CUMBERLAND

Cumberland Income Fund
2013 Year End Review and Outlook

The Cumberland Income Fund gained +1.7% during the fourth quarter of 2013 compared to the gain of +0.4% posted by the DEX Universe Bond Index during the same period. For the year ended 2013, the Fund gained +4.5% while the DEX declined -1.2%. Erratic economic data and changes to both U.S. fiscal and monetary policy contributed to another quarter of heightened volatility in bond yields. But ultimately, it was the U.S. Federal Reserve's pre-Christmas announcement of the much-speculated reduction of its bond purchase program (the "taper") that drove up bond yields to levels not seen for two-and-a-half years. The change in U.S. monetary policy caused investors to sell government bonds, driving bond prices lower. During the quarter, Cumberland maintained its focus on preservation of capital in anticipation of the likely inevitable rise in interest rates. The Income Fund's strategy has been to keep duration low (lower sensitivity to changes in bond prices due to changes in interest rates) and to selectively allocate to higher yielding corporate bonds, preferred shares, and dividend-paying common equities to generate current income.

As seems customary in the post-credit crisis investing environment, developments out of Washington were a key driver of the direction of bond yields (interest rates). In our view, the fourth quarter of 2013 can be divided into two discrete time periods: Before the Washington resolution of the U.S. government shutdown, and after. Pre-resolution, bond yields were still falling (and bond prices were rising) from when the Fed surprised the bond market in September by not reducing its $85 billion per month bond purchase program (QE), and the uncertainty of the U.S. economy's performance from the fallout of the budget stalemate in Washington. But by the third week of October, interest rates bottomed as Washington finally came to an agreement on the budget and U.S. economic data started to come in better than expected, specifically U.S. jobs data. Consequently, interest rates reversed course and headed higher, as is the typical response to a perceived improving economy. Back in September, when Fed Chairman Ben Bernanke justified delaying the tapering of QE he cited two key reasons: The fiscal uncertainty in Washington and the need to see continued strength in the U.S. jobs market. With fiscal uncertainty out of the way with the signing of a federal budget agreement and the unemployment rate improving, bond yields increased to the point where, in our view, the bond market started pricing in the increased probability that the Fed would announce the tapering of QE as early as December. On December 18th, we got just that. The Fed announced the first reduction of their historical QE program by $10 billion and the U.S. 10-Year Treasury yield continued its climb from 2.85% and breached the psychological 3.0% barrier by the end the year, closing at 3.02%. The increase in interest rates took its toll on bond prices and in the U.S., the BofAML broad bond index declined by -0.2%.

In Canada, Government of Canada (GCAN) bond yields moved in the same direction as U.S. Treasury bond yields, but not to the same magnitude. As an example, the GCAN 10-Year bond yield increased by 0.21% during the quarter closing at 2.76%, while the U.S. 10-Year Treasury increased twice that at 0.42%. One of the key reasons for Canada's smaller increase in interest rates was a change in monetary policy. During the quarter the Bank of Canada (BoC) *removed* the following wording from its monetary policy statement: "Over time … a gradual normalization of policy interest rates can also be expected…", implying that BoC is no longer intending to increase the benchmark overnight interest rate in the near term. Said another way, interest rates are now expected to remain low for longer in Canada due to low inflation expectations and weaker than expected economic growth. This contrasts with the U.S. Fed who initiated the taper thereby reducing, albeit marginally, their accommodative monetary policy. We therefore expect Canadian bond yields to continue to increase at a slower rate than U.S. bond yields.

Although Government of Canada and U.S. Treasury bonds posted slight negative returns for the quarter (and for the full year for that matter) due to rising interest rates, investment grade corporate bonds fared only slightly better, with the DEX Corporate Bond Index up +0.9%. With both the economy and corporate profits continuing to improve, corporate spreads (the difference between the corporate bond yield and the government bond yield of a similar maturity date) reached new post-credit crisis lows by the end of the year. This "tightening" of spreads helped offset some of the price erosion due to rising interest rates and indicates that investors' perceived risk of owning a corporate bond over a government bond is declining. Corporate issuers definitely took notice of these attractive spread conditions and sold $25 billion in new bonds in the quarter, making a 2013 a record year in new corporate issuance in Canada at $105 billion compared to $88 billion in 2012 and $78 billion in 2011.

High Yield bonds were the clear "winner" in Q4 and in 2013. The DEX High Yield Index was up +2.1% in Q4 and +5.4% for the full year 2013. The High Yield sector's lower correlation to interest rates and the market's strong bid for riskier assets (including equities) in 2013 prevented any real erosion in bond prices and therefore the sector's return was mainly comprised of the coupon payment.

Preferred shares did not fare much better than bonds during the quarter as the TSX Preferred Share Total Return Index declined by -0.33%. In the quarter, Cumberland took advantage of the higher dividend yields and participated in two new preferred share offerings. One of the preferred share issues we added to the Income Fund was issued by Power Financial Corp. and the second preferred share was issued by AltaGas Ltd. Both these preferred shares have a dividend reset feature every five years thereby somewhat mitigating the risk of rising interest rates over the medium term.

The Income Fund was fairly active in the common equity allocation during the quarter. In our view, some equities are attractive since they seem to have already priced in an even higher interest rate environment. This should provide a greater margin of safety if interest rates *actually do* continue higher. Income Fund added to its position in Alaris Royalty (AD.TO), a buyer of royalty streams from private companies; to Emera, the Nova Scotia based electric and gas utility; and also to American Hotel Income Properties (HOT-U.TO), an owner/operator of U.S. mid-market hotels.

With the tapering of the Fed's asset purchase program now underway, and its ultimate effects on interest rates highly uncertain, we remain cautious due to interest rate risk. We continue to view the direction of interest rates as the single most important determinant of total returns in a bond portfolio in today's rate environment. The reality is that Central Banks have never provided so much accommodative monetary policy for such a long period of time. With its removal now underway, the impact on interest rates and related financial asset prices is highly uncertain. Our view is that as the economy continues to improve (allowing the Fed's taper program to continue) interest rates should continue to be biased higher. We therefore expect to maintain the duration in the Income Fund at around 3 years compared to the DEX Universe Bond Index's 6.7 years. We are also growing more cautious on corporate bonds. The response in the corporate bond market to the increase in underlying interest rates has been for spreads to compress (as mentioned above) making them more and more expensive. There remain pockets of value with select corporate issuers, in our view, and we will look to deploy capital opportunistically into these more favorable risk/reward securities. In addition, our liquidity position (cash and floating rate notes) remains high, allowing us to *take advantage* of this higher interest rate environment as opposed to solely being a casualty to the trend of rising interest rates and declining bond prices. We will continue to manage the Income Strategy to continue delivering on its two key objectives: preserving capital and generating income.

R. Schulte-Hostedde
Portfolio Manager, Fixed Income
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Asset Allocation as at December 31, 2013

Asset Class	**% of Portfolio**
Cash and Cash Equivalents	11.0%
Government Bonds (incl. Floating Rate Notes)	25.6%
Corporate Bonds	42.9%
Preferred Shares	9.5%
Equities/Income Trusts	11.0%

Yield Comparison[1] as at December 31, 2013

DEX Universe	2.8%
DEX Government	2.6%
DEX Corporate	3.1%
Cumberland Income Fund[2]	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 management fees.