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GLOBAL EQUITY AND CUMBERLAND INTERNATIONAL FUND STRATEGIES

Fourth Quarter 2017

Global Macro Review

Our condensed version of the global macro review of 2017 can be done in four words: Trump, elections, terror and China.

It may be fitting to observe that the current number one bestseller is "Fire and Fury", a title that refers to a quote by Trump about the conflict with North Korea which places an exclamation mark on what was an exacerbating year. Since Donald Trump became the 45th US president in January 2017, the world has not been the same. His war of words with North Korean leader Kim Jong Un calling him "Little Rocket Man" and comparing one another's nuclear button sizes, reminds us of spoiled and ruthless children. But here's the problem: these two bullies are dealing with the safety of millions, perhaps billions, of people's lives, with little certainty of a solution in the near future.

We had our share of elections in 2017. President Macron of France and Prime Minister Abe of Japan found success while UK Prime Minister Theresa May failed to maintain her majority post the snap election she called last spring. France is surprisingly strong which should help Macron implement his changes to labor laws. Japan is also showing improvements although many voted for Abe's party because of their fears of change and rising tensions on the Korean peninsula. Prime Minister May now has to contend with a weakened position while trying to negotiate the second stage of Brexit. Overall, populism in Europe struggled to claim victory with losses in The Netherlands and France, but they still managed to gain ground in other countries like the UK, Germany and Austria. The push for Catalan independence created a constitutional crisis in Spain and with their current absolute majority, the lack of stability is expected to continue in Spain.

Terror is a now a fact of life, at anytime and anywhere. The fourth quarter started on a sombre note with a gunman killing 58 and wounding hundreds of people in Las Vegas while three hundred died from a bombing in Mogadishu in mid-October. These were among many terror related events, with the UK suffering three major terrorist attacks in London and Manchester in 2017. Despite the horror of these events, markets did not flinch and kept moving upward.

A review of the global economy would not be complete without assessing the ascent of China on the world stage. As President Xi Jinping cements his grip on power, he continues to pursue his dream of national rejuvenation which he embarked on since becoming China's leader in November 2012. His priorities are to strengthen China's power and standing in the world, and rejuvenate it so that it eventually dominates everything. He continues his campaign against corruption along with cleaning up the environment and cutting industrial capacity which should slow down the deflationary trend that has been exported worldwide. After spending a few days in Shanghai (now at 25 million people) in April and another week in Beijing (at 22 million people) this past December, we confirm that China's competitiveness is astonishing given their pace of modernization and their ability to mobilize such large numbers of people each day with efficiency.

With this as a backdrop, global GDP expanded over the year at a pace on par with the strongest in over six years. In addition, the breadth of above-potential real GDP growth has increased sharply in both the developed and emerging markets. The latest pick-up of GDP growth is rather broad, based on various metrics of GDP, Purchasing Managers Index (PMI), retail sales, capex and by profits. Specifically, in the case of the Eurozone, the European Commission has projected the Euro area growth will be the best in a decade. Estimates for GDP growth for 2017 have increased to 2.2%, up from May's estimate of 1.7%. They expect the Eurozone to acheive 2.1% growth in 2018. Meanwhile, Japan's economy grew at a more solid pace than expected in the third quarter and according to Japan's Cabinet Office, the revised reading on GDP reflected an annualized growth of 2.5% in the quarter.

Although global economies are expected to grow in 2018 with continued consumer confidence, it is a fact that the world is aging. Falling birth rates and lengthening lifespans are causing populations to age which is especially relevant in Western Europe and developed Asia including Japan, Korea, Singapore and Hong Kong. This demographic trend will have an impact beyond the healthcare industry. Currently, Japan has a tight labor market with its unemployment rate at 2.7% which is the lowest since November 1993. Post the collapse of the 1980/90's real estate bubble, Japan was faced with excess unemployment along with excess capacity and excess debt. These structural issues led to weaker domestic demand and eventually deflation. As Japan keeps working its way through these issues, inflation will become easier to achieve. On a short-term basis, however, consumption remains weak making it difficult to see a turn to inflation.

Portfolio Review

Equity markets were strong in the fourth quarter on top of a generally strong year. As described above, we witnessed synchronized global growth in 2017, providing an encouraging backdrop for corporate earnings growth. Eurozone earnings were not downgraded in 2017 however. Furthermore, Eurozone earnings have historically been leveraged to GDP growth and therefore, if 2% GDP growth is achieved in 2018, then Eurozone earnings growth should be in the double-digits. Another factor for positive earnings growth is their ability to further their margin expansion. Eurozone companies typically have a high amount of operating leverage due to their elevated fixed cost bases, mainly from labor. Although the steady improvement in earnings for Japanese companies have improved their returns on equity (ROE), they are still lower than the double digit ROEs of companies in other major markets. About 50% of the Topix constituents maintain a ROE level of 8% which is an improvement over the 70% of that did not achieve the 8% ROE prior to the financial crisis. With the improvement in earnings and the Japanese market passing the 8% ROE level, it is expected the share prices will track earnings with P/E stability.

