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North American Capital Appreciation Strategy
June 2016

The biggest news development during the quarter came in the final few days – this of course was Britain voting to leave the European Union (Brexit) on June 23rd. The S&P500 lost 133 points or 5.3% in two days, only to recover most of the losses (99 points or 4.9%) by June 30th. We published our thoughts on Brexit in a quick note at that time, but it's probably worth a recap along with our subsequent thoughts. To simplify,

Brexit probably means three things: 1) reduced economic growth in the short term at least for the UK and the EU, 2) greater uncertainty and 3) possibly a stronger US dollar. The lower economic growth stems from the fact that businesses will delay capital and hiring plans due to the lack of clarity on what the cost of doing business in a particular jurisdiction will be going forward. Below is a quote from the UK country director at Caterpillar (CAT).

"We acknowledge and respect the decision by the British people for the UK to leave the European Union. As a global manufacturer with a large footprint in the UK and across Europe, we call on the British government and its European partners to make all efforts to move forward swiftly to negotiate a new settlement. The UK is an intrinsic part of our European supply chain and we urge all parties to reach an agreement that quickly removes the uncertainty, allows the UK to retain full access to and from the single market and protects the interests of businesses with strong commitments and investments in the UK."

- Mark Dorsett
UK Country Director, Caterpillar (CAT)

Statements like this should not come as a shock especially given that CAT has 20 of 36 manufacturing facilities in the UK employing 10,000 of 25,000 people in their Europe, Africa and Middle East (EAME) division. It is however some perspective on what businesses are facing.

From a US perspective, the UK accounts for about 3.6% of US exports so it is tough to call this a meaningful event for the US economy specifically. It's unlikely to impact housing starts, auto sales or the level of unemployment in the US, some of the factors we consider the important economic drivers.

Greater uncertainty could be measured by the economic uncertainty we just discussed or greater stock market volatility, which we have already been experiencing. The VIX , which is an index that tracks the S&P500 volatility and is often referred to as the "fear index", went from 17 prior to the Brexit vote (a level considered normal), to 25 and then retraced its way back to 16 by quarter end. European sovereign credit spreads also widened but have since normalized. While both are indicators worth watching one thing we should keep in perspective is that the uncertainty created by Brexit was driven by political events not financial or economic circumstances. However, should financial conditions deteriorate, the Bank of England (BOE), The European Central Bank (ECB) and The Federal Open Market Committee (FOMC) appear willing to provide liquidity if needed. This probably means monetary conditions stay softer for longer, which should actually be a positive for risk assets (stocks). The probability of a rate increase in the US this year has fallen from about 59% pre-Brexit to 13% currently. The uncertainty will likely drag on, however at this point it appears manageable.

The third impact is the possible strengthening of the US dollar, which would likely be a negative for US earnings and US stocks or at least those stocks exposed to related Brexit currencies, just when we were starting to see some relief in this camp. So far the US dollar has appreciated 10.7% to the Pound Sterling since Brexit, while the DXY, which measures the US dollar relative to a basket of global currencies, has appreciated about 3%. While part of this may be a flight to the US dollar safety, it may also reflect the relative attractiveness of higher yielding US securities. The flipside to this is that the weaker Pound Sterling (and Euro) should act as a positive buffer for multinationals operating in the UK and the EU to a lesser extent. To some degree the movements in exchange rates probably reflect the market's best guess at future tariff structures that remain to be negotiated under Article 50 of the Lisbon Treaty, which set the provisions for countries to exit the EU.

During the second quarter, the S&P500 total return was 2.5% in US dollar terms. Adjusting for currency, the S&P500 returned 2.8% as the Canadian dollar was little changed during the quarter closing at US$0.77. During the first six months the S&P500 total return was 3.8% in US

