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Year End Review and Outlook
Cumberland Income Fund
December 2015

Regular readers of Cumberland Income Fund quarterly reviews will recall that "increased volatility" is a theme we have threaded throughout our commentaries in 2015. The fourth quarter of 2015 continued on that theme in earnest. Disappointing economic data, low commodity prices, and the U.S. Federal Reserve's first rate hike in 9.5 years caused material swings in currency, equity, and bond markets. As we exit 2015 and enter 2016 we expect the heightened levels of volatility to continue not only because of global growth uncertainty, but as a result of markets "recalibrating" to a less accommodating Fed. With the central bank of the world's largest economy finally achieving the much anticipated "lift off" of the fed funds rate in December and hinting at further rate-hikes in 2016, investors are anticipating a headwind not felt in quite a while. Closer to home, the continuing deterioration in commodity prices is causing the Canadian dollar to depreciate and the Bank of Canada to publically discuss unconventional tools to further ease monetary policy. Managing volatility amongst these cross-currents remains the priority of the Cumberland Income Fund. The Fund continues to focus on holding investments and deploying capital with a longer-term view into securities offering stable and sustainable income generation while preserving capital. In the shorter-term, this philosophy prioritizes dampening "downside" risk over participating in "upside" bond market volatility, a strategy we expect to have greater sustainability over the long-run.

Government bonds were beneficiaries of the volatility in Canada despite the Fed's rate hike south of the border. The sector generated a total return of +1.1% during the quarter as weakening commodity prices caused a flight to safety into government bonds driving yields lower in Canada. Monetary policy *divergence* between Canada and the U.S. was solidified during the quarter. After the Bank of Canada cut the policy rate twice in 2015 (0.25% in January and another 0.25% in July) the U.S. Federal Reserve finally took the first step to normalize the fed funds rate away from crisis level policy rates (or zero interest rate policy – or ZIRP). On December 16th the Fed raised the fed funds rate from the 0.0%-0.25% range to the 0.25%-0.50% range, the first rate hike since June 2006. The increase was largely hinted at over the prior month through speeches made by other Fed committee officials so the hike was largely "priced in" at the time of announcement. By "priced in" we mean for example, the yield on the 2-Year U.S. Treasury bond increased 0.4 percentage points from a yield 0.60% at the beginning of the quarter to a yield of 1.0% by December 16th in anticipation of the rate hike. By the end of the quarter (in the two weeks after the Fed announcement) the yield only increased a further 0.05 percentage points compared to the 0.25 percentage point hike in the fed funds rate. Perhaps more noteworthy however was during that same post-announcement two-week period, the yield on the 10-Year U.S. Treasury bond actually declined 0.03 percentage points. This is notable because the yield on shorter-term government bonds are typically more influenced by central bank monetary policy, yet government bonds with further-out maturity dates (such as 10-Year bonds) reflect investor sentiment to a greater degree. This divergence in 2-year and 10-year bond yields (or the "flattening" of the yield curve) suggests that the bond market is more skeptical of growth in the economy compared to the expectations at the Fed. We expect this divergence in views between policy makers and the bond market to be a main contributor to volatility in 2016.

Historically, government bond yields in Canada and the U.S. have tracked closely, however as shown in the chart below, the two have been diverging lately. This "divergence" is a theme we expect to see continue in 2016 and goes hand-in-hand with expected continued volatility. Canada's commodity sensitive economy will likely continue to underperform that of the U.S. If the underperformance is sustained the likelihood becomes greater that the Bank of Canada will ease monetary policy further with another policy rate cut (to 0.25%). Volatility caused by uncertainty in monetary policy will likely be compounded with potential changes in fiscal policy. Canadians (investors, individuals, and corporations) await to see what increase in government spending (e.g. infrastructure programs) the newly elected Liberal Party government will announce,

