Portfolio Review – July 2017

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A Brief Review of the Second Quarter

Equities

Global equity markets posted generally positive returns in the second quarter of 2017 with markets outside North America leading the way. Europe, under a cloud of negativity last year due to Brexit and fears of systemic disruption due to dramatic changes in government policy, posted the strongest regional return at 5.0%[1] in the second quarter. Overall, the world's Developed Markets[2] were up 3.7% in the quarter. Emerging Markets[3] have continued to be strong in the last year up 23.9% over the last 12 months and 3.7% in the second quarter. Performance in North America was more muted with the U.S. market[4] posting a gain of 0.5% in the second quarter. While in Canada, our markets fell as the Energy, Materials and Financial sectors all posted negative returns resulting in the S&P/TSX Composite being down 1.6% for the quarter.

Interest Rates and Currency

Interest rates in Canada remained low throughout the quarter with the yield on 10-year Government of Canada Bonds ending the quarter at 1.76%, up from 1.63% after having been as low 1.39% in early June. Interest rates in the U.S. were slightly lower over the quarter with the yield on 10-year U.S. Government bonds ending the quarter at 2.33%. The U.S. dollar fell 4.7% versus a basket of major currencies.

The Canadian dollar started the year at US$0.74 and has strengthened over the first half of 2017 to US$0.77. Stronger-than-anticipated recent economic numbers for Canada and comments from the Bank of Canada suggest an imminent increase in the Bank's policy rate.

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[1] C$ MSCI Europe
[2] C$ MSCI EAFE (Europe, Australasia, Far East)
[3] C$ MSCI Emerging Markets
[4] C$ S&P 500

<u>Asset Allocation – The Most Important Investment Decision</u>

Though we discuss asset allocation at length when clients join Cypress, it is important to review the process regularly. Having an understanding of the factors that influence the appropriate asset allocation will make it easier to maintain the appropriate strategy during the inevitable fluctuations in the equity markets.

While simple, "rule of thumb" asset allocation models based on age are widely accepted and used; we do not believe that they result in the best portfolios for investors.

Focus on each client's individual needs, their risk tolerance and when they plan to withdraw money from their portfolios.

Regardless of age, our approach is to focus on each client's individual needs, their ability to tolerate short-term negative volatility, and the timeframe in which they plan to withdraw money from their portfolios. For example, if the timeframe to withdraw funds is short, then the portfolio should be invested in short-term, fixed-income securities which are not subjected to the volatility of the equity markets. However, if the cash withdrawals are not required for several years, then we believe that inflation is the greater risk to the portfolio in this situation. We would then invest the majority of the assets in a diversified portfolio of equities which should provide a return sufficient to preserve the value of the capital after inflation (purchasing power) as well as provide a positive after-tax return.

Another factor to consider is an investor's ability to tolerate short-term negative volatility. While we believe that over the long-term, having the appropriate asset allocation is a suitable antidote to short-term volatility, the emotional impact of negative shocks to the portfolio can be difficult to withstand and must be considered.

As we have written about before (and we will surely be writing on it again in the future), the primary factors that should influence an investor's asset allocation are:

1. Investment Time Horizon
2. Withdrawal Requirements
3. Return Expectations and Objectives
4. Other Financial Assets

1. Investment Time Horizon

Many investors have a longer investment time horizon than they might initially contemplate.

An investor's investment time horizon can be defined by how long they expect their assets to be invested.

Many investors have a longer investment time horizon than they might initially contemplate. For investors expecting to live off the returns from their investment portfolio, the investment time horizon is approximately their life expectancy. As an example, a couple where each partner is 70 years old could have an investment time horizon of 20 years+. For those focused on passing wealth onto their children or grandchildren, the time horizon is even longer, and the portfolio could be viewed as a family "endowment" with an indefinite time horizon.

Examples of investors (or accounts) with shorter investment time horizons would be Registered Education Savings Plan ("RESP") accounts where the beneficiary is in their mid-teens, or accounts with assets set aside to make a major purchase in the near term.

The investment time horizon is important because it determines the level of short-term volatility a portfolio can reasonably be exposed to, and consequently, what a reasonable long-term return expectation for the portfolio is.

"The American stock market is similar to watching a person walk up the stairs with a yo-yo. People focus on the yo-yo going up and down, while the real story is the consistent movement of the person up the stair."

Tom Lewis summed up the relationship between short-term volatility and long-term returns with this analogy about the U.S. market (which we feel applies to all equity markets):

> "The American stock market is similar to watching a person walk up the stairs with a yo-yo. People focus on the yo-yo going up and down, while the real story is the consistent movement of the person up the stairs."

Not having the correct asset allocation to match your investment time horizon can be costly. Having a portfolio designed for a long time horizon when the actual time horizon is short may result in having to sell equities during times of short-term negative volatility (the yo-yo on the downswing). On the other hand, having a portfolio too focused on avoiding short-term volatility may not provide the investor with enough investment return to protect and grow their purchasing power (moving up the stairs).

The following table outlines the approximate appropriate asset allocation for various time horizons.

Investment Time Horizon	< 2 years	2 to 5 years	5+ years
Tolerance to Short-Term Volatility	Minimal	Moderate	Highest
Asset Allocation	Cash and Fixed income	Balance of Fixed Income and Equities	Equity Focused

2. Withdrawal Requirements

Many investors require regular withdrawals from their investment portfolios even though they have a long-term time horizon.

