2019 – Second Quarter Review

MARKET REVIEW

After experiencing a significant drop of almost 20% in the fourth quarter of 2018 most global equity markets have recovered to meet or surpass their highs of 2018. While the swings both up and down in the market over the past nine months have been reasonably large, they cannot be categorized as extreme and are well within what one should expect in the context of historical market trends. In fact, looking at market history, the outlier is not the increased volatility of the past nine months; rather it was the lack of volatility for the preceding two years that was surprising.

While the swings both up and down in the market over the past nine months have been reasonably large, they cannot be categorized as extreme and are well within what one should expect in the context of historical market trends.

Looking at specific regions, the Canadian market[1] was up 2.6% in the second quarter and 16.2% year to date. The Information Technology and Industrials sectors were the strongest performers in the second quarter. The worst performing sector in Canada was Health Care, led down by the Marijuana stocks.

In US$ terms, the U.S. market[2] was up 4.3% in the second quarter and 18.5% year to date. Currency, which helped Canadian investors in 2018 worked against them in the first and second quarter. In CAD$ terms, the U.S. market was up 2.2% in the second quarter and 13.7% year to date. The International Developed markets[3] lagged the North American market; up 1.8% in the second quarter and 9.8% year to date in CAD$ terms.

ASSET ALLOCATION – THE MOST IMPORTANT INVESTMENT DECISION

Asset allocation is perhaps the most common topic we discuss with clients, both in our quarterly letters and in ongoing communication. Understanding the factors that determine the appropriate asset allocation makes it easier to maintain an appropriate strategy to deal with the inevitable fluctuations in equity markets.

At Cypress, our approach is to focus on each client's individual objectives/goals, their ability to tolerate short-term negative volatility, and the time frame over which they plan to withdraw money from their portfolios. For example, short-term cash needs should be invested in short-term fixed income securities which are not subject to the volatility of the equity markets, but have a lower expected return. If cash withdrawals are not required for several years, then we believe inflation is the greater risk to the portfolio. To preserve the value of the capital after inflation (purchasing power) as well as provide a positive after-tax return, the majority of the assets should be invested in a diversified portfolio of equities.

LONG-TERM EQUITY RETURNS – GIVE THEM TIME

The most comprehensive picture of equity market returns is provided by the U.S. equity markets as measured by the S&P 500 index. Since 1926, the S&P 500 generated a positive return (inclusive of dividends) in 67 of the last 92 years. In other words the annual return for the market has been up on average three out of every four years.

The probability of positive returns increases as the time horizon is extended. Over rolling 5-year periods the market has been positive 87% of the time and over 10-year periods the markets have been positive 98% of the time. The exception being the 10-year period between 1999 and 2009, which captures the peak of the tech bubble to shortly after the 2008 financial crisis.

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

We highlight this to show that the longer an investor can stretch out their investment time frame the more probable the outcome will be positive. If the uncertainty of equity returns can be alleviated, it will reduce investors' fear of short-term volatility and eliminate behavioural decisions that can derail a portfolio's long-term return.

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If investors can remain confident in the long-term direction of equity markets and can correctly match their investments to their capital needs, the more likely it is that they will stick to a plan, and experience a good outcome.

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

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

1. Investment Time Horizon

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

Many investors have a longer 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 to 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 long-term return the portfolio should expect.

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. 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.

The following table outlines our view on 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 Short-Term 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 short-term fixed income. 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 short-term market declines occur, investors can take comfort knowing they will not be forced to sell equities at depressed prices to meet withdrawal requirements.

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

Short-term volatility is the trade-off for higher returns, but if the returns are not required, avoiding the stress and anxiety of the volatility of the markets is a reasonable goal.

3. *Required Return and Objectives*

There is a direct relationship 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 we believe the best way to achieve higher returns is to accept short-term volatility.

While it is not possible to predict the future with certainty, 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 nominal (i.e pre-inflation) 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 6%	5% to 8%+
Expected Short-Term Volatility	None	Minimal	Low/Moderate	Moderate	High

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. Even at a modest 2% inflation, the purchasing power of a dollar is reduced by approximately 33% over 20 years. This means that the purchasing power of $10,000 today would be eroded to $6,700 20 years from now. Our view is 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 invested capital.

If your return objective does not require a higher rate of return, a portfolio constructed of assets that will reduce short-term volatility is a fine option. Short-term volatility is the trade-off for higher returns, but if the higher returns are not required, avoiding the stress and anxiety of the volatility of the markets is a reasonable goal.

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?

Pension income has similar characteristics to fixed income or an annuity, as they both result in regular guaranteed payments. When this is taken into account, an investor may find that they have a larger allocation to fixed-income type assets than 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 your portfolios.

OUTLOOK AND STRATEGY

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 purchasing power of their capital with the caveat that short-term liquidity needs should be set aside in an asset not subject to the volatility of the market. We will reach out to clients in the coming weeks, however, if your cash or spending needs have changed materially or you feel your current portfolio does not reflect your expected liquidity needs, do not hesitate to contact us.

ENVIRONMENTAL, SOCIAL AND GOVERNANCE ("ESG")

Environmental, social and governance ("ESG") are some factors we take into consideration when we make investments at Cypress. However, individuals' views on these issues can be highly variable. We would like to remind clients that if there are any particular companies or industries that you would like to include or exclude from your portfolio from an ESG perspective or for other reasons, please let us know. We would be happy to discuss any issues and accommodate your requests where possible.

ELECTRONIC DELIVERY OF CYPRESS STATEMENTS

Cypress has engaged with a third party vendor to provide secure access to Cypress quarterly statements through an online portal. We hope to offer this service to all clients ahead of the September 30 statements. Those clients who sign up for the online portal will no longer receive paper copies of Cypress statements. Clients who wish to continue receiving paper statements from Cypress are not required to sign up for the online portal. Individual portfolio managers and administrators will be contacting clients in the coming weeks with additional details and instructions.

CYPRESS CAPITAL MANAGEMENT LTD.