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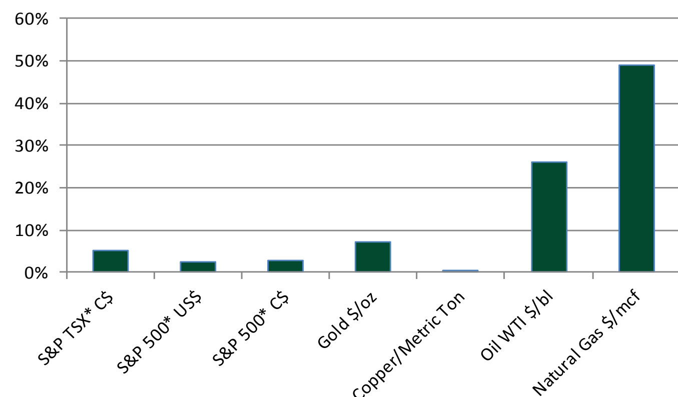
dollar terms but adjusting for currency, the S&P500 was down -2.4% due to the Canadian dollar appreciation from US$0.72 at December 31st. As we discussed in our last quarterly review, we took the opportunity to hedge about half of our US dollar exposure for our Canadian resident clients as the Canadian dollar touched a 13 year low in late January. Regarding economic growth in Canada, second quarter GDP growth looks challenging due to the impact of the wildfires in Alberta that shut down oil production. However, the balance of the year should benefit from the reconstruction as well as higher oil prices, which seem to have found a bottom in the first quarter and the return of oil production in Alberta. Also with the CAD dollar appreciation back to the US$0.77 level and our Central Bank governor signaling a more neutral stance on interest rates going forward, the current range of US $0.75-$0.80 seems reasonable. Furthermore, the likelihood of any major move in interest rates south of the border appears less likely. Therefore we removed the US dollar hedge in our Canadian-resident clients' portfolios in the second quarter, which resulted in a gain. Currently our currency exposure slightly favours Canada at 52% versus the US at 48% of the portfolio. The TSX total return for the second quarter was 5.1% and year to date it was 9.8%.

Exhibit 1
Percentage Change for Quarter to June 30, 2016

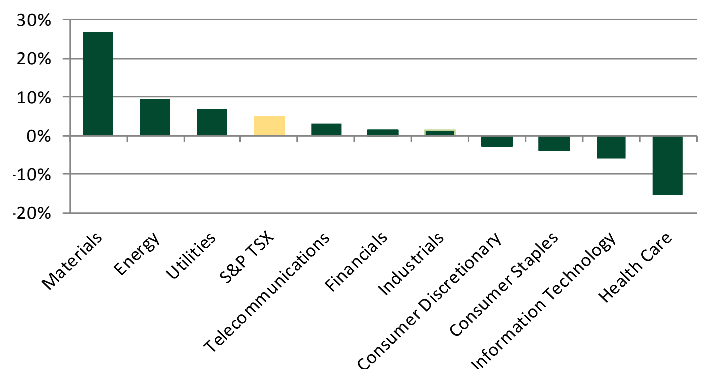


Source: Bloomberg *Total Returns

On balance, we remain constructive on the outlook for the US economy although the latest payroll employment data that came out for May in early June was generally disappointing for the market. There are reasons to believe this was weather-related after strong employment gains through the fall/winter period limited construction, retail and leisure employment growth this spring. While more data will come in later July, the unemployment rate at 4.7% is well within the FOMC's targeted long run range of 4.6% to 5%. Meanwhile the latest Institute for Supply Management (ISM) data rose to the highest level in 16 months suggesting the manufacturing sector in the US is on the mend and is consistent with annualized GDP growth of over 2%. The forward looking New Orders index contained within the ISM report also hit a three month high suggesting this trend should continue. Also ISM data from Europe and the UK improved but obviously this does not capture the full Brexit impact in late June. Strong May consumption growth by US consumers also implied an even higher GDP growth target than 2% in the second quarter and the strong consumer confidence data for June suggests consumer spending growth is set to continue. Meanwhile inflation, as measured by the Fed's Personal Consumption Expenditure (PCE) core price index, is running at 1.6% down from 1.7% in the first quarter, which is slightly below the Fed's longer term target of 2%. However, higher energy prices and US wage growth running at 2.5% should bias this higher over time.

While all of this seems to be a reasonably positive back drop for the US economy, monetary conditions will likely continue to reflect global growth concerns and remain accommodative.

Exhibit 2
S&P TSX Sector Performance (C$)
2nd Quarter 2016



Source: TD Securities

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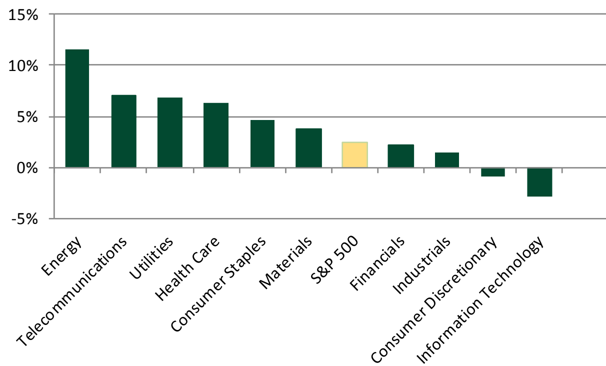
Exhibit 3

