CYPRESS CAPITAL MANAGEMENT

Market review

Though the day-to-day volatility remained elevated, the first quarter of 2021 was generally positive for the equity markets, but negative for the bond market.

The Canadian market was up 8.1%, driven largely by the strength in the Energy sector, which was up over 20% in the quarter. The U.S. market was up 4.7%, also led by Energy, which was up over 24%. The Technology sector was a drag on returns for the first time in several years, up just 2% on the quarter. International markets lagged behind the North American markets. The International market was up 2.1% with several regions including Japan, Australia and China in negative territory for the quarter.

Bond yields moved higher during the quarter, which resulted in negative returns for fixed income investments (higher yields translates into lower bond prices). In some cases, long-term bond prices were down over 15%, which was the worst quarterly performance in over 40 years. Despite the move up, the 10-year Government of Canada bond yield remains very low by historical standards at 1.57%.

Investing, Speculating, Gambling and Storing Value

In recent months, various alternative asset classes have gained prominence in the media. The most notable of these has been Bitcoin; but there are other alternative asset classes such as non-fungible tokens (NFTs), as well as assets such as fine art or even vintage wine, which are being promoted as potential investments. Given that these assets are making headlines, we thought we would take this opportunity to review how we think about various asset classes as long-term investments.

Hopefully, this review will help clients understand our overall thought process.

[1] S&P/TSX Composite

[2] S&P 500 (C$)

[3] MSCI EAFE (C$)

When an individual is looking to earn a return on their capital that individual has, broadly speaking, four options on how to deploy their capital; they can 1) Invest, 2) Speculate, 3) Gamble, or 4) Store Value. Below we define and discuss each option. Some may have slightly different definitions and there are shades of grey between the categories, but for ease of explanation, we will consider each option separately.

There are two key criteria we use to differentiate between the four options:

1) Expected return – what return can an individual reasonably expect to earn on the asset they have purchased? It is important to differentiate between what an individual hopes to earn and what should be expected. This difference is most easily understood when we discuss gambling.
2) Range of potential outcomes – what are the maximum and minimum possible returns for a given investment?

The matrix below shows how these criteria drive the categorization of the various asset classes.

	Investing	Speculating	Gambling	Storing Value
Expected Return	Positive	Positive	Negative	Nominal
Range of Potential Outcomes	Low	High	High	High

Investing

Investing is the process of allocating capital across a diverse range of sectors and asset types. The expected return (discussed in more detail below) is positive based on dividends and interest payments, as well as capital appreciation through cash flow growth. Given that the allocation is diversified, the range of potential outcomes is limited on both the up and downside. This limited range of long-term outcomes is a feature, not a flaw, of investing. Investors forgo upside potential in exchange for limiting downside potential. In the long-term, the likelihood of a negative return from investing is approaching zero. Investing is what we do at Cypress.

Speculating

Speculating is the process of allocating capital to new or emerging technologies and/or taking positions that are more concentrated. In our view, the return expectation from speculating remains positive, but the range of potential outcomes is significantly higher than with investing. The transition between investing and speculating is subjective, but our view is that a portfolio that has the long-term potential of providing a negative return is more speculating than investing. Some investors may prefer the higher return potential that comes from speculation versus investing, but it is important to know that higher upside potential means higher downside potential.

Gambling

It is mathematically indisputable that the expected return from gambling is negative. An individual may hope that their lottery ticket will pay off, but based on the odds, an individual should clearly not expect to make a positive return. If an individual selects the winning numbers in a lottery it does not alter the fact that at the time the ticket was purchased the return expectation was negative.

It is important to make this distinction between expected return and actual return. It is often the case that people look at the actual return after the fact and conclude that was the return they should have expected all along. This is clearly faulty reasoning.

Given that the expected return is negative we, unsurprisingly, believe gambling should be avoided. It is worth noting that this analysis only considers games of chance and not games where there is potentially some degree of skill involved, such as poker or sports betting.

Storing Value

Storing value is allocating capital into an asset that does not produce, nor is it ever expected to produce, a cash flow. The list of assets that fit this category includes – physical gold, fine art, hockey cards, Bitcoin, etc. Any return from owning these assets will be the result of selling them to somebody else at a higher price in the future. This is very different from investing in stocks and bonds where much, if not most, of the return will come from dividends, interest, and earnings growth.

Stores of value can generate significant returns. However, as we saw with the example of the lottery ticket, the fact that something generated a significant return does not alter the expected return when the purchase was made.

