2019 In Review

2019 proved to be a strong year for equity markets globally. As such, the most important decision for an investor was simply to be invested in the equity markets. Which market was a secondary consideration. In Canadian dollar terms, the Canadian and U.S. markets returned 22.9%[1] and 25.2%[2] respectively. Developed Markets outside of North America gained 15.4%[3], while Emerging Markets were up 14.3%[4], also in Canadian dollar terms.

Interest rates remain very low with the 10-year Canadian bond rate closing at 1.7%, down slightly on the year.

A calendar year is a fairly short and arbitrary time horizon and much of the return in 2019 was a quick recovery from the sell-off in the fourth quarter of 2018. On a two-year basis the returns are more modest with Canada up 5.8% annually and the U.S. up 13.9%. Outside of North America the returns for the last 2 years were pretty meagre, around 3.5% a year for both Developed and Emerging Markets. All this simply serves as a reminder of how volatile the markets can be in the short-term and the importance of having a long-term time horizon.

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Cypress 20 Years On

2019 marked Cypress' 20th anniversary and while it may be somewhat cliché we thought we would take the opportunity to reflect on how the investment industry has evolved over the last 20 years. Like any industry, technology and access to information has changed the landscape for investing dramatically, however it appears to us that little has changed in terms of what it takes to be a successful investor.

What Has Changed?

Obviously much has changed in 20 years. What we have below are just some of the observations we have found most interesting or surprising.

Cost

The last 20 years has seen a dramatic reduction in trading and management cost. This has been a huge benefit to investors. In the late 1990s management expense ratios (MERs) on actively managed funds where often over 3%, whereas today MERs are typically closer to 2% and many are under 1%. The costs per trade in the late 1990s was in excess of $100 and is now typically less than $10 and in some cases even free - though there are some strings attached. Fees are one of the few things that investors can control and we expect to see a continued trend toward lower fees for trading and actively managed funds.

The fees on Exchange Traded Funds (ETFs) have also come down, though the impact to an investor's overall return is less dramatic as the fees were typically low from the outset. 20 years ago the MER for a broad market Canadian index was 0.17%, now it can be purchased for 0.05%. The U.S. leads the way in terms of cost. At the end of 2019 the U.S. Total Market ETF from Vanguard had an expense ratio of 3 basis points or 0.03%.

The rise of ETFs and passive investing

When Cypress was founded, passive investing was in its infancy and ETFs were largely unknown. The first ETFs were launched in the early 1990s and when Cypress opened its doors in 1999 there were only a handful of ETFs globally and only two ETF providers, State Street and Barclays (Vanguard didn't launch their

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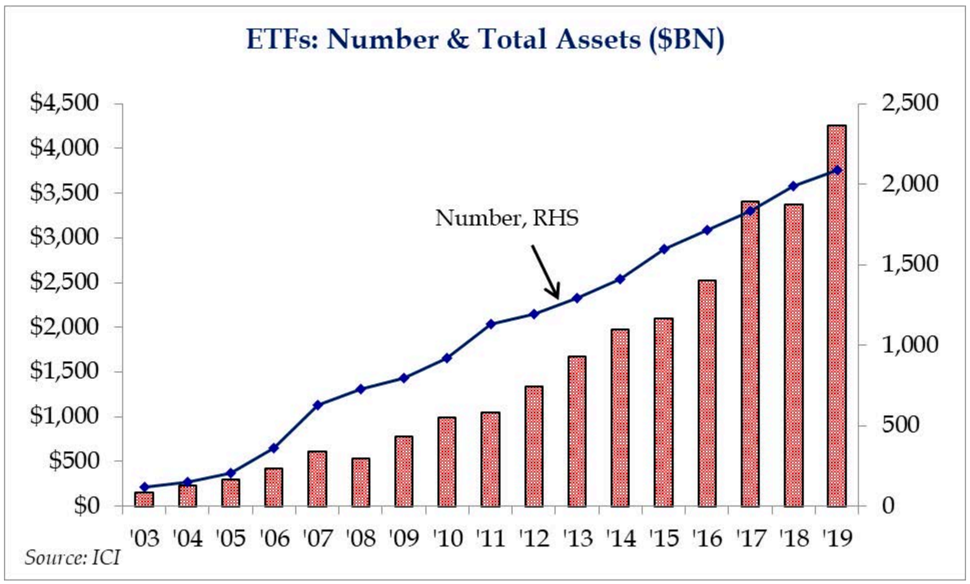
1 S&P/TSX Composite
2 S&P 500
3 FTSE Developed Markets ex-North America
4 FTSE Emerging Markets All-Cap

ETF platform until 2001). Today there are thousands of ETFs globally and upwards of 100 different providers. We discussed passive ETFs in detail in our Q3 2019 letter, please reach out if you would like a copy.

