Market Review

In our letter to clients from the first quarter of this year, we noted that markets have always recovered from steep declines and after such a severe decline, the worst may have been behind us. With that said, it would be a stretch to suggest we anticipated the speed with which the markets would recover from the March lows. However, as we have discussed in the past, and discuss again below, predicting the short-term movements of the equity market is a fool's errand.

The third quarter saw markets continue to move higher globally. For the three months, ending September 30th, the Canadian market[1] was up 4.7%, while the U.S. market[2] and International markets[3] were up 6.9% and 3.5% respectively in Canadian dollar terms. Year to date, the Canadian market is now down 3.1%, while the International market is down 3.9%. The outlier remains the U.S. market, which, on the back of the strength of the technology sector, is up 8.3% for the year.

Bond yields continue to remain at historically low levels. At the end of the quarter, the ten-year Government of Canada bond yield was 0.54% down from 1.62% at the start of the year. We continue to see little in the way of real return potential in the bond universe.

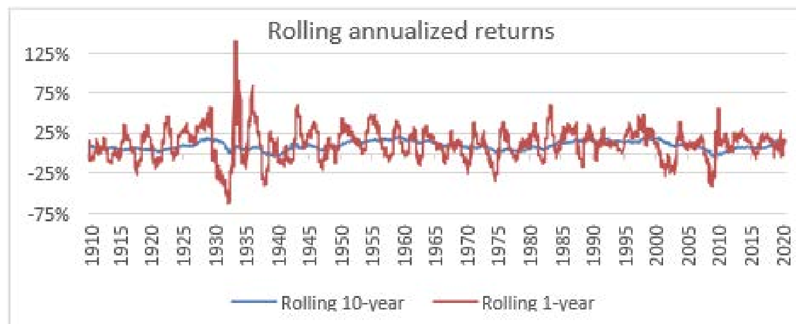
Markets move significantly in the short-term – both up and down

We consistently remind clients that in the short-term markets are very unpredictable. Typically, the focus is on the short-term downside potential of the markets, but it is perhaps equally important to be aware of the short-term upside potential. 2020 has provided a dramatic example of this phenomenon with equity markets being up and down double-digit percentages in a few short weeks.

The fact is that to capture the long-term returns of the market an investor needs to capture the short-term returns. This statement may seem obvious, but much of the media commentary we see suggests the best strategy to generate solid long-term returns is to somehow avoid the short-term downside. We have discussed these market-timing strategies in the past and they simply do not work. The first nine months of 2020 simply adds to the long list of historical examples concerning the folly of trying to predict what equity markets are going to do in the short-term.

If we accept the conclusion that short-term market movements are unpredictable, it means those exposed to the equity markets must have a long-term time horizon. History has shown that over the longer-term equity market returns have been far more predictable, though certainly not perfectly so. Below we analyze market returns over longer time horizons, in this case 10 years.

The charts and tables on the next page show annualized returns for the S&P 500 for rolling 1-year and rolling 10-year periods going back over 100 years. The reason we use S&P 500 data is the ease of obtaining data and the reliability of the numbers, also the S&P 500 makes up about half of the total global market capitalization of publicly traded companies. The annualized return over the period was 9.8% per year.



Source: www.officaldata.org, Cypress Capital Management Ltd.

Rolling 1 year		Rolling 10 year	
Annualized Return	% of periods	Annualized Return	% of periods
less than -%5	18.8%	less than -%5	0.0%
-5% to 0%	7.7%	-5% to 0%	3.8%
0% to 5%	8.8%	0% to 5%	15.1%
5% to 10%	9.2%	5% to 10%	37.9%
10% to 15%	11.6%	10% to 15%	21.9%
15% to 20%	11.8%	15% to 20%	20.8%
greater than 20%	32.1%	greater than 20%	0.5%

Source: www.officaldata.org, Cypress Capital Management Ltd.

[1] S&P/TSX Composite
[2] S&P 500 (C$)
[3] MSCI EAFE (C$)

There is a lot of information to process in the chart and table above, but the main takeaways are that based on historical data:

- Long-term returns have been strong at 9.8% annualized.
- The likelihood of negative returns over 1-year periods has been over 26%.
- The likelihood of a greater than 20% return over a 1-year period has been over 32%.
- The likelihood of being down over a 10 -year period has been less than 4%.
- The market has returned greater than 5% annualized returns over 10 year rolling periods over 80% of the time.

10 years is undoubtedly a long time, but most investors have time horizons that can be measured in decades for at least part of their portfolio, so, in our view, it is a reasonable time period to analyze. Based on history, equity market returns have been reasonably consistent over longer periods. In the short-term, it is a very different story. The reason for the heightened short-term volatility has to do largely with investor and market psychology. Emotions such as fear and greed can have a significant impact on short-term market movements. We discussed volatility at length in our last quarterly letter.

Over the long-term, trends in the market are more closely correlated with the underlying earnings and cash flows of the companies that make up the overall market. Long-term earnings and cash flows are not typically impacted by short-term events.

