

## 2024 Second quarter review

The strong price performance of the largest companies in the U.S. meant that global equity markets continued their trend higher in the second quarter, but the performance across geographies was mixed. The Canadian market was down 0.5%<sup>1</sup> in the quarter but is up 6.1% year to date (YTD). The U.S. market was up 5.4%<sup>2</sup> in the quarter and is now up 19.1% YTD. Developed Markets were up a modest 0.5%<sup>3</sup> in the quarter and up 8.6% YTD. Finally, Emerging Markets were up 6.2%<sup>4</sup> in the quarter and are now up 11.5% YTD.

Benchmark interest rates remained essentially unchanged in the quarter, with the 10-year Government of Canada yield at 3.42%.

There has been much discussion in the financial media about the level of concentration in the U.S. market and whether this is a risk to equity market investors. At the end of the quarter, the top 10 largest stocks in the S&P 500 (a proxy for the U.S. market) made up 37% of the total market, while over the past three decades, the average weight of the top 10 stocks has been around 20%. The market is clearly more concentrated than usual, and the overall market performance has been driven by a small number of companies. We will not get into a detailed discussion of concentration risk in this letter, but we wanted to let clients know we are closely monitoring the current concentration levels and continue to adjust portfolios where it is deemed appropriate.

## Why are moves in equity prices so volatile and unpredictable?

Likely the most consistent message in our quarterly letters is, to earn higher returns, long-term investors must live with the short-term volatility of the equity markets. Volatility presents two key issues for investors:

- 1) A desire to avoid volatility leads investors to allocate, in our view, an excess amount to fixed income and cash than is optimal given circumstances.
- 2) When the volatility shows up, investors panic and end up selling at depressed prices and not participating in the inevitable market rebound.

<sup>1</sup> S&P TSX Composite

<sup>2</sup> S&P 500 (C\$)

<sup>3</sup> MSCI EAFE (C\$)

<sup>4</sup> MSCI Emerging Markets (C\$)

These discussions take the market volatility as a given, but we have rarely (if ever) addressed why it is that individual equity prices, and by extension equity markets, are so volatile. At first glance, the size and frequency of large price moves seem totally irrational. Below we have highlighted a handful of price moves in well-known stocks over the past twelve months.

Stock	Price July 1, 2023	Price June 30 2024	Difference %
NVIDIA	46.75	124.3	166%
CN Rail	156.68	160.82	3%
TD Bank	62.81	54.54	-13%
GM	37.94	46.68	23%
Nestle	112.17	94.4	-16%
Tesla	267.43	209.83	-22%

Source: Yahoo Finance

The underlying fundamentals, meaning primarily earnings and cashflow, of the individual companies, or the economy more generally, can barely begin to explain these price moves. Fundamentals simply do not change that much in the short-term. The economic fundamentals for General Motors have not improved so much in the last 12 months that the shares should be up 23%, conversely the fundamentals have not deteriorated so much for Nestle and TD that the shares should be down double digits.

The early 2000s provides many examples of the short-term (or perhaps medium-term) disconnect between fundamentals and share price performance. From 2000 through to 2007, Amazon grew revenues at a compound annual growth rate approaching 40%, Microsoft saw revenue growth averaging 14% annually, and Cisco Systems enjoyed revenue growth averaging 22% annually. During that period, all these stocks posted negative cumulative total returns, with Amazon losing -5.5%, Microsoft losing -20.3%, and Cisco losing -57.4%.

If financial and economic fundamentals do not explain short-term volatility, what does? Below we will review five factors which help explain the volatility and unpredictability.

### 1) Prices are set at the margins

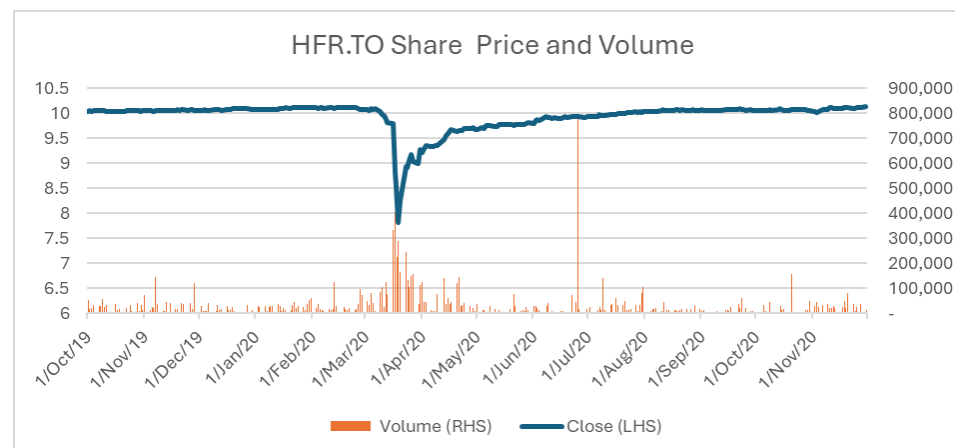
Most public market equities have millions of shares issued and outstanding and, on any given day, only a small fraction of those shares trade. See the summary of the Royal Bank below, where, on average, 0.31% of the shares outstanding trade daily.