S&P 500 Total Returns (US$)
2nd Quater 2016



Source: TD Securities

During the quarter, our exposure to equities increased 6% which resulted in reduced cash and fixed income (bonds) weight. Our exposure to Canadian equities has steadily risen since the beginning of the year from about 28% to 40% mostly in Energy, Industrials, Materials and Financials while our US equity exposure declined from 56% to 49%. At that time, we discussed that the TSX was trading about 14.3x forward earnings as compared to its long term average of 15.4x and the S&P500 at 16.1x. We also noted that the TSX had underperformed the S&P500 for five consecutive years and this had never happened six years in a row. This shift has been a positive benefit to the portfolio.

Asset Allocation for Capital Appreciation Strategy As at June 30, 2016	
Equities	89%
Fixed Income	4%
Cash	7%

In terms of new additions to the portfolio this quarter, in Canada, we added Canadian Western Bank (CWB), Industrial Alliance Insurance (IAG) and WestJet Airlines (WJA). While the first half of 2016 has been characterized by leadership in energy and materials, we think financials (both in Canada and US) will likely gain some of that leadership in the back half of 2016. We expect this will be driven by strong dividend and earnings stability along with an attractive valuation in an ever increasing yield hungry world.

Financials in general, both in Canada and in the US, have lagged due to investor pessimism around slowing loan growth and rising loan losses. Meanwhile high yielding credit spreads peaked in February and that typically coincides with a peak in loan losses. In the case of Canadian Western Bank, it clearly has geographic exposure to those provinces hit the hardest by the collapse in oil prices, however we believe the company has addressed the majority of this in recent earnings releases and has taken appropriate actions to shore up its balance sheet. With CWB trading at a 3.8% dividend yield and a dividend payout ratio of 34%, which is materially lower than the rest of the Canadian bank group, we purchased CWB trading at the same level of price to book value as it was during the financial crisis (2008-2009) and at a multiple of earnings that is one standard deviation below its long term 20 year historical average. Industrial Alliance is similar to CWB in that it trades at a substantial discount to other Canadian insurers as measured by price to earnings and price to book valuation, yet offers an attractive 3.2% dividend yield and one of the lowest dividend payout ratios at 27% as compared to the Canadian insurance group average of 43%. Finally IAG earnings are quite sensitive to rising interest rates should that happen, but there is nothing priced into the stock for this today.

WestJet's key competitive advantage is its low cost structure compared to its largest peer, Air Canada. This is due to a number of competitive advantages including a more focused alignment of the type of aircraft, which helps to reduce maintenance costs, an attractive incentive profit sharing program that aligns the interest of employees with shareholders, as well as higher asset utilization of which WestJet reports 40% lower costs that has been sustainable over time. WestJet Airlines is similar to Canadian Western Bank in that it has a large exposure of about 25% to the Alberta market. The good news is that the assets are portable and WestJet reallocated some 85 flights out of this market. Redistributing capacity takes time owing to the lead times for flight bookings; however, we believe Q1 marked the low in load factor (capacity utilization), which should greatly alleviate fare discounting pressure going forward.

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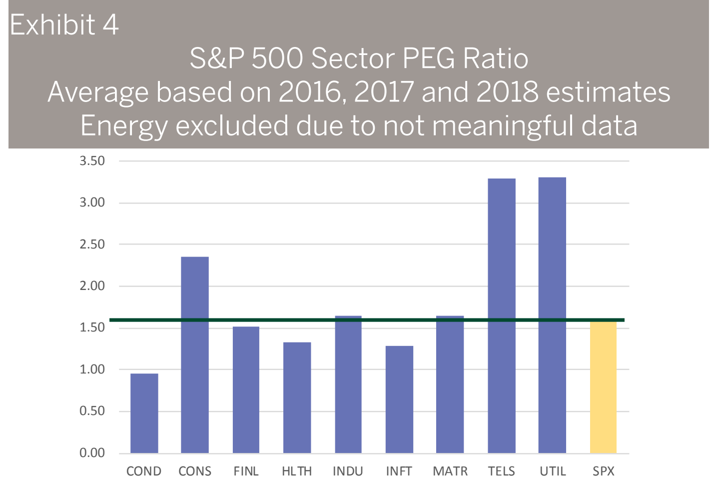
On the US side, we added Microsoft and HealthSouth Corporation. Microsoft, is an established global leader in productivity and operating system software and is in the midst of a global shift to cloud computing that we believe will expand its addressable market opportunity to accelerate revenue growth. While Microsoft's LinkedIn acquisition is relatively small it does enhance opportunities in enterprise networking similar to Facebook in the social networking world.