When we assess the Global Equity Portfolio's performance in 2017, it is clear that our overweight in Technology and our stock selections of AIA, Nidec, and Keyence were key contributors. Similarly, the International Fund also benefited substantially from its overweight in the Technology sector and stock selections (AIA, Nidec, and Samsonite).

Cumberland Global Equity Portfolio Performancec as at December 31, 2017 (Gross)		
C$%	**Q4**	**2017**
Global Equity Portfolio	6.13	12.25
MSCI World	5.88	14.02
Value Add	0.25	-1.77
Cumberland International Fund Performance as at December 31, 2017 (Gross)		
C$%	**Q4**	**2017**
International Fund	4.54	17.16
MSCI EAFE	4.59	16.45
Value Add	-0.05	0.71

On the other hand, a key detractor in both portfolios in 2017 was our level of cash which had a negative impact of about 2.30% for the Global Equity Portfolio and 2.40% for the International Fund. In a strong market, like 2017, we were punished for having cash and a conservative posture within the portfolios overall. The portfolios were also underweight relative to the benchmarks in Asia and Japan which outperformed the European markets.

In this context, it is important to provide updates on Fresenius SE, Newell Brands, TJX, and Johnson Controls that detracted from our performance during the year.

Fresenius SE, a global diversified healthcare company with sales of more than €29.1 billion in 2016, has been a long-standing holding in both the Global Equity Portfolio and International Fund which has served us well over the past ten years given its strong track record of generating profitable growth and good returns. However, the stock lost significant value due to a number of issues at its Kabi business of generic injectables which has been one of the main growth drivers. As a result, this investment underperformed both its peers in healthcare and the German DAX and regional benchmarks. Yet, we continue to hold our investment as we believe the company is not broken and the events that took place in 2017 will not be chronic. Fresenius is a high-quality business operating in several attractive end markets. While equity markets are concentrating only on the Kabi business, its Helios business (private hospitals) continues to perform ahead of plan. In addition, it also has an option to develop a biosimilars business over the next few years.

Newell Brands was a significant detractor to both the quarter and annual returns. As a reminder, we had added to our position last quarter as we believed that the impacts of the post-hurricane cost inflation and the Toys R Us bankruptcy would prove to be transitory events. However, during the quarter, the Company reported very disappointing third quarter results and reduced full year guidance, as the Company experienced weaker than expected sales during the critical back to school season, which was exacerbated by accelerated inventory destocking amongst their brick-and-mortar retail partners. The subsequent sell-off in the shares triggered our internal non-discretionary stop loss rule, which led us to divest the shares. While we had contemplated the potential for some mixed near-term trading in its end-markets, in retrospect, we underestimated the severity of inventory destocking especially amongst some of the more challenged retail channels.

TJX was a holding in the Global Equity Portfolio and was a detractor for the quarter and the year. The retail landscape has changed tremendously over the past several years. Although online shopping accounts for only 8.5% of the world's spending and slightly higher in the US at 10%, e-commerce has been growing by 20% a year for a decade and we have witnessed the carnage in the US retail sector where thousands of stores have shut down this year and where retailing accounts for one in nine jobs. Amazon has demonstrated the havoc it can create each time they enter a market, such as groceries and drugstores. E-commerce has lowered the barriers to entry by allowing manufacturers to distribute goods and having a broad reach while benefiting consumers with wider and lower cost choices. While we believe TJX has a unique proposition in their treasure hunt aspect of shopping, their competitive advantage has diminished somewhat with this new e-commerce environment. After being a part of the Global portfolio for many years and providing an excellent return, we did not want to watch our gains deteriorate from the new retail threat.

Johnson Controls (JCI), a holding in the International Fund, was a detractor to its annual returns. Despite driving solid margin improvement from synergies arising from the Tyco and Johnson Controls merger throughout the year, the Company struggled to deliver an acceleration in organic revenue growth due to continued weakness in their resource related end-markets. In addition, management's ability to convert earnings into free cash flow disappointed both our and the Street's expectations. Given reduced expectations going forward, we determined that JCI no longer offered a sufficient risk-reward proposition compared to other investment opportunities and as such, we disposed of our holdings during the quarter.

In addition to the changes above, we made a few additions to both portfolios during the quarter. In the Global Equity Portfolio, we invested in TE Connectivity and S&P Global, and increased our positions in Comcast, Starbucks, Intact, JPMorgan and Wells Fargo while reducing Luxottica and Roche.

Meanwhile, in the International Fund, we also invested in TE Connectivity along with two new Japanese companies of Kao and Hoshizaki and reduced our positions in Unilever, Luxottica and Roche.