Royal Bank	
Market Capitalization	\$208Bn
# of shares outstanding	1,413mm
Average Daily Volume Shares	4.6m
Average Daily Volume \$	671m
% of total traded daily	0.31

Source: Yahoo Finance

The results of these trades are extrapolated to give the overall value of the market. Given this pricing and extrapolation, a small number of motivated participants can have a dramatic impact on prices. Put another way, on any given day 99.7% of Royal Bank shareholders do nothing, but the price is set by the 0.3% who do.

Changes in the composition of market participants, specifically buyers or sellers entering and exiting the market, can have a significant impact on prices. These price movements are enhanced if some of those buyers or sellers are not sensitive to price. This can have a significant impact on the overall market valuation. A telling example of this phenomenon was during the early days of the COVID-19 work disruptions. Several prominent market participants exited the market for a short period of time leaving primarily desperate sellers and bargain-hunting buyers. Below is an example of a floating rate exchange traded fund that typically sees virtually no volatility in normal markets but dropped 25 % in March 2020 on a spike in volume as some typical market participants were out of the market. The 2008/2009 financial crisis saw similar price moves as participants exited the market when Lehman Brothers went bankrupt.



Source : [www.theglobeandmail.com/investing](http://www.theglobeandmail.com/investing)

### 2) Divisibility of investments in public markets

Unlike many long-term investments, such as real estate or private business, public market equities can be divided and sold in whatever quantity suits the investor. This divisibility leads to investors taking perfectly rational actions that can exacerbate price moves. It is easy to think of examples where an investor might want to sell a portion of their portfolio and not be sensitive to price. For example, in March 2020 it was perfectly rational for many investors to increase their liquidity reserves. This may have meant selling a small percentage of a portfolio at a steep price discount to recent price levels. Similar fractional selling is not possible with real estate or private assets where it is typically an all or nothing situation. You cannot buy and sell a portion of your house. This divisibility increases the likelihood there will be buyers and sellers who are not price sensitive which exacerbates price moves.

### 3) Near frictionless trading

While not entirely costless, trading in the equity market is inexpensive compared to other markets. The result is there is far more trading in the public market than in the private markets, even for similar asset types. An obvious example is public versus private real estate. Factoring in realtor fees, property transfer tax, legal fees, and other sundry expenses, the cost to transact in the private market could easily be 5% of the value of the transaction. The median detached house price in Vancouver is \$2.3m, which would result

in well over \$100,000 in fees. A similar value of public market real estate equities could be purchased for a few hundred dollars in transaction fees. The cost friction in the private market reduces trading volume and brings down overall volatility.

#### 4) *Sheer number of participants*

There are hundreds of millions of individuals and institutions participating in the equity markets. All these participants bring innumerable combinations of motivations, goals, time-horizons and whatever else might factor into an investor’s decision-making process. Combine this with the fact that motivations, goals, time-horizon, and whatever else might factor into an investor’s decision-making process are constantly changing, and it quickly becomes clear that trying to determine what is going to happen in the short-term is a fool’s errand. All this complexity is flattened when we simply talk about the ‘market’. When one steps back to consider the complexity of what makes up the ‘market’, it becomes clear why the movements are so unpredictable in the short-term; there are simply too many moving parts.

#### 5) *Human emotions*

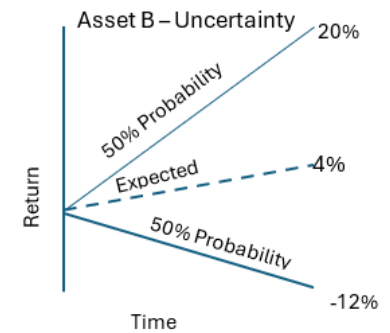
Last, but not least, is emotions. Greed, fear, and envy serve to accelerate any trend that is already present in the market. The result is prices that are rising or falling will continue to do so well beyond what would be expected if investors were totally rational.