Cypress was an early adopter of the ETF strategy and spent years encouraging Vanguard to come to Canada. We continue to believe that no other innovation has been more beneficial for the individual investor. However, the number of ETFs on the market now does give us cause for concern. As we have touched on in previous letters, an ETF is only as good as the underlying holdings.



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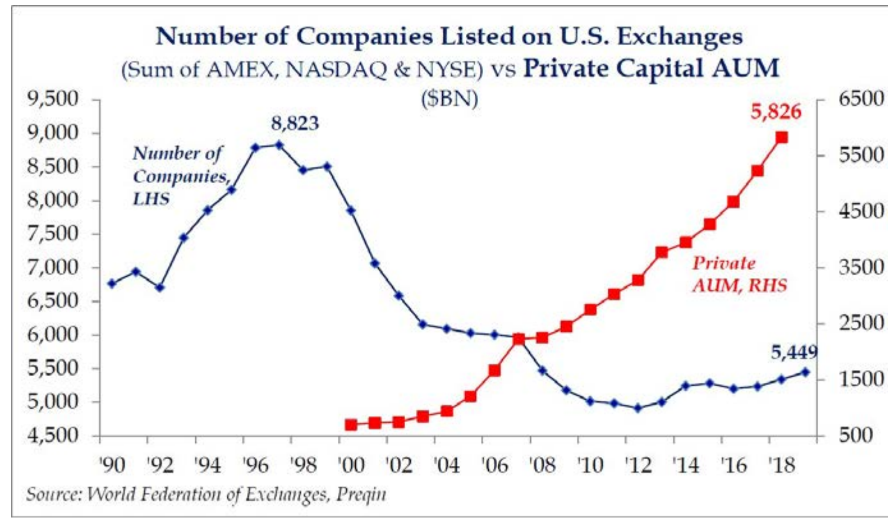
Massive growth in private investments

Somewhat curiously alongside the rise in passive investing there has also been a tremendous rise in private investment vehicles, specifically private equity. The reason this is curious to us is that private investments offer none of the benefits that passive investing does. Passive index investing is low-cost, transparent and liquid. Private investments tend to be higher-cost, opaque and illiquid, in other words the exact opposite of passive investing. Owning an asset in the private market may be justified if there is no equivalent asset available in the public market, however this does not explain the massive recent growth.



Historically the attraction of investing in the private markets versus the public markets has been the potential for higher returns in the private market. The trade-off investors were making was higher potential returns in exchange for illiquidity and opacity. Going forward we have no doubt that certain private funds will perform very well, however our observation of the private market is that the trade-off has shifted to *lower* expected returns in exchange for lower volatility.

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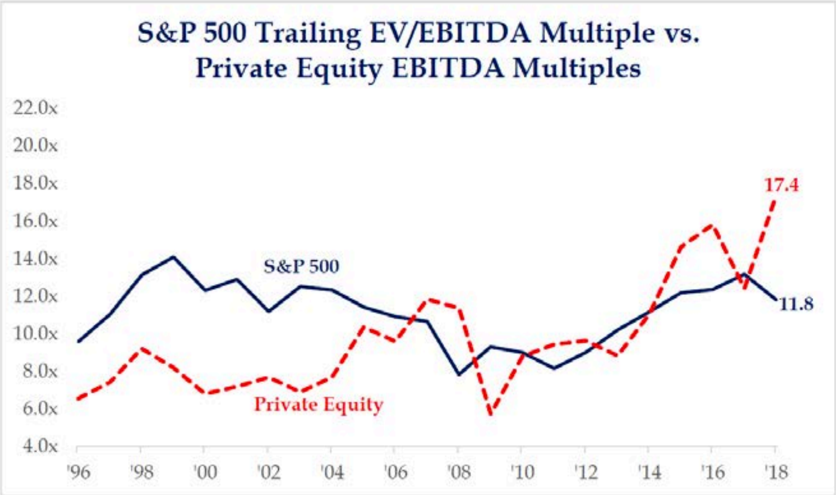
Regardless of whether an asset is held publicly in the equity markets or privately in a fund, the underlying economic fundamentals of the asset do not change. A perfect example of this is rental apartments. The cash flow potential of a rental apartment is driven by rents and costs, not how the apartment is owned. What is different is how the asset is priced and traded. A rental apartment which trades on the stock exchange trades frequently and is priced based on the whims of the market at any given moment. A rental apartment that is held privately is priced and traded infrequently (if ever). The result is that the observed price of the privately-held apartment appears much less volatile than the publicly-held apartment building even though the economics of the underlying investment are the same.

