CYPRESS CAPITAL MANAGEMENT

2023 Market Review

2023 saw global equity markets make back most of the losses from 2022. With the benefit of hindsight, the equity markets at the end of 2021 were somewhat overextended and 2022 was a year of recalibration to more reasonable valuation levels. 2023 saw inflation and interest rates stabilize and, with that, equity markets moved higher. Looking at the performance of the various regional markets for the year: the Canadian market was up 11.8%[1], the U.S. market was up 23.5%[2], Developed Markets outside of North America were up 14.3%[3], and finally, Emerging Markets were up 6.8%[4].

Despite spiking to almost 4.3% during the year, the 10-year government of Canada bond ended the year essentially unchanged at about 3.1%. While current nominal (interest less inflation) rates remain elevated compared to recent history, taking a longer historical view, they are not usually high, especially in the context of current elevated inflation.

Returns After Down Years

After the significant drawdown in 2022, should investors have expected a strong recovery in 2023? The table below compares the market movement from 2022 and 2023 with other significant negative calendar year returns over the last 100 years.

The 10 Worst Years for the U.S. Stock Market (US$)			
Year	S&P 500	Reason	Next Year
1930	-25.1%	Great Depression	-43.8%
1931	-43.8%	Great Depression	-8.6%
1937	-35.3%	1937 Crash	29.3%
1941	-12.8%	WWII	19.2%
1973	-14.3%	1973-1974 Bear Market	-25.9%
1974	-25.9%	1973-1974 Bear Market	37.0%
2001	-11.9%	Dot-Com Crash	-22.0%
2002	-22.0%	Dot-Com Crash	28.4%
2008	-36.6%	Great Financial Crisis	25.9%
2022	-18.1%	The Great Inflation	26.3%

Source: NYU

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

Attentive readers will note that three of the worst down years - 1930, 1973, and 2001 were immediately followed by *another significant down year* - 1931, 1974 and 2002. So, the market being down significantly one year is no guarantee it will recover the following year, far from it. However, there are three key points to consider. First, the periods of extended market declines are associated with severe economic contractions and overvaluations, neither of which was the case in 2022. Secondly, even if it takes several years to recover from a severe market decline, at some point the market will recover. Thirdly, it is highly likely the market will move rapidly higher at some point, making it imperative to stay invested to participate in the recovery.

So, investors should not have expected a strong recovery in 2023, nor should they have been surprised by it. The market was eventually going to experience a strong rally, but there was no certainty it was going to be in 2023. This is yet another reminder how the short-term movements of the markets are simply not predictable.

Revisiting Behavioural Finance

The global economic and market impacts of various governments' response to the COVID-19 pandemic, followed by a spike in inflation and interest rates has meant that, for the past few years, these quarterly letters have focused very much on current events. While reviewing and analyzing current markets and trends is important, we like to think one of the value-adds at Cypress is client education, specifically around the principles of investing. Recently we came across an article that referenced a study on Ambiguity Aversion[5] and this triggered us to want to revisit a topic we have discussed in the past which we believe is important to long-term investing success - Behavioural Finance. The study showed how uncertainty about a negative outcome can lead to significantly more stress than knowing for certain a negative outcome will occur. How this relates to investing is it highlights how humans are not rational, outcome-optimizing, decision making machines, rather we all are influenced by emotions which impact our decision-making process.

[5] https://www.sciencedaily.com/releases/2016/03/160329101037.htm

Behavioural Finance has been one of the most interesting areas of study in investing and portfolio management over the past few decades. Behavioural Finance studies how psychological influences and biases impact investors' behaviours. Much of economics and modern portfolio management assumes that individuals are rational actors seeking to optimize some predetermined outcome. Even a casual observer of the markets would conclude that investors are not always, or even often, rational. Behavioural Finance seeks to analyze and explain this apparent irrationality. Why this is important to the individual investor is that these psychological influences and biases can lead to poor investing decisions that can have devastating effects on long-term financial outcomes. *Our experience has taught us the worst investment decisions are often the result of cognitive bias.*

Below, we will review some of the key biases we believe are most likely to have negative impacts on an investor's decision-making process and long-term financial outcomes. It is likely impossible, and certainly impractical, to eliminate these cognitive biases entirely, so the goal is to recognize these biases exist and to plan accordingly to improve the overall decision-making process. Those interested in an in-depth review of various cognitive biases and decision-making in general are encouraged to visit The Decision Lab online www.thedecisionlab.com. The site also includes some very entertaining graphics.