The trouble with predicting the future path of the markets

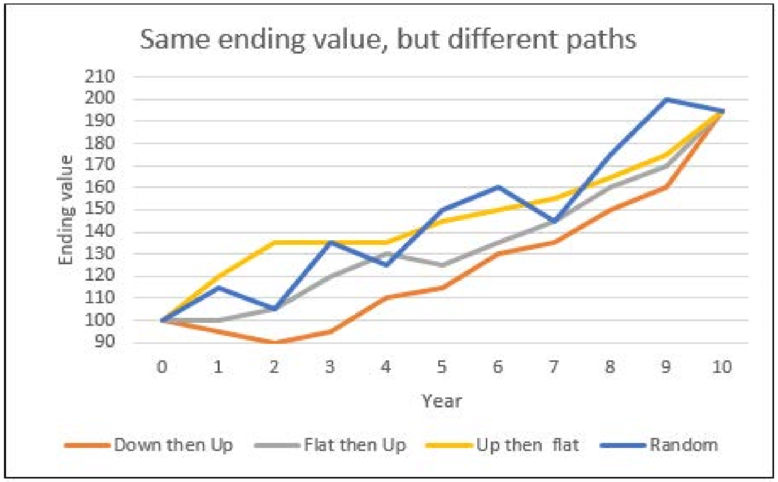
Our consistent focus on the long-term does not mean we simply ignore the short-term. As discussed throughout previous letters and ongoing client communication, the most important short-term consideration is individual spending and liquidity needs. However, we are also keenly aware of the various concerns that investors have concerning the current state of equity markets, including, but not limited to:

- Higher than average equity valuations based on historical data (though we would note that bonds are much more expensive).
- Significantly depressed near-term, and potentially medium-term, economic activity due to COVID-19 and the related policy response.
- A dramatic increase in government debt (likely a more significant concern for bonds than equities).
- A seeming rise in political tension in the United States and globally.

Given the above concerns, it is tempting to conclude that it would be wise to significantly reduce equity exposure and wait for the concerns to pass. Unfortunately, that is not how markets work. There will be no ‘all-clear’ signal telling investors now is the time to invest for the long-term; there never has been. In our view the best way to deal with these issues is not to attempt to time the market, but rather for an investor to critically review their asset allocation relative to their circumstances and, perhaps more importantly, to update their return expectations.

Given the concerns noted above it is reasonable to conclude that the next 10 years is likely to generate ‘below average’ equity market returns, certainly it makes sense to plan for below average returns. For the sake of argument, let us assume a 7% return for the equity markets over the next 10 years, which would be in the bottom third of what the market has historically generated. What path might these returns take?

To demonstrate the potential path ahead and the risk of predicting short-term movements, below are four hypothetical return profiles over the next 10 years. These are not forecasts, simply illustrations of how the market might generate a 7% annual return. Note that the annual returns in the examples below are well within what we have seen over the last 20 years.



	A - Down then up	B - Flat then up	C - Up then flat	D - Random
Year	Annual return	Annual return	Annual return	Annual return
1	-5%	0%	20%	15%
2	-5%	5%	13%	-9%
3	6%	14%	0%	29%
4	16%	8%	0%	-7%
5	5%	-4%	7%	20%
6	13%	8%	3%	7%
7	4%	7%	3%	-9%
8	11%	10%	6%	21%
9	7%	6%	6%	14%
10	22%	15%	11%	-3%
Annualized return	7%	7%	7%	7%

To demonstrate the risk of relying on a short-term outlook to make long-term asset allocation decisions we can look at the various forecasts.

Take an investor who is very confident in forecast A and believes that the market will be down in the short-term, then up in the long-term. What if the forecast is wrong and the market does not go down? Investors relying on this forecast will be sitting on the sidelines waiting for a better entry point. If the actual return profile is C or D it is possible the investor misses double-digit returns in the next year. It is very unlikely that a long-term investor can miss significant short-term gains and still generate solid long-term returns.

Conversely take an investor who is very confident in forecast C and believes the market will be up significantly over the next 24 months. What if that forecast is wrong and the market goes down materially similar to forecast A? An investor who is expecting short-term gains is unlikely to patiently wait years for the market to recover.

Any of the above scenarios are possible, along with countless others. The point is that there is too much uncertainty concerning the path of returns to make any short-term market timing decisions. We believe that looking for returns in the equity markets over the next 10 years in the 7% range is reasonable, but we do not believe it is reasonable to make predictions on the short-term path to those returns.

Of course, it is possible the next 10 years sees returns in the equity markets that are significantly below 7% or even negative as history suggests this is possible. However, our view is that the current outlook, though somewhat depressed, is not so dire as to suggest very meagre or even negative returns over the long-term. The periods associated with very low or negative long-term returns were depressions and extreme starting valuations, neither of which is the case today.

Outlook and strategy

With the markets having recovered all, or nearly all, of their COVID-19 losses it is tempting to conclude that risk to the market from the pandemic is behind us. While the pandemic may not be as deadly as was feared in March there remains no proven vaccine, unemployment remains at very high levels and economic activity is still well below pre-crisis levels. There is always the potential for volatility, however it does seem to us that there continues to be a heightened level of uncertainty. With this in mind we continue to urge clients to review their short-term spending and liquidity needs to ensure there is a sufficient amount set aside in an asset not subject to the short-term volatility of the equity markets. We do not want to be a forced seller of equities at depressed prices if the market moves down.

Despite the below average outlook, our view is that the return potential for equities remains substantially above other investable assets classes, specifically bonds. This superior relative valuation supports our continued belief that equities are the asset class mostly likely to protect and grow the purchasing power of an investor's capital.

As always, please contact us if you have any questions or concerns, or if you need to update us on your circumstances. Thank you for your continued support and trust in us during these 'unusual' times.

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