HealthSouth is one of the largest players in the inpatient rehabilitation facilities care and home health care industry in the United States. We believe the combination of a highly fragmented industry, favourable aging demographics and high free cash flow generation, should drive future share price appreciation for HealthSouth. A complete summary of new positions added during the quarter including business fundamentals and valuation metrics is contained in Appendix 1.

Outlook

While the Canadian market had a decent first half, the US has lagged at least in Canadian dollar terms. Concerns about slowing global growth, the prospect for a series of Fed rate hikes in the first quarter and more recently Brexit all played a role in capping the upside for the S&P500; however as we are writing, it is within 1.6% of the all-time highs. While energy and materials have fared well in the first half of 2016, the other big driver of sector performance has been the direction of interest rates. Year to date the ten year US Treasury has fallen 81 basis points (-0.81%) to 1.46%. The impact on yield sensitive groups to lower rates has also been material, which is evident in Exhibits 2 and 3 in particular for the telecom and utilities group. However it appears to us that economic conditions are improving particularly in the US and volatility post Brexit has stabilized as measured by the yield spreads of sovereign credit.

From a valuation perspective, the S&P500 is trading at 16.7x forward earnings which is the exact same level as we discussed three months ago. Yet, the difference today is that the forward earnings at $126 for the S&P500 are 2.2% greater which equates to about the move in the market over the past three months. Our thesis last quarter was biased to the upside on equities with further confirmation that S&P500 earnings had bottomed. While that appears to be the case and it is similar in Canada as earnings have also risen approximately 4% during this time period, we believe overall market valuations at current levels are not cheap by historical measures. Some discretion is needed to discriminate as to which sectors offer the most compelling valuations and the most attractive earnings growth prospects. The chart below shows the PEG ratios for each sector of the S&P500. The PEG ratio is the price/earnings ratio divided by the forecasted earnings growth rate for each sector of the S&P500. This calculation allows one to distinguish how much you are paying for the earnings growth rate between sectors. In the chart, the sectors with the lowest PEG ratios represent the most attractive valuations. Currently four of the ten industry sectors in the S&P500 have PEG ratios less than the S&P500 PEG ratio. These are Consumer Discretionary, Financials, Health Care and Information Technology. Currently these four sectors represent about 57% of the equity portion of the Cumberland portfolio.



Source: BMO Investment Strategy Group

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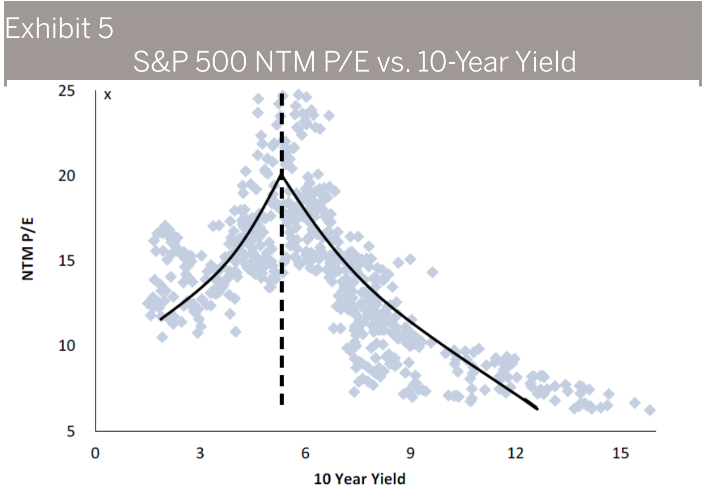
Two sectors to which we have no exposure, namely Telecommunication Services and Utilities, represent the most expensive sectors trading at PEG ratios north of 3x. The two others sectors that are meaningful to us are 1) Industrials, which we have seen pockets of outperformance in this quarter and have recently been decreasing our exposure and 2) Energy, on which we are still constructive on given the contracting supply growth trend that continues in the US and stronger demand outlook through the balance of 2016. As we highlighted last quarter, oil production continued to fall in the first quarter by approximately an additional 200,000 barrels per day in the US. This compares to an additional 580,000 barrels per day second quarter decline. Meanwhile OPEC production has leveled off during the first half of 2016 after increasing consecutively in the two prior years.



