates, bonds generated essentially flat returns for the year. The 10-year Government of Canada Bond opened the year with a yield of 1.39% and finished it at 1.72%. Over the course of the year, the US 10-year Treasury yield rose from 2.27% to 2.45%. These moves may appear modest, but at one point the yield on the 10-year bond in Canada dropped below 1% and was close to 1.4% in the US. Since the US presidential election, yields globally have risen sharply, causing bond prices to fall significantly. In the fourth quarter of 2016, the price to the 10-year bond in Canada dropped 5.9% and the 30-year bond dropped 12.9%. Despite the recent rise in yields (and associated decline in price), bond rates remain low by historical standards and we continue to view bonds as expensive.

The two big events during the year that were expected to impact markets were obviously the Brexit vote in the UK and the US presidential election. There are countless articles and op-ed pieces about what gave rise to the surprising results in both cases so we will not go into detail on that. We will however make a comment on the market reaction to the events. While both results were a surprise as far as pollsters and pundits were concerned, the overall impact on the market has been neutral to positive. It was somewhat surprising to us that the US presidential election did not lead to more short-term downside volatility given the slim odds Trump was given of winning by most major media outlets, but it is not surprising that markets have largely moved on.

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When evaluating the potential impact of any geopolitical event it is important to separate the political impact from the market impact.

The fact is neither Trump nor the Leave Campaign are proposing policies that will fundamentally alter the equity markets specifically or the capitalist system more broadly. By contrast if Trump was suggesting something extreme such as suspending property rights or nationalizing industries then investors should be concerned. Under the proposed policies there will be winners and losers in terms of individual industries and companies, but broadly speaking the impact on markets should be fairly muted. Politically, the reaction to both Brexit and the Trump victory is anything but muted, but that is politics. When evaluating the potential impact of any geopolitical event it is important to separate the political impact from the market impact.

How does Cypress Actually Work?

The primary purpose of these quarterly reports is client education.

The primary purpose of these quarterly reports is client education. The focus of the reports is on good investment practice, markets, and portfolio management in general. We try to put the current market conditions in historical context or address some of the more technical aspects of portfolio management such as asset allocation and return expectations. We are well aware that we often repeat ourselves in these reports, but we firmly believe the single biggest deterrent to investment success is bad decision making which is rooted in emotion, human biases, and a lack of understanding of how the markets work. The best defense against bad decisions is to have a solid plan and to actually understand what that plan is. Client education is about having clients buy in to the plan.

While this may sound something like a sales pitch for Cypress, this quarter we thought we would provide a review of Cypress more generally to give clients some insight into the firm's structure and operations. Many clients may be well aware of much of this information, but hopefully it will be a worthwhile review and will help reinforce clients' confidence in the firm's overall portfolio management practices.

A Bit of Background

We are focused entirely on servicing existing clients.

2017 is going to be Cypress' 19th year in operation. The firm currently manages over $3 billion in private client assets and employs 27 people. Staff includes investment professionals, portfolio administrators, a dedicated trader, new accounts personnel and an operations team that looks after compliance, settlements, performance measurement, amongst a great number of other things. The firm has no relationship managers or business development and marketing personnel. We are focused entirely on servicing existing clients.

Our scale allows us to provide clients with best-in-class service while still charging a fee that is amongst the lowest in the country for the service offered. Our structure allows us to access research from a broad range of providers and gives us total autonomy over the investment process. We are, however, not so large that we cannot add value by actively managing in Canada. When it comes to active management, size is the enemy of performance. We will continue to look to grow the firm through referrals and asset appreciation, but we are not looking to materially change our overall assets under management.

Fees and Client Service

Two of the very few things we can control are fees and client service.

We have no control over the noise that impacts short-term portfolio values. Changing investor sentiment, earnings surprises and geopolitical events are unpredictable, though often very obvious in hindsight. Two of the very few things we can control are fees and client service.

The fact is fees matter a great deal when looking at long-term investment returns. A reasonably constructed balanced fund might return 6% a year on average. If an investor is paying an annual management of fee of 2%, that works out to 33% of the overall return - that is very significant. Our maximum fee is 1% and in most cases is significantly lower overall due to our tiered pricing schedule. Our goal is to keep fees as reasonable as possible and also increase the overall return potential by having superior asset allocation when compared to the typical balanced account.

Failure to live with the volatility of the equity markets has been the undoing of countless investors.

