2022 In Review

The fourth quarter of 2022 saw equity prices move higher globally, but overall 2022 was a down year for markets. The Canadian market finished the year down 5.8%[1]. Internationally, in Canadian dollar terms, the U.S. market was down 12.4%[2], Developed Markets outside of North America were down 8.0%[3], and Emerging Markets were down 14.5%[4]. The technology heavy NASDAQ index was down 28.3%. The bond market fared just as poorly as the equity markets, with the benchmark Canadian broad bond market index down 11.7%. Long-term bonds fared even worse, with the Canadian long-bond index (bonds with maturities in excess of 10 year years) down 21.5%. In fact, we have seen it reported that 2022 was the worst year on record for bonds in the U.S. and perhaps the worst year since 1932 for a 'Balanced' portfolio of stocks and bonds.

2022 was certainly not a good year for equity or bond markets. It was also not a good year for most other asset classes. Housing prices and sales activity have seen material declines across most regions. Private market valuations are down significantly and even gold, which is typically thought of as a hedge against inflation, was flat on the year. Commodities were up, but knowing the long-term returns on commodities, few long-term investors would, or should, attempt timing a switch from equities to commodities.

As we have discussed in the past, the value of virtually every asset class is impacted by changes in interest rates; rising interest rates will lead to lower asset prices. With a high degree of certainty we were confident this would happen. What was unknowable was the timing and magnitude of the interest rate changes. The speed of the interest rate rise has been surprising when compared to history, something we will discuss in more detail below.

2022 In the Broader Historical Context

History has taught us that broad market declines are to be expected, even double digit percent declines. For obvious reasons, these periods can cause stress and anxiety. This stress and anxiety is compounded by the fact that most investors feel the pain of losses disproportionately to the joy of gains. When markets are down, investors just want the pain to stop.

To combat this stress and anxiety, we (unsurprisingly) encourage clients to extend out their time horizons. Evaluating portfolio returns over longer periods of time will hopefully allow investors to put the current market movements into perspective. As a general rule investors should look to evaluate portfolio returns over their contemplated holding period, which for most clients, is measured in multiple years, if not decades, for at least a portion of their portfolio.

With the goal of putting 2022 into historical context, Appendix A (included at the end of this letter) shows the range of annual returns going back to 1928 for the U.S. market. To aid in the analysis, we have highlighted the returns by decade in different colours to show the distribution over time. In our view, the key takeaways from the table are very simple, but crucially important to long-term investing success. We summarize these as follows:

- *Equity markets rise significantly quite often*. Annual returns have been in excess of 20% over a third of the time and in excess of 10% nearly 60% of the time.
- *Equity markets fall significantly sometimes.* Once or twice a decade investors can expect declines in excess of 10%.
- *'Average' annual returns are not very common. Since 1928, the S&P 500 has generated a cumulative average annual return of 9.8%. As can be seen in the table,*

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

returns are not often in the 9.8% range. Investors should not expect the long-term average in any given year.

We should note that we use the U.S. market data as it is the easiest data to access and the U.S. market represents roughly 60% of the total world market, so it is a reasonable proxy for analyzing the overall equity markets.

Equities versus Bonds (and Other Asset Classes)

Looking back

For the better part of ten years, we have finished almost all our quarterly letters with some comment on our preference for equities over bonds. For example, our December 2017 letter concluded *with 'our view remains that a diversified basket of high-quality equities offers long-term investors the best opportunity of meeting the fundamental goal of protecting and growing purchasing power.'*

Our concern with bonds was that interest rates were so low that any material increase would wipe out returns. While we never claimed to have any particular insight into the exact timing of increasing rates, our overall concern from an asset allocation point of view has been proven correct. As can be seen below the return on bonds over the past 10 years has been very meagre and would likely not have kept up with inflation. For comparative purposes we have added some other asset classes, including Vancouver housing prices since it is a comparison that many of our clients make.