Source: S&P, Thomson Financial, Federal Reserve, Haver, Fact-Set, and RBC Capital Markets

In conclusion, in an environment of improving economic growth and accelerating earnings, at least in North America, equities should remain the asset class of choice especially given the low level of global bond yields. And in an environment where any upward move in interest rates would likely be confirmation of stronger growth, we believe equities should also continue to perform reasonably well. The final chart shows the relationship between US ten year bond yields going back to 1964 and the forward price earnings ratio in the next twelve months (NTM). As indicated in the chart, rising yields, at least from very low levels like we are experiencing today, generally result in higher multiples as the market will pay up for future earnings growth.

Peter Jackson
Chief Investment Officer
July 4, 2016

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.

Appendix 1
New Equity Investments:
North American Capital Appreciation Mandate
Quarter ended June 30, 2016

United States

HealthSouth Corporation (HLS)

HealthSouth is a leading provider of in-patient rehabilitation facilities (IRF) and home health services in the United States. IRF is the larger of the two businesses providing specialized rehabilitative care to treat disabilities or injuries like strokes and hip fractures that are generally non-discretionary in nature. The home health business provides skilled nursing, physical occupation and speech therapy in the home setting. Roughly 60% of HealthSouth's IRFs are within a 30-mile distance from a home health location, allowing the company to coordinate care protocols and offer a full continuum of care for its patients.

HealthSouth operates in an industry with a favourable demographic trend. An aging population and life expectancy should increase the demand for facility-based and home-based post-acute care services. Furthermore, IRFs offer a lower cost of treatment option, making them attractive for patients that require rehabilitative care following their discharge from the acute care hospital.

Microsoft Corp (MSFT)

Microsoft is a leading global provider of productivity and operating system software for both commercial and consumer uses. Key products include Microsoft Office, Windows, Windows Server, Xbox, and Bing. Given the ubiquity and how heavily embedded the products are into workflows and processes, this creates high margin, sticky, and recurring revenues. The company is currently in the midst of a company-wide shift to a cloud computing platform that will enable customers to access Microsoft solutions anywhere and from any device. While this shift brings the potential of new competitors, we believe this is in fact an opportunity for the company longer term, as it increases the addressable market for Microsoft, which it can monetize through its well-entrenched consumer and enterprise relationships.

Canada

WestJet Airlines Ltd. (WJA-T)

WestJet is Canada's second largest airline, offering scheduled service to more than 100 destinations in Canada, the US, Central America, the Caribbean and the UK/Ireland. WestJet has grown quickly since its founding in 1994 by exploiting its sizable cost advantage to gain market share against incumbents such as Air Canada. In a testament to management, WestJet has delivered this growth while maintaining double digit returns on invested capital and an investment grade credit rating (both are rare amongst airlines).

Recently, WestJet's profit margins and stock price have fallen as the added seat capacity and fare pressure have not fully offset the higher associated expenses. The margin pressure peaked in early 2016 when WestJet faced a struggling Western economy and the added costs to launch wide-body jet service to London, England. At this point, we initiated our position in WestJet believing revenues would benefit from the redeployment of excess capacity from Alberta to stronger North American markets, and the inaugural flights to London Gatwick. With evidence now of improved capacity utilization, WestJet share have started to recover.

Canadian Western Bank (CWB-T)

Canadian Western Bank is a Canadian 'Schedule A' bank with $24 billion in assets, primarily focused on secured lending to commercial and industrial borrowers in Western Canada. CWB is a high quality franchise, delivering double digit loan growth and return on shareholders' equity for over two decades.

As a result of its concentration in oil-affected regions, the Company has seen a marked rise in provisions for credit losses since 2014. Following weak earnings results in early June, CWB sold additional common shares in mid-June 2016 to rebuild its capital base. We participated in this offering to initiate our position in the Bank. While uncertainty remains around the current credit cycle, we

Appendix 1
New Equity Investments:
North American Capital Appreciation Strategy
Quarter ended June 30, 2016

believe the cycle is adequately priced into CWB's shares -current assumptions for loan losses are well above prior-cycle peaks and trading multiples have reached prior cycle lows. With a stronger capital base and recovery in oil prices, the risk-reward trade off owning CWB is favorable.

Industrial Alliance Insurance (IAG-T)

iA Financial is a Quebec-based life insurance company with a superior track record (it has compounded book value at a rate of 8% over the last decade) that trades at a significant valuation discount to its peers in the life insurance industry. This track record has been earned over a decade of low and declining interest rates and iA Financial provides excellent earnings leverage to a day when interest rates begin to rise again. If long-term interest rates rise by one half of one percent earnings at iA Financial would rise by 35% which is the highest among Canadian life insurers by a significant margin.