First Quarter Review

Drafting this letter began prior to the tariff announcement, so the market sell-off is not reflected in the First Quarter Review. The scope and goals of the tariffs being implemented by the Trump administration have baffled most market participants, however, the analysis below concerning diversification and putting volatility in context still holds, even considering the early April market moves.

Global equity market returns in the first quarter were mixed. In a reversal of recent trends, the strongest markets were observed outside the U.S. Developed Markets excluding North America increased 6.4%[1] during the quarter and Emerging Markets rose by 1.3%[2]. The Canadian market was up 1.5%[3], whereas the U.S. market declined -4.2%[4].

Bond yields experienced a slight decline during the quarter, with the 10-year Government of Canada Yield decreasing from 3.32% to 3.19%.

With that brief review concluded, the remainder of this letter addresses two key pillars of long-term investing success that Cypress wishes to reinforce to clients:

- The importance of keeping volatility in context.
- The importance of diversification.

Putting the Volatility in Context

On most valuation metrics, the U.S. market began the year at higher levels than other global markets.

	U.S.	Canada	Developed Markets	Emerging Markets
Price to Earnings	26.5	20.4	14.1	13.7
Price to Book	5.1	2.1	1.8	1.7
Price to Cash Flow	21.8	13	10	7.4

Source: Bloomberg (as of January 1, 2025)

While valuation is not a reliable predictor of short-term market movements, it is not surprising that the most expensive markets have experienced underperformance. The narrative surrounding the recent pullback in the U.S. market has focused primarily on tariffs and trades wars; however, the relative performance disparity between the U.S. market and the rest of the world can be partly explained by differences in valuation.

The uncertainty created by tariffs and trade wars is certainly not good for the equity markets, and the economic arguments for the tariffs make little sense to us. However, many factors influence equity market price movements beyond taxes and tariffs on imports. The equity markets are not simply a referendum on trade policies; regardless of how irrational those policies may seem.

Typically, we focus on the overall market. However, we wanted to look at individual securities for a change, as the market is, after all, simply the amalgamation of the underlying securities. Focusing on individual securities highlights just how volatile prices are in the short term. Below, we have summarized the price movements, up to the end of March, of the five largest companies in the U.S., Canadian and International Developed Markets, tracing back to the equity market bottom of 2009.

Stock	% From All Time High as of March 31, 2025	# of Drawdowns more than 10% since Jan 1, 2009	Total Return since Jan 1, 2009
Royal Bank	-9%	11	767%
TD Bank	-21%	8	619%
Enbridge	-2%	10	507%
Brookfield Corporation	-15%	14	1119%
CN Rail	-22%	17	654%
Apple	-14%	21	8090%
Nvidia	-26%	22	34100%
Microsoft	-18%	17	2890%
Amazon	-19%	20	6369%
Meta	-21%	14	1762%
SAP SE	-9%	14	851%
Novo Nordisk	-52%	18	1605%
Louis Vuitton	-38%	15	1673%
ASML Holdings	-38%	19	6843%
Taiwan Semiconductor	-24%	23	3329%

Source: Tiingo / https://dqydj.com/stock-drawdown-calculator/

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

The key takeaway is that individual equities, even the largest and most established companies globally, which have proven to be great long-term investments, often experience declines of double-digit percentages. This volatility is a feature of equity investing and the primary reason long-term investors can anticipate higher returns from owning volatile equities compared to less volatile fixed-income securities.

On Diversification

Understanding that diversification reduces risk is intuitive. Most people know the proverb – 'don't put all your eggs in one basket' which is so clearly sensible that it hardly requires explanation. The most effective way to mitigate negative outcomes (or risks) in investing is to be properly diversified.

As is often the case with investing, the nuances of analyzing the benefits of diversification depend on the definition of risk. Depending on how one defines risk, there is good and bad diversification.

Revisiting risk

In our previous quarterly letter, we discussed how the financial industry often uses short-term volatility - a figure that is easily calculated - as a proxy for risk. We believe this leads to sub-optimal portfolio construction. By concentrating too heavily on minimizing short-term volatility, investors may fail to maintain and grow the purchasing power of the underlying capital. How investors should think about diversification will demonstrate our concerns.

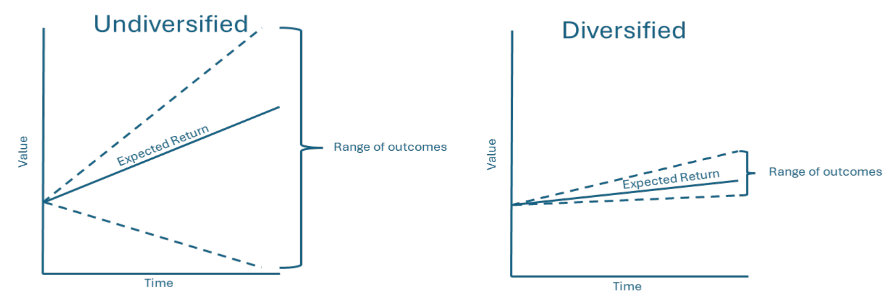
As with most investment analysis, it is important to distinguish between short-term and long-term. In the short-term, volatility is a significant risk, as it can negatively impact purchasing power. In the long-term, inflation is the greater risk.