Depending on the necessity of the withdrawals, it is advisable to allocate two to four years of expected withdrawals to relatively low-volatility fixed income securities. The greater the necessity of the withdrawal, the more years' of expected withdrawals should be set aside in a "cash reserve." This cash reserve serves to insulate the investor from some of the risk associated with short-term volatility. When we experience short-term market declines, investors can take comfort knowing that they will not be forced to sell equities at depressed prices to meet withdrawal requirements.

It is also good discipline to reduce the equity allocation and increase the fixed income allocation if a significant withdrawal is expected in the near future (a property purchase, for example).

3. Return Expectations and Objectives

The best way we believe to achieve higher returns is to accept higher short-term volatility.

There is a direct correlation between the amount of short-term volatility in a portfolio and the expected long-term returns. Over the long-term, we expect different asset classes to provide different returns and the best way we believe to achieve higher returns is to accept higher short-term volatility.

While it is not possible to predict the future, given today's interest rate environment and equity valuations, we are of the view that investors can expect over the long-term to achieve the returns outlined in the table below.

Asset	Cash	Government Bonds	Investment Grade Corporate Bonds	High-Yield Corporate Bonds	Equities
Expected Long-Term Annual Return	0% to 1%	1% to 2%	2% to 3%	3% to 5%	5% to 7%+
Expected Short-Term Volatility	Minimal	Low	Low/Moderate	Moderate	High

Historically, investment returns have been in excess of the rates shown above. The U.S. and Canadian equity markets have achieved annualized total returns of 7.2% (in U.S.$) and 6.9% (in CA $) respectively in the 20-year period ending June 30, 2017. Current valuation levels suggest that bond returns should be much lower and equity returns could be somewhat lower over the next 20 years.

When setting a return objective, it is important not to forget about inflation. While inflation has been relatively muted over the past few years, anticipating annual inflation to be 2% or more over the next decade seems reasonable to us. This means that cash and government bonds are unlikely to preserve the purchasing power of the invested capital over the long-run and investment grade corporate bonds will preserve but not grow the purchasing power of the invested capital.

4. Other Financial Assets

In determining the appropriate asset allocation it is important to take into consideration all assets that provide a financial benefit. This includes not only all investment accounts but also pension income (both government and company benefits), real estate, future inheritance, etc.

So how does future income influence asset allocation?

Depending on the stability of the payments, pension income has similar characteristics to fixed-income securities or an annuity, as they both result in regular payments. When this is taken into account, an investor may find that they have a larger allocation to fixed-income type assets than they first assumed.

In summary, each investor will have different requirements and there may be other investor specific factors that influence the appropriate asset allocation. But, in general, a long-term investor who wants to protect and grow the purchasing power of their capital should invest the majority of their assets in a diversified portfolio of equities.

Keeping Cypress informed of any changes in personal circumstances that would affect any of the above factors is important to ensure an appropriate asset allocation is maintained for the portfolios.

The Importance of Diversification

It is important to remember that diversification is not only for downside protection, it is also critical to overall portfolio return.

Last year, unexpected events, like the result of the Brexit referendum in June, or the election of Donald Trump in November, highlighted the importance of maintaining a well-diversified portfolio. Although some International markets experienced significant volatility following the Brexit result, North American equities were only moderately impacted. Conversely, after an expected sharp drop in U.S. markets when Donald Trump was elected, the market actually rose and has remained positive ever since. Unexpected events are, by nature, unpredictable. Equity markets do not like uncertainty and respond with volatility.

It is through broad diversification that an investor can lessen the impact of this volatility over the short term and reduce the long-term risk of losses. Furthermore, it is important to remember that diversification is not only for downside protection, it is also critical to overall portfolio return. The European market, which has had a strong quarter and year had performed poorly and was volatile over the prior several years. It is important to maintain some exposure to challenging markets where valuations seem more reasonable, like Europe, in order to benefit from the eventual, longer-term recovery.

Outlook and Strategy

Currently, the equity markets around the world are trading at or near record levels, but the market valuation metrics are still reasonable by historic standards.

As mentioned in our last quarterly letter, equity markets around the world are trading at or near record levels but market valuation metrics, while high, are not unreasonable by historical standards. Interest rates have remained low which means that equity securities remain “the best alternative” for long-term investors who wish to earn positive returns after inflation.

In most years, markets have recorded intra-year declines of 10% or more even as the markets have continued to move higher.

We have continued to see a lack of volatility in equity markets. Within Canada, we haven't seen a major broad market decline since March of last year. Equity markets with such low volatility are not the norm, as in most years markets have recorded intra-year declines of 10% or more, even as these markets have continued to move higher. Therefore, we shouldn't be surprised when market volatility picks up.

While equity markets will continue to be volatile, 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.

New Cypress Clients

Recently, we have been asked by several clients if we are accepting new clients and what our investment minimums are. At Cypress, our main role is to care for our clients – providing competitive after-tax long term rates of return while keeping our fees low. We have done very little marketing over the last 15 years as most of our business has come through referral. We are more than happy to speak to any of your friends and family to determine if we are a fit for them, regardless of account size.

We will be reaching out to you in the next few weeks to review your portfolio. ***However, if there have been any changes in your circumstances which would impact or change your investment objectives, please give me a call immediately to discuss.***

Sincerely,

CYPRESS CAPITAL MANAGEMENT LTD.

Please see our website www.cypresscap.com for our latest Disclosure Statement.