2018 – Third Quarter Review

EQUITIES

While worldwide equity markets were generally up in the third quarter, the Canadian market[1] was down 0.6% bringing the total return for the year to 1.4%. Results in Canada were mixed over the quarter, with Materials, Energy, Consumer Discretionary, Consumer Staples and Utilities sectors all down while the rest of the market was up.

In CAD terms, the U.S. market[2] was the strongest of the major markets with gains of 5.9% in the third quarter, benefiting from tax reforms and trade war fears. The U.S. market posted a 14.1% return year to date in CAD terms. The International Developed[3] markets were down modestly in CDN$, returning -0.3% in the third quarter for a total return of 2.2% over the first nine months of the year.

REVIEWING OBJECTIVES

Managing portfolios that are tailored to clients' individual needs is of paramount importance to us at Cypress. In order to do this, a clear understanding of your objectives is required. One aspect of this is the Client Account Agreement Update forms we send out periodically (thank you for signing and returning them). These forms provide your portfolio manager with the most basic information needed to manage your portfolio based on your objectives and circumstances. In addition, we like to have consistent contact with our clients to get a more fulsome understanding of their personal circumstances.

We encourage our clients to review their own financial objectives regularly or when major changes occur. When reviewing your financial objectives, consider what are the purposes of this account? What are your liquidity requirements? If you are considering a major purchase or have any other major expenses upcoming (wedding, university, etc.), these need to be considered as short-term cash needs. Do you need to withdraw cash in the future? If so, how much and how often? These funds need to be secure and readily available at your request.

Next, consider your medium-term goals which we would define as any use of your funds to the best of your knowledge that you might require in the next 3 – 5 years. Many of these may be similar to your short-term goals. However, if you're planning to sell your home or change jobs eventually, this would be useful for your Cypress portfolio manager to know. We can take a longer-term view with these funds. Meaning, we have more certainty over 3 - 5 years versus 1 – 2 years on how equity markets may perform.

Finally, consider the goals you have for your future – when do you plan to retire? Make a major purchase? Have kids? All of these events create a picture that needs to match your portfolio.

[1] S&P/TSX Composite
[2] S&P 500
[3] MSCI EAFE (Europe, Australasia, Far East)

It is also important to consider restrictions on the account. Everything from withdrawal requirements, risk appetite and specific sectors or companies you would prefer to have or not have in your portfolio should be taken into consideration.

Good communication and ensuring your personal and family financial situation is well understood will allow us to provide a more tailored service and to ensure your portfolio is best suited for you.

ASSET ALLOCATION

This naturally leads into our next topic: asset allocation. Understanding your objectives leads to choosing an appropriate mix of stocks, bonds and cash for your account. We view this as one of the most important drivers of account performance. In fact, the vast majority of the total variation in returns is attributable to asset allocation - not specific stock picking[4]. Recently, we have had a number of clients mention an old "rule of thumb" that says, 100 minus your age should be your approximate allocation to equities with the remainder in bonds. It would be nice if the process was that simple but this likely leads to an inappropriate asset allocation.

Consider these numbers as calculated by Morningstar over a 90-year period ending in 2017:

Please note: We are presenting data from the United States because the data is more robust over a long time horizon.

Table 1

Asset Class	Nominal Returns	After Inflation	After Taxes & Inflation
Stocks	10.2%	7.1%	5.1%
Bonds	5.5%	2.6%	0.6%
Cash Equivalents	3.4%	0.5%	-0.8%

Source: Morningstar. Returns for 1926 – 2017[5]

Annualized returns of stocks over that time period were 4.5% higher than bonds after taxes and inflation. If an investor was concerned about avoiding the volatility of the equity markets, they gave up most of their return to inflation over the long-term. It's important to understand your financial objectives so that capital can be allocated into investments that will overcome the long-term loss of purchasing power due to inflation.