Central to *TE Connectivity's (TEL)* story are the tailwinds from both strong automotive sales and strong content gains per vehicle. Over 90% of TEL revenue is focused on connectivity and sensing and 80% of the revenue is derived from harsh environment applications. These applications are highly engineered and designed into the architecture of the customer's solution, positioning TEL as uniquely qualified to meet many customers' demands. Over the last five years, TEL has delivered mid-single digit growth and above company average margins with their harsh business. As a result, we believe the key thesis to owning TE Connectivity include the following:

1. TEL is leveraged to the long-term secular shift away from combustible engines to Electric Vehicles and increasing content per vehicle; that is, additional sensors for safety/infotainment.

2. TEL is leveraged to the long-term theme of automation and robotics, via Industrial internet-of-things, connected devices and growth of cloud computing.

3. We expect continued margin expansion beyond market expectations as TEL should benefit from restructuring savings, recent M&A transactions to drive leverage along with operating leverage from increased end-market capital spending (industrial, telecommunication, aerospace) as TEL is the market leader in the connected and sensors industry.

We initiated a position in *S&P Global Inc.* (SPGI) in the Global Equity Portfolio which benefits from a few long-term structural shifts that are underway currently. We believe the three key reasons to invest in this Company are:

1. The shift of assets toward passive funds, which we think is likely to continue.

2. A steady and predictable organic growth from the wave of global debt corporate debt demand for the next four to five years, with 61% of revenue considered to be recurring.

3. SPGI's strong track record of steady share buybacks, improving returns on invested capital and consistent total shareholder returns.

We met with *Hoshizaki's* management during our research trip to Japan in early 2017. While any investment will have its own risks and in the case of Hoshizaki, it would be weaker than expected consumption recovery in the key Japanese market, we believe there are also three key reasons for investing in Hoshizaki:

1. Hoshizaki is the leading manufacturer of commercial kitchen equipment in its core Japanese market, with dominant market share in its key product categories. The Company's key competitive advantage in Japan rests in its direct sales force network, which allows the Company to provide prompt maintenance/service and act as a consultant for customers to maximize kitchen efficiency.

2. While Hoshizaki continues to have room to take market share and expand into new product categories in its domestic market, we believe the Company also has a long runway to expand overseas. The Company has already grown to capture leading market share in the US commercial ice maker segment and is currently building capacity to expand its offering in commercial refrigerators.

3. Hoshizaki possesses a significant net cash position of ¥163 billion at the end of last fiscal year which represents ~22% of its market cap. We believe this provides the Company with significant strategic flexibility in the form of potential shareholder returns or acquisitions.

We have followed *Kao* for a number of years and have spoken with management prior to our making an investment within the International Fund. The three key reasons for having Kao as part of the portfolio are:

1. Kao is a leading manufacturer of home and personal care products in Japan, with strong market share across most of the categories in which it participates. Its competitive advantage lies in its local market scale and its strong track record of innovation.

2. We believe Kao has ample opportunity to expand its presence and share in international markets where it has already been leveraging its domestic product portfolio to develop a strong presence in China and Southeast Asia and is targeting niche categories in the US and Europe. In addition, Kao is in the midst of developing its high-end cosmetics business which could contribute additional sales and margin upside.

3. Compared to its global peers, we believe Kao possesses meaningful runway for margin expansion as the Company leverages the upfront investments that it has made in its growth markets.

The MSCI World benchmark is expecting earnings to be U$124.78 or the next twelve months for a valuation of 16.96x forward P/E, which is higher than the ten-year average of 13.84x. Similarly, S&P500's forward 12-month P/E of 18.35x exceeds their ten-year average of 14.47x and is more expensive the MSCI World. In our case, both the International Fund and the Global Equity Portfolio have higher return on equity metrics than their benchmark market indices while having lower beta metrics, making these portfolios less volatile overall than the market.

Outlook

With the synchronized global expansion, 2017 was a year where the major asset classes exhibited strength, despite the terror and the potential vulnerabilities from political conflicts discussed in our macro review. The markets were typically not impacted by the global reverberations, but that may not be the case in the event of a weaker economy. We were penalized somewhat in choosing to err on the side of conservatism or in the words of Benjamin Graham, the father of value investing, for maintaining a margin of safety that serves to protect against the "unknown unknowns" of an investment.

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We believe we have to be cognizant of the changing macro environment, namely the gradual change of all central bank policies. Post the financial crisis in 2008, central banks globally, with different starting times, have kept short-term interest rates close to zero and markets have been rising against this backdrop. These policies will start to unwind, with the US Federal Reserve starting the shift to higher rates and eventually, other central banks will follow. The gentle execution will be key to ensuring the market does not experience a major correction. Nevertheless, we expect the road ahead to be more challenging.

Many central banks have confidence in letting go of their quantitative easing policies because the world economy is stronger now. As discussed earlier, positive economic data is pointing to a healthy global economy. And this provides a positive scenario for strong earnings growth, thereby a positive trend for the Global and International portfolios. For now, both Europe and Japan have monetary support from their central banks and both regions are demonstrating better growth metrics on a macroeconomic level as well as on a fundamental basis for its companies.

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