CUMBERLAND

Global Equity and International Fund Strategies
Year End 2016 Review

Global Macro Review

If you are a liberal in your political views, 2016 was definitely a discouraging year, highlighted by the Brexit vote and Trump's victory, along with secondary events such as the loss by the Italian government in its referendum and the rise in popularity of the right wing National Front in France. The winning theme in 2016 seems to have been that globalization is a scam to benefit only corporations and the rich. Thus, with the rise in populist politics and resulting in potential protectionist policies, a key question we ask ourselves as global managers is whether globalization is dead.

We can empathize with the anger of the middle class. Based on a report by McKinsey Global Institute, they found the real incomes of two-thirds of households in twenty-five advanced economies were flat or fell between 2005 and 2014, compared with an increase of 2% in the previous decade. In addition, the Canadian Center for Policy Alternatives reported that the 100 richest CEOs in Canada will earn by 11:47 am of January 4th what the average Canadian will make in a whole year or 193 times the average Canadian, while it is about 300 times in the US. The economic and social impact of income inequality is potentially corrosive and those negatively impacted by this trend expressed negative opinions about free trade and immigration. In short, they view globalization as the primary cause for wage inequalities and job losses.

The Boston Consulting Group submits that the global economy has changed drastically over the past decade. Firstly, affluent countries have a diminished role while secondly, the less-than-affluent countries are increasing their influence and lastly, there is diversity in growth across the global economic landscape. Technological change, the financial crisis and subsequent slow recovery have muddled the landscape.

Affluent countries no longer exclusively dominate the global economy. Although the US, Germany and Japan remain leading economic powers, their role on the world stage over the past two decades has diminished compared with emerging economic giants such as China. Half of the global growth between 2004 and 2013 was generated by countries whose annual GDP per capita is significantly lower than those of affluent countries. As a result, the share of the global GDP of affluent countries has diminished significantly. With this dynamic and the uncertainty that has emerged with Trump as the next US president, we are about to have a toxic mix of volatility in politics, trade and markets in the coming years.

We are certain that 2017 will be met with uncertainty. President-elect Trump is using the bully pulpit via Twitter to shame and manipulate companies to demonstrate his power and continue his bombastic outbursts that won him the election. Yet, he has created a Strategic and Policy Forum headed by Stephen Schwarzman, the co-founder and CEO of Blackstone as well as including the CEOs of General Motors, IBM, JPMorgan Chase, BlackRock, Walt Disney and Boeing and former CEO of GE. These executives are certainly not supporters of protectionism. We can only speculate what game Trump is planning to play with polar opposite teams of appeasing to his anti-immigrant voter base while appointing senior corporate executives to his cabinet. The market is currently only focusing on the potential positive impact from the pro-growth policies Trump has promised that include corporate tax cuts, deregulation, and fiscal spending. A legitimate question is how these tax cuts and fiscal spending will be funded. Fiscal spending, while positive, may have a delayed impact on growth. Furthermore, based on a study by strategists at Exane BNP Paribas, they conclude that US earnings per share is unlikely to be rescued by repatriation of offshore cash. Hence, on balance, we believe the risk premium should be higher.

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However, we should recall that Trump's central theme during the campaign was based on anti-trade and anti-immigration, thereby winning over the older, white, male vote and surprisingly, the suburban white female vote. Consequently, if he does pursue a policy that leans on protectionist and anti-immigration policies, it is generally viewed as a negative for global growth as well as on expected earnings growth for companies. Furthermore, based on various studies on the cost of protectionism, the poorest 10% of consumers would lose 63% of their spending power if borders were closed given that they buy relatively more imported goods. In this same study of 40 countries, of which 13 were developing countries, people with high incomes in comparison would lose just 28% of their purchasing power. Therefore, if Trump carries out his promise of protectionist policies, that may end up hurting more than aiding a large portion of the population that voted for him.

Based on a survey of executives conducted by McKinsey, political transitions are seen as a leading risk to global and domestic growth while executives in China and developed Asia view slowing trade as a dominant threat to global growth. This concern over slowing trade is in line with the World Trade Organization's revised outlook for 2016 from 2.8% to 1.7%, making it the slowest trade growth since the financial crisis.

Another factor for the uncertainty and challenge in the coming year is the unharmonious state of Europe post the success of the Brexit vote. Although it was not a great surprise that the "No" vote won the referendum in Italy in early December, it was still alarming that such a high percentage voted against constitutional reform. The huge gap between the Yes and No vote is a major victory for the anti-establishment and anti-euro Five Star Movement and Northern League parties as the most prominent No campaigners and as result, increases medium-term political risk for Italy.