Here are two very simple examples:

Example 1:

A person who is 40 years old, employed, and has a $300,000 portfolio. The old "rule of thumb" would suggest this individual should have $180,000 of their wealth in equities and $120,000 in bonds. If the investor is saving for retirement and doesn't have a use for the money for several decades, 40% in fixed income is likely far too conservative as it may leave the portfolio vulnerable to long-term inflation risk. Referring to the table above, historically this would have exposed 40% of the account to 2 – 3

[4] "Determinants of Portfolio Performance" 1986 Financial Analysts Journal, Brison, Hood, Beebower

[5] Inflation over that time period was 2.9%. Stocks are represented by the Ibbotson® Large Company Stock Index. Government bonds are represented by the 20-year U.S. government bond, cash by the 30-day U.S. Treasury bill, and inflation by the Consumer Price Index. Federal income tax is calculated using the historical marginal and capital gains tax rates for a single taxpayer earning $120,000 in 2015 dollars every year.

decades of very little annual return for the purpose of avoiding short-term volatility.

Example 2:

This person is 70 years old, retired, and has a $1,000,000 portfolio. The "rule of thumb" would suggest this individual should have $700,000 of their wealth in bonds. Now we must consider their living expenses. Short-term market volatility becomes a greater issue now as the account is likely subject to regular withdrawals. Ideally, 3 - 5 years of withdrawals should be in near-cash and bonds to avoid exposure to short-term gyrations in the market and the rest likely should be in equities to mitigate longer-term inflation risk. The "rule of thumb" is potentially still too conservative if the investor doesn't need $700,000 for living expenses in the short-term and, therefore, a higher equity weighting may be more appropriate.

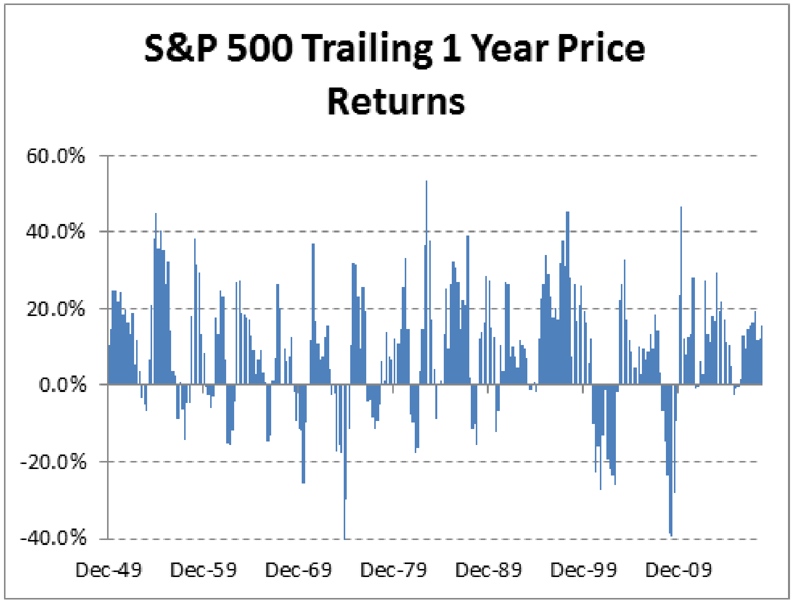
We think of risk as the chance that the amount of money you expect to have at a certain point in the future is not available

The problem with any "rule of thumb" is that it oversimplifies the solution. The real problem with this particular "rule of thumb" is that it hasn't been updated for today's interest rate environment, inflation assumptions as well as for longer life expectancy. For the last 35 years, interest rates have been falling and bonds generally have risen in value. The problem with long-term bonds today is that while rates rise their coupons payments stay the same, so to compensate for rising rates, the value of the bond falls (all else being equal). Since rising interest rates weren't a problem for so many years, bonds have earned a somewhat faulty reputation as being a less risky investment.

Risk can be defined in many ways, but for an investor we think of risk as the chance that the amount of money you expect to have at a certain point in the future is not available. This can roughly be broken into two parts, short-term risks (less than 3 - 5 years) and long-term risks (more than 3 - 5 years). Mitigating short-term risks has to do with avoiding short-term volatility.