With client service we strive to be very responsive to client queries and questions, and to be proactive where possible. Not only is this simply good practice, it is a crucial part of building our clients' trust in the firm. The more confident our clients are with the firm generally, the less likely they are to make negative emotional decisions during the inevitable periods of market volatility. Failure to live with the volatility of the equity markets has been the undoing of countless investors, so anything we can do as a firm to allow clients to more easily live with the volatility, we try to do it.

Investment Process

The decision making process is largely by consensus.

The investment team is made up of 8 portfolio managers. Each week the managers meet to discuss the firm's view towards the various asset classes and sectors and discuss any high-level events that are going on in the market. In a given week between 5 and 10 outside analysts from various investment banks or independent research providers visit our office to discuss specific sectors and companies and these analyst meetings would all be discussed by the managers. Each manager is responsible for specific sectors and stocks and will update the group as needed on their sectors. The decision making process is largely by consensus. No one manager has the final say on any given decision, rather the group must decide how to proceed. This process leads to some healthy debate and lengthy discussions, but these debates and discussions go a long way to preventing us from making poor investing decisions.

While no two Cypress clients will have identical portfolios, there is significant overlap in holdings. This means that for all the major holdings across the firm there are 8 people following events and developments concerning that security.

To ensure that we are entirely focused on the management of client portfolios, Cypress staff do not buy individual securities for their own accounts, rather our own exposure to the capital markets is through our internally managed pooled funds, exchange traded funds (ETFs), and government bonds. So we are completely invested alongside our clients. If we find a stock we would like to own personally the only way to gain exposure to that company is through the Cypress Pooled Funds.

Active in Canada, but Passive Outside

Very few managers add any value picking individual securities in the US or other developed markets versus simply owning a passive ETF based on an underlying index.

Most clients are, no doubt, aware that in Canada we focus primarily on individual securities, or our internal pooled funds, while for exposure outside of Canada we use almost exclusively passive ETFs. This strategy is not out of indifference towards markets outside of Canada, far from it. We recognize that outside of Canada we have no particular edge or insight that would provide with us with any expectation of consistently outperforming a broad index. The academic research on this topic is voluminous and it clearly shows that very few managers add any value picking individual securities in the US or other developed markets versus simply owning a passive ETF based on an underlying index. Furthermore it is virtually impossible to identify those few talented managers without the benefit of hindsight. In fact, the research shows that active management in most developed markets detracts value, sometimes significantly. Outside of Canada developed markets are highly efficient in terms of pricing individual securities.

For an individual investor, the focus should be on how much of their overall portfolio should be allocated to the market or sector, not which individual security to own.

In markets where pricing is inefficient and the sectors are skewed, there is the opportunity to add value by picking individual securities and that is what Cypress has done.

In Canada, the market is less efficient. In the global context, the Canadian market is very small and with almost 70% of the index concentrated in Resources and Financials, it does not provide an appropriate benchmark for building a well-diversified investment portfolio. The sector exposure in the US market, on the other hand, is far more balanced. In markets where pricing is inefficient and the sectors are skewed, there is the opportunity to add value by picking individual securities and that is what Cypress has done. To date we have been very successful actively managing in Canada and we believe we will be able to continue this success into the future.

Strategy and Outlook

2016 reminded investors how unpredictable the markets can be in the short-term. At the start of the year, if an investor had known the UK was going to vote to leave the EU and that Donald Trump was going to be elected President most people would have expected the markets to be down. Going forward the short-term unpredictability of the market is not going to change. Over the longer-term, the equity markets broadly still offer a reasonable expected return from these levels, while fixed income continues to look expensive. As such, we continue to view a broadly diversified equity portfolio as the best way for clients to protect and grow the purchasing power of their capital with the caveat that short-term liquidity needs should be set aside in an asset that is not subject to the volatility of the market.

Sincerely,

CYPRESS CAPITAL MANAGEMENT LTD.

Remembering Bradley Dean

As most clients are aware, Bradley Dean died tragically in a cycling accident in early November. Brad joined Cypress in 2011 and was an integral part of the investment and compliance team. His loss has left a tremendous void at the firm; he will be sorely missed. We would like to thank clients for all their kind words and support through what has been an extremely difficult time. Those wishing to honor Brad's memory can make donations to either the Burnaby Velodrome Club or Prostate Cancer Research. In addition, a memorial scholarship for deserving students in the music program at Semiahmoo Secondary has been established through the Vancouver Foundation. Anyone wishing to make donations can visit the links below.

www.burnabyvelodrome.ca

www.prostatecancerbc.ca/home

www.vancouverfoundation.ca/BradDean