### Why should long-term investors be rewarded for living with the volatility of the equity markets?

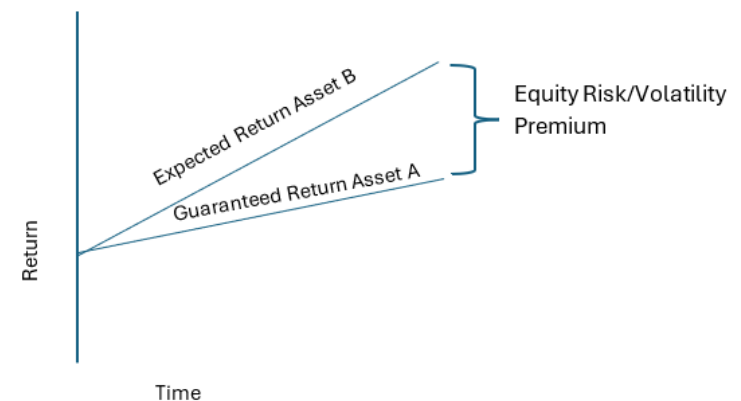
If we accept that equity markets are inherently volatile, which history, and our analysis above suggests we must, then the obvious follow-up question is why should that volatility necessarily translate into higher returns?

The simplest way to illustrate why volatile assets should generate higher returns is to think about two assets. The first asset has an expected and guaranteed return of 4% and the second asset has an expected return of 4%, but a range of outcomes of up 20% or down 12%. For the sake of illustration, we have assigned probabilities of 50% to the high and low return.

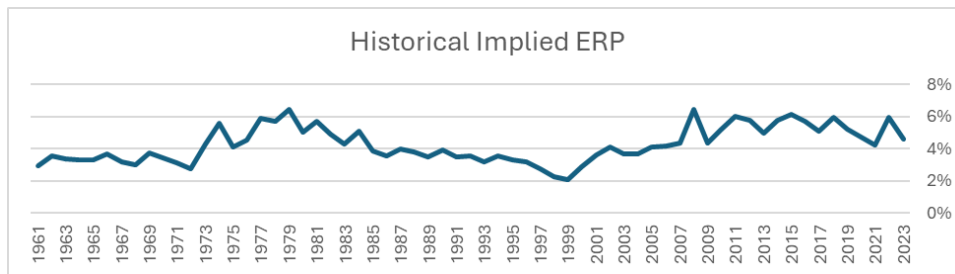
A) Guaranteed Return Asset			B) Volatile Return Asset		
Probability	Return	Expected	Probability	Return	Expected
100%	4%	4%	50%	20%	10%
			50%	-12%	-6%
					4%



So, we have two assets that have the same **expected** return, but very different levels of certainty over return. In this scenario why would any investor own asset B over asset A? In short, they wouldn’t. A rational investor would *never* own asset B in the scenario above. A rational investor will demand compensation for the uncertainty or volatility of that return. This compensation takes the form of a *higher expected* return. The situation depicted above will rarely present itself in the real world. The prices of the assets, and therefore expected return, will diverge before any buyers or sellers have transacted.



This difference between the guaranteed return from Asset A and the uncertain expected return from Asset B is known as the Equity Risk Premium (ERP), though we prefer the term Equity Volatility Premium. It is the extra expected return equity investors demand for owning equities versus the risk-free rate. The actual ERP is determined by the market and can fluctuate; furthermore, there is much technical nuance around how the number is calculated that is beyond the scope of this letter. However, as a simple measure of how much more equities have returned compared to the risk-free rate, the ERP has historically hovered between 3% to 5% at the global level. In most calculations of the ERP, the risk-free rate is defined as the long-term federal government bond rate. This means equity investors have typically demanded an expected return of 3% to 5% annually over government bonds as compensation for being exposed to the volatility of equities.



Source: <https://people.stern.nyu.edu/adamodar/pc/datasets/histimpl.xls>

Note that we are discussing *rational* investing. Gambling, by contrast, involves paying for the uncertainty rather than being compensated for it. Gambling, however, is not rational if the goal is to earn the highest expected return over the contemplated holding period. Furthermore, investors, and the markets more broadly, are not always rational and there are times the ERP may be negative for certain sectors of the market, but this is rare. Finally, while we can make an educated estimate of the current ERP, the actual ERP at any given time is only known with the benefit of hindsight.

The discussion above summarizes what would be several chapters of a finance textbook into a few paragraphs, so there is much more nuance and detail that could be discussed. However, for the individual investor the key takeaways are:

- Equity prices and equity markets are, and always have been, volatile and there is no reason to believe this is going to change in the future.
- Rational investors should demand a higher expected return as compensation for being exposed to the volatility of equities compared to the risk-free rate of return. This compensation is known as the Equity Risk Premium.

- It is impossible to know with certainty what the current Equity Risk Premium is at any given point in time, but historically it has been 3% to 5% annually.
- The Equity Risk Premium is earned over the long-term. In the short-term, *actual* returns can, and will, vary wildly from *expected* returns.

### Outlook

With interest rates up over the past 24 months and equity markets at, or near, all-time highs, it is reasonable to expect the premium earned by owning equities, compared to bonds, over the next few years to be lower than it has been in recent years. With this in mind, we have been increasing the fixed-income weight in many portfolios and will continue to do so where appropriate. However, we continue to believe there is a premium to be earned by owning equities and counsel those who have a long-term time horizon to keep their equity weighting as high as circumstances allow.

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