Consider this graph of returns if you invested in the S&P 500 for one year periods from 1949 to present:

Graph 1



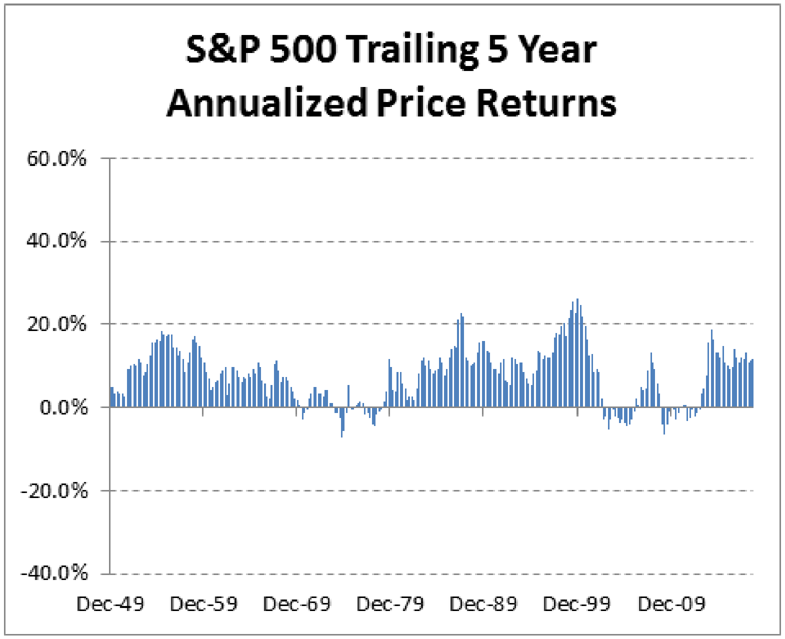
Source: S&P 500 Price Return Index. Returns calculated quarterly.

70% of the time returns were positive[6] but there were some extreme negatives.

[6,7] Calculated using price returns of the S&P 500 on a rolling 4 quarter basis

Now consider if your investment time expanded to five years:

Graph 2



Source: S&P 500 Price Return Index. Returns calculated quarterly.

Inflation quietly erodes purchasing power and is often ignored as a form of risk as it takes effect over the much longer term.

The chance that you lost money over the 5-year holding period is significantly reduced. However, the human tendency is to be more concerned about avoiding losses than achieving gains. A behavioural finance concept we wrote about in our last letter was Myopic Loss Aversion which tends to compel investors to try to reduce volatility as they have misconstrued this as risk.

Avoiding short-term volatility increases exposure to the long-term risk of a decline in the purchasing power of your capital over time. Inflation quietly erodes purchasing power and is often ignored as a form of risk as it takes effect over the much longer term.

The last asset class, which was not mentioned in the rule of thumb, is cash – essentially your savings account. We just don't know what the market will do over the short-term (see Graph 1) so any money needed in the next year or so should be kept in something very stable, secure and liquid. As you can see in the previous graphs, while the market is up 70% of the time[7], some of the down years are quite extreme. You likely don't want to risk a 30% chance that the money you need in the next two years is not there, or that you have to use a larger portion of your wealth than expected to achieve the same goals.

In summary, think about your asset allocation as buckets of capital you need at different times. The money you need in the short-term should be in near cash, medium-term in bonds, and long-term in stocks. This will help you mitigate long and short-term risks while maintaining purchasing power and gaining capital appreciation. So as you review your own personal and family financial situation, consider how much of your portfolio you need and when you might need it.

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.

CYPRESS CAPITAL MANAGEMENT US LTD.

We would also like to mention that your RRSP will soon have a U.S. Dollar side for your U.S. Dollar denominated securities. We have added this to reduce the currency conversion cost of trading and dividends/interest received. If you have any questions regarding this, please feel free to call.

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