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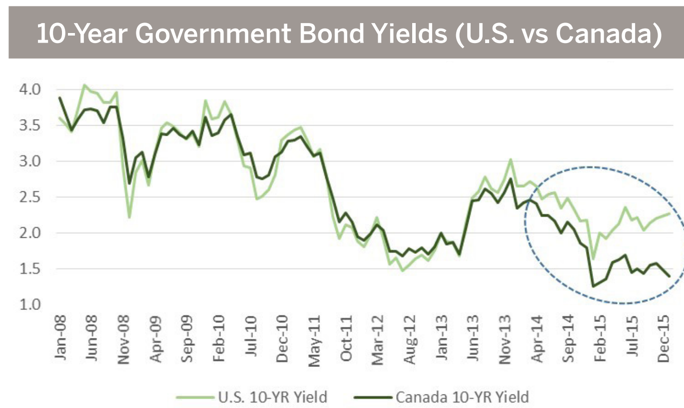
and whether it will have any sustainable impact in counteracting the headwinds of lower commodity prices. If accommodative monetary and fiscal policies prove "bullish" to market expectations then we could see the risk of ultra-low Government of Canada bond yields rising (prices declining) modestly. We therefore continue to have minimal exposure to this fixed income sub-sector.



Investment Grade corporate bonds (credit rating BBB- or higher) underperformed the broad FTSE TMX Canada Universe Bond Index for a second year in a row. Consistent with the risk-aversion tone in the equity markets, Canada corporate spreads also headed higher (or cheapened) during the quarter. Corporate spreads backed up 42 basis points (0.42%) causing the Canada Corporate Bond Index to return +0.63% in the fourth quarter compared the +0.98% of the Canada Universe Index. As shown in the chart, corporate spreads reached levels not seen since 2012, and in the case of BBB rated bonds, spreads reached levels not seen since the 2011 U.S. debt default scare. Although the cheapening of the corporate bond sector has raised concerns over the increased borrowing costs for corporations, it simultaneously provides investors with opportunities in certain corporate bond sectors. One such sector that continues to cheapen and offers an attractive risk-reward profile, in our view, is subordinated Canadian bank bonds. During the quarter we purchased a bond issued by TD Bank (A rated). The bond (TD 2.692% 24Jun25) is callable in 2020 and was purchased at a discount to par ($100) to yield 3%. Another indication of market uncertainty was the low level of corporate bond issuance in Canada this quarter. Corporations issued the smallest amount of bonds in a fourth quarter period since 2008 (C$14.8 billion).

10-Year Indicative Canadian Corporate Bond Spreads

Source: BMO Capital Markets

After declining 5% in the third quarter, the High Yield bond sector (credit ratings BB+ or lower) fell another -2.5% in the fourth quarter according to the FTSE Canada High Yield Index. Bonds issued by energy companies were the largest contributor to this negative performance driven primarily by the 18% decline in price of crude oil (WTI) during the quarter. Concerns over cash flow generation of energy companies and poor liquidity in the high yield secondary market resulted in lower prices / higher yields. The Fund's High Yield holdings are comprised mainly of issuers of non-commodity related businesses. As of December 31, 2015, only 1.1% of the Fund is exposed to high yield bonds issued by companies directly related to commodity production, and another 2.4% of the Fund is exposed to high yield issuers indirectly related to commodities or Western Canada. We remain positioned to take advantage of any market dislocation in the high yield space and look to deploy capital in the non-commodity segment if the opportunity presents itself.

After having a difficult first-nine months of 2015, preferred shares in Canada rebounded somewhat

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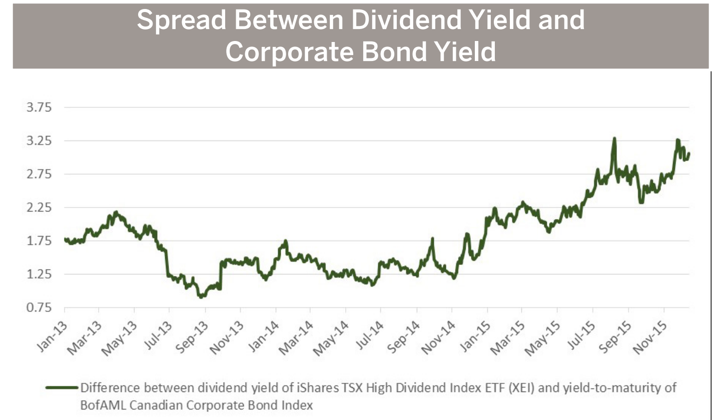
during the final quarter. The TSX Preferred Index returned +6.8% on a total return basis and the TSX Preferred Laddered Index (a proxy for the rate-reset portion of preferred share market) generated a total return of +9.1%. Investors began buying back preferred shares that had sold off to very attractive levels. The Fund repositioned some of its preferred share holdings for tax planning purposes and added to some preferred shares with a new structure. The Fund initiated positions in new preferred shares issued by AltaGas, Brookfield Renewable Partners, and Brookfield Infrastructure Partners. All three preferred shares offer a new feature that puts a *floor* under the reset dividend. This ensures that the dividend does not get reset to a level below the initial dividend rate at the time of reset (every five years). We view this feature of having a "guaranteed" dividend particularly attractive during times of volatility in interest rates, such as we have currently. Furthermore, if bond yields do head higher, then the new dividend will continue to get reset *higher* at the pre-determined *spread* to the 5-Year Government Bond yield or be called by the issuer at $25.00.