There is no shortage of people predicting the rise in value of various stores of value, and in many cases, those predictions will turn out to be correct, but “predictions” and “expectation” are not the same thing. **Simply put, we do not believe investors should expect anything more than a nominal return from buying an asset that will never generate a cash flow.**

In summary, when we look at the four alternatives for deploying capital to earn a return; investing, speculating, gambling, or storing value, the first one is the only one that we find appealing. The latter three may have the potential for higher returns, but they also come with substantial risk.

Why do we believe the expected return on investing is positive?

To give the full picture, we should discuss why we believe the expected return on investing is positive. Our expectation that investing will generate a positive return relies on two assumptions:

1) that a portfolio of stocks and bonds will continue to generate interest and dividends, and;
2) the earnings of the companies will continue to grow over the long-term.

History suggests that these are very reasonable assumptions.

Below is a simplified example of the return outlook for a basket of stocks trading at $100, paying a 2% dividend and that dividend is growing at 5% a year. Under this scenario, it is reasonable to expect a 7% return per year over the long-term.

	Year 0	Year 1	Year 2	Year 3	Year 4	Year 5
Price ($)	100.00	105.00	110.25	115.76	121.55	127.63
Dividend ($)	2.00	2.10	2.10	2.32	2.43	2.55
Yield	2.00%	2.00%	2.00%	2.00%	2.00%	2.00%
Dividend Growth	5.00%	5.00%	5.00%	5.00%	5.00%	5.00%
Return (Dividend + Price)		7.00%	7.00%	7.00%	7.00%	7.00%

The price increase is a function of the increasing dividend, while the valuation (yield) stays the same. Generating a positive return in this scenario does not require another investor to be willing to pay an ever increasing price in the future. Our belief is that investing in a diversified basket of assets that generate real cash flows and not overpaying for those investments leads to a positive expected return.

It is possible that valuations become so high that there is not a reasonable expectation of a positive long-term return. The Dot-Com period of the late 1990s and the Japanese Nikkei Index of the late 1980s are examples of periods when valuations reached extreme levels. We have discussed valuations in the past so we won't revisit here, but our view is that, while current valuations are higher than the historical average, they are not approaching the levels where expected future long-term returns are negative.

Covid-19 predictions versus market predictions

We have avoided discussing Covid-19 in client letters since we do not know anything more than anybody else about the pandemic. However, we do have experience concerning short-term forecasts for the markets and the reporting of those forecasts. In many ways, short-term predictions concerning Covid-19 are similar to how market predictions are reported.

Decades of observations concerning stock market predictions have taught us how unreliable short-term predictions are. Two key observations:

1) In an effort to attract attention the media will highlight predictions that are either highly optimistic or pessimistic. Headlines are constantly predicting markets surging or plummeting, when in reality nobody knows.

2) A positive prediction that turns out to be wrong is far more damaging to a forecaster's credibility than a negative prediction that turns out to be wrong. This is a crucial point if you are actually trying to evaluate forecasts that are reported in the media as it means there will be a pessimistic bias to what is reported. Forecasters that consistently call for doom and gloom do not lose credibility when the market does not crash, whereas forecasters that are overly optimistic when the market plummets are seldom relied upon again.

A similar dynamic appears to be playing out with regards to Covid-19 forecasts and reporting. Articles predicting extremes attract more readers than more circumspect predictions that see the pandemic slowly receding over the coming months and perhaps years. Those that have made forecasts that have proved to be overly optimistic are labeled irresponsible and rash, whereas those that have made forecasts that are overly pessimistic are considered cautious and prudent.

Caution and prudence are undoubtedly the wise course of action during a pandemic, so we are not making a judgment call on the forecasters or media outlets. The point is that we have found that recognizing and understanding the biases that exist for the media and forecasters has allowed us to better process and evaluate market predictions over the years. Recognizing and acknowledging these biases may allow people to better process and evaluate pandemic predictions as well.

Outlook and Strategy

Our outlook and strategy remains unchanged.

1) Keep near-term spending needs in an asset not subject to the volatility of the equity market.
2) Maintain a significant bias to equites since this is the asset class with the highest long-term return expectations in our view.
3) Ensure that return expectations reflect the valuation realities of the current market.

As always, if you have any questions or concerns do not hesitate to contact us.

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Please see our website www.cypresscap.com for our current disclosure document