Loss Aversion Bias – Likely the most important bias in relation to portfolio construction, loss aversion describes how people feel the pain of losses disproportionately to the pleasure of gains. Some studies show the pain of a loss is felt twice as powerfully as the pleasure of an equivalent gain. This bias leads to investors building portfolios that are too focused on avoiding the pain of near-term downside at the expense of long-term growth. Learning to live with the short-term pain is key to long-term investing success.

Hindsight Bias – There is a great deal of research into how, as a species, humans do not like unpredictability or randomness. The hindsight bias describes how people look for patterns and explanations for unpredictable events, also known as the 'knew-it-all-along' effect. There are few things in the real world as unpredictable as the short-term movements of the equity markets, yet investors are constantly convincing themselves there is some rational explanation for daily market movements. Searching for patterns that do not exist leads to poor investment decisions, since investors may be acting on spurious information.

Illusion of Control Bias – In a similar vein to hindsight bias, illusion of control describes how people believe they have much greater control over events than they do. When investors see causality in the markets where there is none, it will lead to wasted time and effort. Investors should focus on the few things they can control such as asset allocation, time-horizons, spending/savings and, perhaps most importantly, emotions.

Confirmation Bias – Likely the most widely known and cited cognitive bias; confirmation bias describes people's tendency to place greater reliance on evidence and information that confirms a pre-existing belief and, conversely, to be overly skeptical of evidence and information that contradicts pre-existing beliefs. This bias can be observed in pretty much any field of academic study. Everything from politics, medicine, law, religion and economics has demonstrated confirmation bias. Cypress choosing to uncritically reference a study discussing Ambiguity Aversion is likely demonstrating a confirmation bias on our part. It is easy to see how failing to appropriately update beliefs based on new evidence can lead to negative outcomes in investing. Poor investments will be held onto for too long, while effective new strategies or products may be missed or ignored.

Recency Bias - Recency bias describes the tendency to place greater reliance on information that was recently received compared to historical information. The phenomenon is often observed when evaluating performance, where the most recent performance numbers tend to dominate investment making decisions. This can lead to investors and portfolio managers chasing short-term performance at the expense of long-term asset allocation.

Availability Bias – Availability bias describes the tendency to favour information that is readily available or comes to mind quickly and easily when making decisions. Events that are memorable end up playing an outside role in the decision-making process. Significant short-term moves in the market or a specific asset class, often impact portfolio management decisions far more than is rational.

House Money Bias – The house money bias describes how investors tend to take more risk with money earned from investing profits than they do with investments funded through employment earnings. Investors feel reinvesting profits is the gambling equivalent of playing with 'house money'. All else being equal, the source of the funds should not impact investment decisions. A dispassionate investor, optimizing for a specific outcome, will be indifferent to the source of the funds.

This is by no means a comprehensive list. There are perhaps a dozen or so other identifiable biases that impact portfolio management decisions, including anchoring, self-attribution and endowment. The goal of this brief overview is to encourage clients to pause and reflect on the inputs they are using to make investing decisions and reflect on how cognitive biases might lead to suboptimal decisions. It is also a reminder for us, as portfolio managers, to pause and reflect on the same considerations as well.

Media and Bias

Both social and traditional media are the enemy when it comes to battling bias. The business model of many, if not most, media companies is to leverage biases, including confirmation and hindsight bias, to sell content. Several prominent news organizations seem to exist almost exclusively to allow their subscribers to demonstrate their confirmation bias. Financial media specifically exploits loss aversion to attract eyeballs. Stories of the imminent market collapse or debt crisis dominate in the financial media space. There is nothing sinister or evil about this. The media companies are simply responding to market incentives. Consumers of media, especially financial media, should understand these incentives and biases, and attempt to calibrate their response accordingly.

Outlook and Strategy

As we have noted in recent letters, the rise in interest rates has made fixed income a viable alternative in many portfolios, and we have been making adjustments where appropriate. We continue to believe the long-term expected return on equities remains higher than fixed income, so for those clients with no, or limited, near-term liquidity needs and long-term time horizons, we will keep the equity allocation elevated. Within the equity allocation we will continue to adjust portfolios to reflect the valuation differences between countries and sectors, however these adjustments will largely be at the margins, we do not anticipate any significant changes unless driven by changing client circumstances.

As always, please keep us up to date on your circumstances, specifically time-horizons and cash needs. We never want to be a forced seller of equities in a down market, so we must ensure portfolios appropriately reflect liquidity needs.

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