Dividend-paying stocks outperformed high yield bonds in Canada but still posted a negative quarter. The TSX Composite High Dividend Index generated a return of -2.7%, including dividends, for its third consecutive negative performing quarter. Once again, energy related businesses were sold aggressively during the quarter. On a year-to-date basis the Index is down -14.5%. Similar to the high yield segment strategy within the Fund, there is minimal exposure (just 0.4%) to a business model whose revenues are generated through commodity exposure. We continue to view exposure to select dividend paying stocks as a key component to attaining an income stream greater than inflation within the Fund. We currently view the dividends in all the Fund's equity holdings as "safe", with no positions having a financial profile that would put the dividend at risk, in our view. Additionally, if we compare the dividend yield of high dividend paying stocks (as per the S&P TSX High Dividend Index) to the average corporate bond yield-to-maturity (YTM of Bank of America Merrill Lynch Canadian Corporate Bond Index) we see that dividend paying stocks are near their cheapest levels in three years, as shown in the chart below. We expect attractive opportunities to present themselves in 2016.



OUTLOOK

Central Banks around the world seemed to have run out of runway in their ability to suppress market volatility with their unconventional monetary policies in 2015. Over the longer-term we think the increase in the fed funds rate will prove to be a positive for the economy as the ultra-low rate environment seemed to shift from a stabilizing policy (during and immediately after the financial crisis) to a destabilizing policy. Over the past several years, low quality / high risk business have been able to borrow (issue bonds) at low interest rates not commensurate with their level of riskiness. It has also fostered an investing environment which has encouraged investors to "reach-for-yield". Ultimately, this results in a misallocation of capital – the energy sector is a good example – and the market is forced to recalibrate the pricing of risk. We expect as the Fed normalizes the policy interest rate investors may somewhat reduce their misallocation of capital and set the stage for a healthier U.S. economy. However, it is the *transition* that brings uncertainty and volatility. Furthermore, the after-shocks of the Fed's policies continue to be felt in Canada. Low interest rates caused an over-investment in oil production, which in turn resulted in a decline in oil prices, directly causing a slowdown in the Canadian economy. We now expect Canada's economy and monetary policy to further *diverge* from that of the U.S. This divergence will likely keep interest-rate sensitive securities somewhat

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unstable in the near-term – providing attractive entry points to deploy additional capital. We therefore continue to maintain high levels of liquidity to dampen volatility and allow the Fund to be opportunistic in the event of market dislocations. Finally, in 2015, the environment has once again demonstrated that holding some allocation to bonds offers the benefits of diversification within a broader investment portfolio, a characteristic we expect to continue in 2016.

R. Schulte-Hostedde

Portfolio Manager, Fixed Income

January 2016

Asset Allocation as at December 31, 2015

Asset Class	% of Portfolio
Cash and Cash Equivalents	10.9%
Government Bonds (incl. Floating Rate Notes)	16.0%
Corporate Bonds	52.3%
Preferred Shares	7.8%
Equities/Income Trusts	13.0%

Yield[1] Comparison as at December 31, 2015

FTSE TMX Canada Universe	2.0%
FTSE TMX Canada Government	1.7%
FTSE TMX Canada Corporate	2.7%
Cumberland Income Fund[2] (today)	3.6%

1. Yield is the rate of income generated on an annualized basis. Yield does not represent the total return of the Fund or the indices shown in the above table.
2. Gross of fees.

Cumberland Private Wealth Management Inc. is a leading independent investment firm that provides discretionary investment management and wealth management services for high net worth individuals, their families and foundations, with $1 million or more in investable assets. All of Cumberland's investment mandates are centered on building and preserving our clients' financial wealth. Founded in 1997, the firm is privately-owned by its employees and headquartered in Toronto, Canada.