The European Union will have a number of crucial elections in 2017 with nationalism being a platform of the populist right-wing parties. Starting in March, we have the general election in the Netherlands, then the first round of the presidential election for France in April and the second round in May, and finally, Germany's general election in September. While the markets would view Merkel's defeat to become Germany's Chancellor for the fourth time to be negative, it is unlikely the far-right will be victorious given Germany's parliamentary system. This would be a similar situation in the Netherlands. However, for France, we cannot discount the possibility of the unimaginable of the far right party of Marine LePen becoming President given the outcomes in the US and UK last year. We expect there will be a run-off between Marine LePen of the National Front and the Republican's François Fillon. If victorious, LePen's Eurosceptic platform would prove to be disastrous for the Eurozone.

Global companies have always had to consider political risk as part of their overall strategic planning. Global success comes to companies if they are able to track the changes in the economic landscape and update the list of priority countries including demographics, national fiscal positions and political environment. Unfortunately, Trump and the growing protectionist movement in many parts of the world is a new variable for all global companies to consider going forward. We are aware that globalization is not perfect given there are those who are hurt by it, but on balance, there are a greater number of beneficiaries. Thus, we do not believe we are at an end to globalization, mainly because submitting to insular policies is conceding to defeat to progress.

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Portfolio Review

The markets quickly positioned for the reflation trade post Trump's election victory. Generally, for both the Global Equity portfolio and the International Fund, we were not positioned to benefit from this, primarily as a result of the overweight in the cash balance and the underweight in Financials. We should be aware the market is ignoring the tougher stance on trade policy and its implications. Hence, this resulted in a rise in inflation expectations, interest rates, the US dollar and US equities, which at today's level, a probability of a correction has increased significantly. The sector rotation into Cyclicals and Financials took place on the hopes of fiscal stimulus and loose regulations; add to that the OPEC agreement on November 30th to cut production helped the Energy sector.

The best performing stocks in 2016 for MSCI EAFE were Fortescue Metals Group, Anglo American, South32, Glencore and ArcelorMittal while MSCI World had Teck Resources and Nvidia Corp. included among the top performers. We admit we missed the magnificent move of Nvidia; however, our investing philosophy of buying companies with strong business models in secular growth areas with low volatility precluded us from considering the mining companies which ended up being the best performers in 2016. We should mention the moves in these mainly occurred in the fourth quarter with the euphoria the market has experienced post the Trump victory.

The Global Equity Portfolio and International Fund are underweight in the Financial sector. This underweight position has been a detractor to performance in the second half of the year when a sector rotation took place. Similar to our discussion last quarter, the health of the European Financial sector continues to look uncertain. For example, Italy's banks have struggled with high costs and low returns for years and billions of Euros in loans are questionable due to economic stagnation. Monte dei Paschi di Siena, the world's oldest bank lost 87% of its market value in 2016 and will need a €20 billion bailout from the government. In addition, another Italian bank, UniCredit announced plans to raise €13 billion and slash thousands of jobs to improve their finances. We wrote last quarter that Deutsche Bank was fined US$ 14 billion for their inappropriate sales of mortgage-backed securities. They were able to strike a deal worth US$ 7.2 billion with the U.S. government to settle the claims. Once again, this sort of volatility points to the fragility of the banking industry. If we decide to invest in this sector, we shall need to have the confidence the financial institution meets our investment criteria while ensuring the banks have adequate level of capital.

C$%	Q4	Year to Date	One Year
Global Equity Portfolio Performance as at December 31, 2016 (Gross)			
Global Equity Portfolio	1.5	0.8	0.8
MSCI World	4.4	4.6	4.6
Value-Add	-2.9	-3.8	-3.8

Our Global Equity portfolio closed the year with a cash level of 10% and this detracted from performance during the fourth quarter and was the largest detractor for the year's underperformance. As discussed above, our preference to be prudent and underweight in Financials was the largest detractor to performance during the fourth quarter. In addition, given the surge in the US market in the fourth quarter, our underweight in North American equities relative to the benchmark also contributed to our underperformance. For the year, the Global Equity portfolio benefited from positions in Schweiter Technologies, Comcast, and JP Morgan.

We initiated a position in Becton Dickinson during the quarter. This Company is a high quality healthcare

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company that develops, manufactures, and sells medical supplies, devices, laboratory equipment, and diagnostic products worldwide. It is focused on enhancing its relevancy as a value-added partner to healthcare providers capable of addressing critical unmet needs. As a leader in most of the areas it operates, we expect Becton Dickinson to enhance its capabilities, either organically or via acquisition.

