2018 – Fourth Quarter and Year End Report

EQUITIES

This has been a difficult time for investors. Stock markets around the world have sold off in recent months resulting in broad global equity markets posting negative returns for the year.

Looking at specific regions, the Canadian market[1] was down 10.1% in the fourth quarter and down 8.9% for the year. Energy and Consumer Discretionary led the way with both sectors down double-digit percentages for the year. The only three sectors that posted positive returns for the year were Information Technology, Consumer Staples and Real Estate but these sectors only make up a modest portion of the overall Canadian market.

It is important to remember that we have seen similar negative market volatility in the past and we will continue to see it in the future.

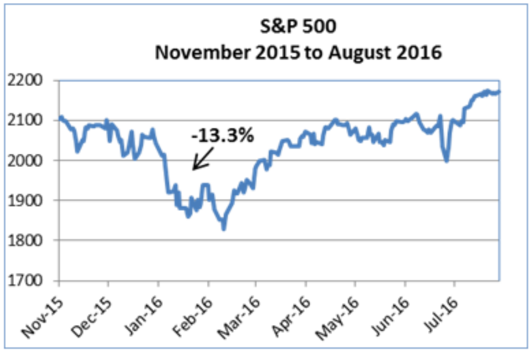
In US$ terms, the U.S. market[2] was down 13.5% for the quarter and down 4.4% for the year. Currency helped Canadian investors who were exposed to the U.S. In CAD$ terms, the U.S. market was down 8.6% in the quarter and actually ended up 3.7% for the year. The International Developed[3] markets essentially mirrored the Canadian market: down 7.9% in the fourth quarter and down 9.1% for the year in CAD$ terms.

RECENT EXAMPLES OF NEGATIVE MARKET VOLATILITY

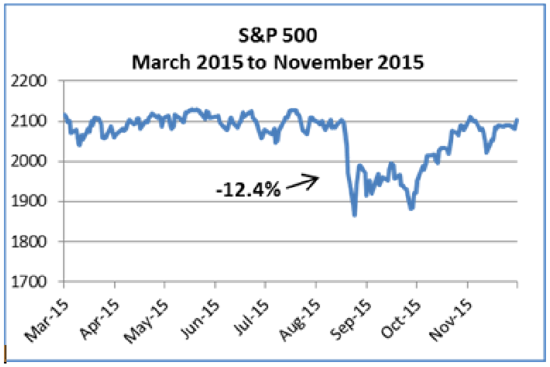
These sharp moves down can test the resolve of any investor, but it is important to remember that we have seen similar negative market volatility in the past and we will continue to see it in the future.

Since the 2008/2009 financial crisis, the U.S. market[2] has experienced four significant stretches of negative market volatility, which are each illustrated in the following graphs and coupled with a newspaper headline that appeared at the time.

Some investors may remember each of the events, but it is just as likely that these events have been forgotten as equity markets recovered and moved higher.



"RBS cries: Sell everything as deflationary crisis nears"
-Daily Telegraph Jan 11th, 2016



"US stock markets fall due to renewed concerns about the Chinese economy"
– The Guardian Sept 28th, 2015

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

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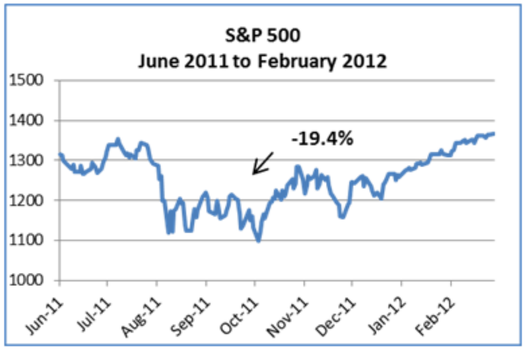
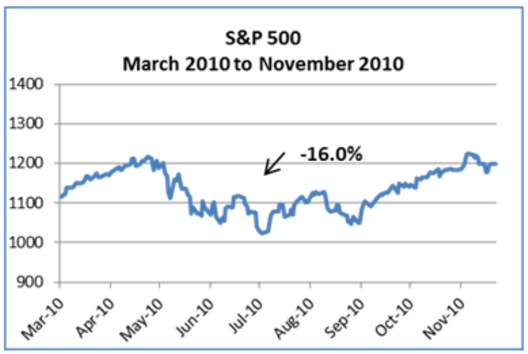


"THE GLOBAL ECONOMIC CRISIS. THIS COULD GET REALLY UGLY. Market Turmoil. World Leaders Floundering."
– Maclean's Magazine Cover Aug 2011.



"Stocks slammed by global slowdown fears"
– CNNMoney.com June 29th, 2010

This most recent instance of negative market volatility is likely eliciting additional reaction as the negative volatility has occurred at the end of the calendar year when many investors have a tendency to pay closer attention to their investment statements. The recent decline has also led to a negative calendar year return which, while an arbitrary time frame, tends to attract extra focus.

THOUGHTS ON THE CURRENT MARKET

The central question is whether the recent decline in the broad equity markets is the beginning of a sustained and prolonged bear market or whether this most recent decline is another example of the typical market volatility that occurs rather frequently. Keep in mind the decline in the equity markets has already occurred, what is important now is what will happen in the future.

While it is impossible to forecast with certainty, our view is that the recent correction is not the beginning of a prolonged and sustained decline. This view is primarily derived from our assessment that the global economy, while not particularly strong, should continue to grow and not slip into a recession in the near-term and that the valuations of the companies in which we invest remain reasonable.