Bad Diversification

If one thinks of risk solely as a function of short-term volatility, then adding *any asset* into a portfolio that is not perfectly correlated with the existing assets will reduce overall risk by decreasing volatility. Following this logic, an investor should diversify their holdings by owning a little bit of everything.

However, if we define risk as the failure to protect and grow purchasing power, diversifying into assets with no or low expected returns may increase risk, even if those assets lower overall expected volatility. Assets that reduce volatility while also diminishing expected returns are poor long-diversifiers.

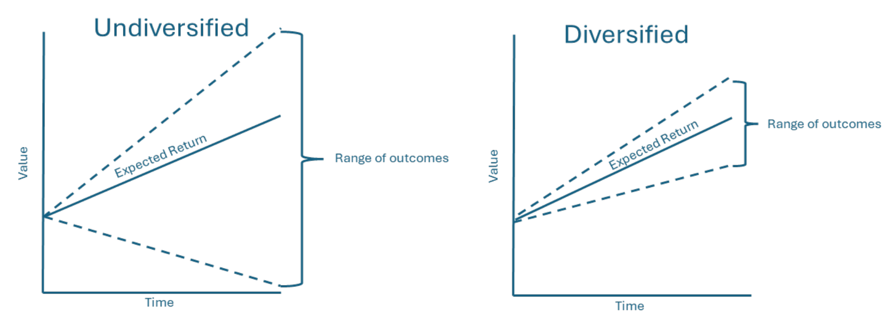
Bad Diversification: Lower Volatility and Lower Expected Returns



Good Diversification

Good long-term diversifiers are assets that can be added to the portfolio, which decrease overall volatility without negatively impacting the expected total return over the contemplated holding period.

Good Diversification: Lower Volatility and Same Expected Return



Obviously, the ideal assets would be those that enhance expected returns while simultaneously reducing volatility; however, such assets do not exist. There is no free lunch in investing. Volatility is the price you pay for higher expected returns.

In theory versus in practice.

In theory, given the appropriate inputs, building the optimal portfolio is straightforward. However, the obvious problem is that, in practice, no one can predict returns with certainty. The expected returns in the diagrams above are, at best, an educated forecast and, at worst, a total guess. Historical data, experience, and financial expertise offer some insight into what return expectations should be for a given asset class at various valuation levels, but the actual returns will not necessarily align with our projected expectations.

So, how do we determine expected returns? We believe the long-term historical performance provides a solid foundation for forecasting long-term future returns. While some adjustments are necessary to account for above- or below-average valuation levels, assuming that the future will resemble the past serves as a reasonable starting point when forecasting return expectations. With this in mind, we have listed the long-term returns of various asset classes below.

Asset Class	10 Year Annualized Returns %
U.S. Equities	13.9
Private Equity	12.5
Gold	10.1
Developed Market - ex U.S.	8.8
Canadian Equities	8.5
REITs (International)	8.5
High Yield U.S. Benchmark	5.6
Emerging Markets	5.4
Investment Grade Corporate Debt (CDN$)	2.5
Short-Term Government Debt (CDN $)	1.7
CDN / USD	1.3
Commodities	-0.5

Source: RBC, Cambridge Associates

Those asset classes highlighted in green we would call 'good' potential long-term diversifiers and those in 'red' bad long-diversifiers. Observant clients will notice the inclusion of gold and private equity in the above list as potential good diversifiers, though they are not asset classes we own in scale in most portfolios. Private equity has historically been expensive and illiquid, and we have been unable to identify an appropriate investment vehicle, which is why it does not constitute a substantial portion of our portfolios. The expected return on gold is a topic of frequent internal debate. and will no doubt continue to be in the future. While the past 10 years have been good for gold, most of that return has been generated in the last 12 months, and gold can experience decades of minimal returns. So, while we continue to debate the inclusion of private equity and gold in portfolios for long-term diversification, there is no debate concerning cash and short-term fixed income. The low long-term expected returns on these assets make them 'bad' long-term diversifiers.

Outlook and Strategy

Despite the recent sell-off in the equity market, investors should not do anything differently today than they should have done in the past. While tariffs have increased uncertainty, it does not change the fundamentals of long-term investing:

- Evaluate spending and set aside short-term spending needs in an asset not subject to the volatility of the equity markets.
- Maintain sufficient liquidity to manage anxiety. One should not be losing sleep over the short-term moves in the equity markets. Anxiety leads to bad decisions. This can be within your Cypress account or elsewhere.
- Allocate long-term investments to what has the highest expected return over the contemplated holding period. Over the next 5+ years, we expect a diversified portfolio of equites to have a higher return than cash or bonds.

CYPRESS CAPITAL MANAGEMENT LTD.