Other transactions included selling our position in Occidental Petroleum and replacing it with Schlumberger, which is a position we already hold in the International Fund. We bought Occidental Petroleum in order to have an exposure to energy without the inherent volatility given this company was considered one of the most solid energy companies in the US. However, the Company has not benefited from the upward move in the energy prices as expected and we expect Schlumberger to be a better beneficiary of oil prices at this level.

C$%	Q4	Year to Date	One Year
International Fund Performance as at December 31, 2016 (Gross)			
International Fund	-1.4	-2.6	-2.6
MSCI EAFE	1.8	-1.8	-1.8
Value-Add	-3.2	-0.8	-0.8

During the quarter, the key detractors in the International Fund were also the high cash allocation and the underweight in the Financial sector. For the year, being underweight in Materials and Energy while having an overweight in Healthcare and Cash were the key detractors to the Fund's performance. The individual holdings that contributed the most during the year included Johnson Controls, Keyence, and Schweiter Technologies. Allergan, being one of the largest detractors to the Fund's performance during the year, was sold during the fourth quarter.

Outlook

It would be easy to abandon our investment process when we are impacted by financial markets that overlook the fundamentals. However, it is during times of market extremes such as the tech bubble and the financial crisis where a presence of an investment process is crucial. It may feel right to join the momentum for short-term gains and be part of the party, but we believe maintaining our investment process will enable us to hold on the quality companies and find undervalued ones.

We construct our portfolios one company at a time. Hence, our portfolios are composed of companies that have the best fundamental long-term prospects as a result of having characteristics we require in a company: they operate in industries with secular growth, have a global footprint, strength and leadership in product or service, lower volatility given the company's overall stability, limited exposure to commodities, growth in free cash flow and an attractive valuation. It is at these junctures where we examine the business models of our holdings and take a thorough check of whether their competitiveness, industry landscape and the thesis of our initial purchase are still intact and whether any slowdown is a cyclical or structural issue. We still believe overriding themes of demography (via healthcare), automation (through leading industrial and technology companies), travel and aerospace and wealth are key themes that are sustainable.

Based on a study conducted by Morgan Stanley, there is meaningful evidence that quality strategies outperform in the long run. A quality strategy is one that includes companies that have best business models with long track records. There are going to be occurrences where there will be market rallies, such as the one we experienced since the US election where the market has favored cyclical companies over quality companies.

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The outlook for the coming year is cloudy at best and along with stretched valuations and anticipation of higher interest rates in the US, it justifies being cautious going forward. The euphoria over an anticipated Trump stimulus is overdone in our opinion and believe Japan and Europe provide better potential for returns in the coming year. The rise in US interest rates and a stronger dollar are headwinds for emerging markets. Although we believe the long-term structural growth will continue in the emerging markets along with a growing middle class, these headwinds will make it difficult for emerging markets to be extremely attractive.

We may witness voters' remorse for those who voted for Brexit in the coming days when they realize that the UK's prosperity will be negatively impacted by poor trend growth. Business investment is expected to contract as Brexit uncertainty weighs on sentiment. The hard Brexit is looming on the horizon and with it, the attractiveness of London as one of the world's biggest financial centers has been diminishing.

We expect global monetary policy divergence to continue. While the US Federal Reserve raised rates by 25 basis points in December, we expect the UK and Japan to remain accommodative and the ECB to extend its asset purchases. As a result, the US dollar will remain strong relative to all other currencies and therefore, could impact negatively for US companies with foreign sales.

The MSCI World benchmark is expecting earnings to be U$106.40 in 2017 for a valuation of 15.9x forward P/E, which is higher than the ten-year average of 13.6x. Similarly, S&P500's forward 12-month P/E of 17.1x exceeds their ten-year average of 14.2x and is more expensive than MSCI World. The key valuation metrics for the Global Portfolio and the International Fund are shown below. Furthermore, both the International Fund and the Global Equity Portfolio have higher return on equity metrics than their benchmark market indices while having a lower beta metric, making these portfolios overall less volatile than the market.

	CPWM Global	MSCI World
P/E Forward 12m	18.5x	15.9x
Net Debt/F12m EBITDA (ex-Financials)	0.82	0.52
Return on Equity (adj.)	24.5%	21.8%
Dividend Yield	2.0%	2.5%
	CPWM International	MSCI EAFE
P/E Forward 12m	18.0x	14.8x
Net Debt/F12m EBITDA (ex-Financials)	1.71	1.65
Return on Equity (adj.)	23.3%	15.8%
Dividend Yield	2.3%	3.2%

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