Economy

While a wide variety of factors impact equity markets, a majority of prolonged bear markets have been associated with recessions. At present, our view is that global economic activity will likely slow in the near term but will continue to expand as the U.S. economy continues its long (albeit slow) expansion and the Chinese government continues to undertake expansionary monetary and fiscal policy. Overall inflation remains modest and interest rates (i.e. borrowing costs) remain low even after the recent rise. The probability of a recession in the U.S. or a dramatic slowdown in China in the near term appears to be low.

Canada's economic activity is on a less sure footing given low oil prices and relatively higher consumer debt, but the Canadian economy and in particular the Canadian companies in which we invest are heavily influenced by the wider global economy.

This is not to say that there are no risks. If political uncertainty in the U.S. and Europe or an escalation in the trade war between the U.S. and China (and others), begins to have a material negative impact on business and consumer confidence then real economic activity will be impacted.

Given that equity markets are highly liquid and investors have the ability to sell small portions of their investment, equity prices react quickly and often overreact to increased levels of uncertainty. Long-term business and consumer decisions that drive the economy are much less sensitive to daily economic news. While equity markets may react to the most recent headline, business decisions to invest in new products or an individual's decision to buy a new house or car are much more strategic and forward looking.

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Valuation

Valuation refers to the process of determining the 'fair' value of an asset or company. There are numerous valuation methodologies but one of the most straightforward is estimating the future earnings generated by a company and then deciding how much you are willing to pay today for those future earnings. This decision must take into account the uncertainty surrounding those earnings and the potential return on other investment options. The less certain that one is about the future earnings the less an investor should be willing to pay now.

The current equity price (i.e. current market value of a company) is compared against the estimated 'fair' value of the company to make a judgement as to whether the current equity price is reasonable.

The fair value of assets or companies will change based on changes to the estimates of future earnings, the degree of uncertainty and the relative value of other investment options, but these changes in value are generally modest compared to the sometimes dramatic short-term fluctuations of equity prices.

To illustrate (delving into a bit more detail than we normally go into in our quarterly letter) why we believe current equity prices appear reasonable, we can look to the large Canadian banks[4] that are a core holding in client portfolios. These companies operate as an oligopoly protected by the federal government, have a very long track record and can be expected to operate for a long time into the future.

In aggregate, the large Canadian banks are currently valued at approximately 9 times expected earnings in 2019 and pay approximately a 4.7 % dividend. Historically, over the past 10 years, the large Canadian banks have traded at around 11 times expected next year's earnings (with a range of approximately 7.5 to 13 times). If we assume the value placed on the future earnings remains at 9 times (which is about a 20% discount to the historical average) and that earnings grow at 4%, then investors should expect a compounded annual return in the range of 8 to 9% (4.7% dividend and 4% share appreciation). The assumptions are reasonable given that the average compounded annual earnings growth for the large Canadian banks over the past 5 years has been approximately 8% and is expected to be in the 6% range for the next few years.

Also to further illustrate the long-term track record of the large Canadian banks: RBC, TD and Scotiabank have increased their dividends at an annual compounded rate of over 11% from 2000 to 2018.

While over the long-term it may be reasonable to expect that the Canadian banks can deliver a compounded annual return in the 8 to 9% range to investors, this return will be earned in an inconsistent manner. It will be earned as it has been in the past. For example with a +14.6%[5] return one-year and a -7.9%[6] return another, due to equity price volatility.

[4] BMO, Scotiabank, CIBC, RBC, TD and National Bank.
[5] 2017 S&P/TSX GICS Bank Index Total Return
[6] 2018 S&P/TSX GICS Bank Index Total Return

INVESTMENT OPTIONS

In our last letter we wrote extensively about the importance of setting and reviewing your investment objectives. Although each individual has their own goals and objectives, the primary objective for many of our clients is to protect and grow the purchasing power of their assets over the long-term so that they can generate a sustainable income to cover current and future expenses. The only effective way to do this is to invest in something that generates an after-tax return well in excess of inflation.

When recent equity market returns are negative, it is natural to ask whether your investment objectives could be met through a less volatile investment. Generally, the answer is 'no'. A 10-year Canadian Government Bond currently yields just under 2% per year and a 5-yr GIC offers only a slightly better rate at around 3.5%, but the funds are locked up for 5 years. Neither of these options enables investors to meet their goals of protecting and growing their purchasing power over the long-run.

At present, the only way to achieve a return well in excess of inflation is to take on some form of uncertainty in your investments, or put another way, there is no free lunch in investing. This uncertainty can come in many different forms including credit risk on a loan (i.e. the probability you will not be paid back), liquidity risk (i.e. an investment that is difficult to sell) or short-term price risk. All investments that have the potential to earn a return above the steady return offered by Government Bonds will have some uncertainty. This uncertainty is sometimes obvious like short-term negative volatility experienced by equity prices or it may be hidden as is the case with private debt or equity holdings.

Looking across the potential investment options available to investors, our view is that for long-term investors the best option continues to be a well-diversified basket of equities. The risk from the uncertainty around short-term price movements can be managed through diversification and having a sufficiently long-term time horizon to ride out the volatility.

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The recent market volatility can create a strong urge to do something and to make dramatic changes. While we regularly review your portfolio and make changes based on the current market conditions, it is changes in your goals and personal circumstances that would lead to significant changes to the portfolio, not a stint of market volatility. 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 or if you have any questions, please give me a call immediately to discuss.

CYPRESS CAPITAL MANAGEMENT LTD.

Brian Alexander

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A couple of administrative items

- *The deadline to make an RRSP contribution for 2018 is March 1st 2019 and the TFSA contribution limit for 2019 has been increased to $6,000. Please contact us if you would like to transfer funds between your accounts to make either of these contributions.*
- *You have likely noticed that RRSP/RRIF accounts now have 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.