Broadly speaking, investors have historically demanded a higher return potential for owning private assets due to the illiquidity and lack of transparency. Put another way, investors demanded a higher return for tying their money up long-term and not having insight into the actual value of the underlying asset. This trade-off makes perfect sense to us, however what we are seeing now is the valuations in the private market are often higher that the public market, which, all else being equal, means a lower potential return in the private versus public market. Investors appear to be willing to give up return, liquidity and transparency in exchange for lower perceived volatility. This does not strike us as a very attractive trade-off.



What Has Not Changed?

Equally as interesting and relevant to what has changed in the industry in the last 20 years is what has not changed.

Fads and manias

1999 was the middle of the Tech Bubble hype. We don't propose to go through the history of the bubble here, but when the NASDAQ peaked in March 2000 valuations, to put it mildly, made no sense. Since the Dot Com Bubble burst in 2000 we have seen a number of fads and manias come and go and we see no reason to believe we won't see more in the future. To name just a few over the last 20 years:

- *U.S. housing* – Likely the most damaging to the overall economy was the bubble in U.S. housing that peaked in 2006.
- *Rare earths* – Perhaps best described as a niche bubble, some rare mineral prices such a Lanthanum (used in high-end lens and screens) rose 4,000% between January 2010 and June 2011. Values are down some 95% from their peaks.
- *Valeant* – A made in Canada mania. Between January 2012 and July 2015 Valeant Pharmaceuticals shares rose 600%. At one point in 2015 Valeant was the most valuable company on the TSX surpassing the Royal Bank. The company has since changed its name and trades at the same price it did in 2011. Full disclosure; we were drawn in by some of the Valeant hype assuming that we must have missed something when evaluating the company.
- *Cryptocurrency* - Seemingly out of nowhere, cryptocurrency became all rage in 2017 with Bitcoin being the standard bearer. In U.S. dollar terms the price of a bitcoin went from $1,000 on Jan 1, 2017 to almost $19,000 in December of that year. By December of 2018 the price had dropped to $3,100. Prices

today are roughly $7,000, so to be fair, long-term investors in the space may have made money.

- *Cannabis* – The first and largest cannabis ETF was launched in 2015 (ETFMG Alternative Harvest ETF). Between 2015 and 2018 the ETF returned close to 80%, but has since collapsed to trade about 40% below the price it initially traded at in 2015.

It should be noted that these fads, manias or bubbles are all in legitimate industries or businesses, it is simply a matter of valuation. In many cases there was a higher demand for investment in the product, than actual demand for the underlying product. Any asset, regardless of how novel or fantastic, is a bad investment if you pay too much for it.

Investor behaviour remains the biggest risk

The research into behavioural finance and investor psychology over the past 20 years has been incredible and clients can expect this to be an ongoing theme in our letters and meetings. Despite the research and increased understanding of the negative impact behavioural biases have on investing, investor behaviour has changed very little and remains a key risk. This was true 20 years ago when Cypress was founded, it remains true today and will very likely remain true 20 years from now. If an investor canvasses the media and marketing material available it is clear that the investment industry remains focused on short-term performance and volatility and has not embraced the potential benefits of focusing on behaviour and psychology. We will continue to reflect critically on our biases as investment counsellors which will hopefully make us better coaches of client behaviour. We feel this will continue to be an area of differentiation for Cypress.

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Outlook and Strategy

The strong performance of the equity markets in 2019 does not change our long-term view that investors wishing to protect and grow the purchasing power of their capital should continue to have significant equity market exposure. Return expectations may need to be recalibrated to take into account the higher valuations, but overall when we look at the investment landscape we conclude public market equities remain reasonably attractive when compared to the alternatives. As always the caveat to this is if an investor has a short-term need for the capital, in which case it should be set aside in an asset not subject to the volatility of the equity market. We ask that clients review their capital needs regularly and update us accordingly on any changes in their circumstances.

Finally we would like to take this opportunity to thank clients for their trust and loyalty over the last 20 years. Many of the clients that were here from the start remain clients today and hopefully clients that are here today will remain clients 20 years into the future.

CYPRESS CAPITAL MANAGEMENT LTD.