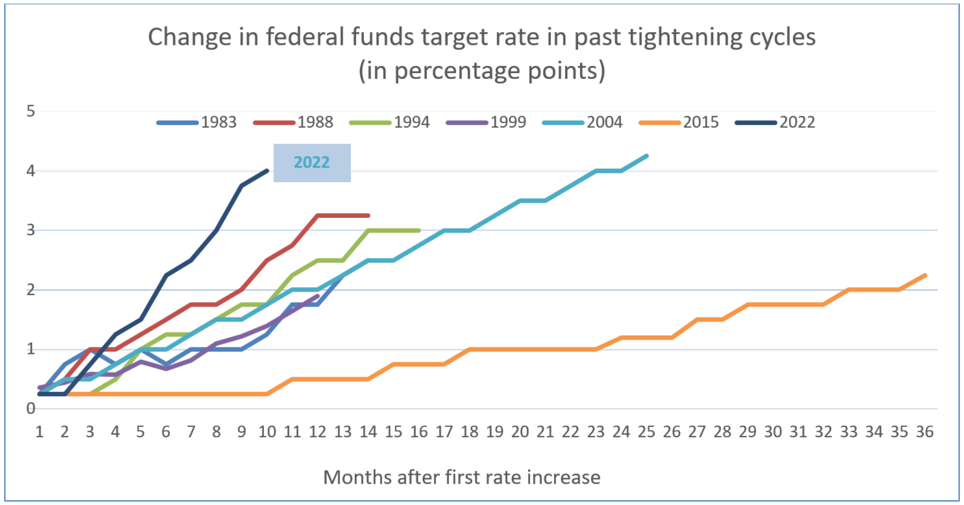
Returns to Dec 31, 2022	1 year	3 year	5 year	10 year
Canadian Overall Bond Universe	-11.7	-2.3	0.2	1.6
TSX Composite (Canadian Market)	-5.8	7.5	6.8	7.7
S&P 500 (U.S. Market C$)	-12.4	9.2	11.2	16.1
International Developed (C$)	-8.0	2.8	3.7	8.8
Emerging Markets (C$)	-14.6	-1.3	0.2	4.6
Gold	-0.2	6.2	7.1	0.9
Commodities	17.5	13.9	6.7	-2.0
Vancouver Benchmark Detached	-4.5	8.6	2.6	7.0

Source: GVREB, RBC Capital Markets, JP Morgan Guide to Markets

Despite the material pullback in 2022, a diversified basket of equities was the clear winner over the last decade.

Looking forward

Interest rates have moved up a great deal in a short period of time. As discussed in the past, this is primarily driven by central bankers looking to bring down the overall inflation rate. The chart below compares the recent size and speed of the interest rate increases to previous cycles. Compared to history, interest rates have risen faster and higher than anticipated.



Source: Federal Reserve, Statistica

While the rise in interest rates has had a deleterious impact on asset prices, it does mean that today, a broad basket of bonds is far more likely to provide a real after-inflation return going forward than at any other point in the last decade. For many years, we have advocated treating bonds primarily as a vehicle for managing short-term liquidity needs, but bonds may now provide a reasonable long-term alternative to other asset classes. We continue to believe that equities will outperform bonds over the longer-term, so for many clients there will be no adjustment to the overall allocation. However, where, for client-specific reasons, time horizons are shorter and the higher returns from equities are not needed to meet overall goals, we will look to increase the bond holdings.

Asset Allocation versus Stock Picking

In these letters we primarily discuss asset allocation, volatility, time horizons and broad market trends. We rarely discuss specific sectors, individual securities, or funds. This is not to suggest that stock and sector picking is not important, we believe it is. Rather, we are trying to focus on what has the broadest relevance for our clients. Experience has taught us that the ***big*** mistakes in investing are made at the asset allocation level. When investors fail to appreciate volatility, return expectations and time-horizons, it can lead to an inappropriate asset allocation or, even worse, poor investor behaviour. If we can avoid the big mistakes, we reduce the likelihood of poor long-term outcomes. We work hard to ensure we have the right mix of sectors, funds and individual securities, however in the long-term, great stock picking is unlikely to overcome poor asset allocation. In future letters, we will likely discuss stock and sector selection in more detail, but the majority of the discussion will continue to be asset allocation and broad investment fundamentals.

Outlook

We concluded our 2021 year-end letter with the following:

> *'The strong equity markets over the past few years likely means that future returns will be lower than what we have recently experienced. At the very least we believe it prudent to keep return expectations in check. Over the very long-term, global equity market returns have been close to 10% a year, while in the last 5 years that number has been over 14%. Assuming returns ultimately revert to the average makes it reasonable to plan for a period of below average returns.'*

The drop in equity prices in 2022 means that return expectations going forward have moved higher. While these market resets are not enjoyable, they are a feature of the markets that investors must accept if they wish to earn the better long-term returns offered by the equity markets. Looking forward, our expectation is that future long-term equity returns will look much like the past.

As always if there are any questions or concerns do not hesitate to reach out. It is important that clients are comfortable with their overall asset allocation and that our understanding of client circumstances is up to date.

CYPRESS CAPITAL MANAGEMENT LTD.

Please note we have changed the sector classification scheme in the portfolio valuations to better align with industry standard. This does not impact the overall holdings.

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

CYPRESS CAPITAL MANAGEMENT

Appendix A

Explanatory note: This chart below takes the annual returns for the S&P 500 since 1928 and groups them by range of returns. The purpose is to show that the distribution of returns is not 'normal', rather is it skewed towards higher returns. The colour coding of decades is to highlight that the distribution is fairly consistent over the long-term; occasional bad years, but mostly good years.