CUMBERLAND

Global Equity and International Fund Strategies
Third Quarter 2015 Review

Global Review

Suspenseful drama with lots of twists and turns may be enjoyable to watch in a movie, but these are not the ingredients we want for equity markets. And we had our share of ups and downs this past quarter. Concerns of a global slowdown continued to dominate global markets and recent data confirmed fears around emerging markets as China posted weak trade and Purchasing Managers' Index (PMI) data while Brazil's sovereign debt was downgraded to junk. U.S. and European PMIs also slowed, all of which prompted the Fed to keep rates on hold. In short, investors remain concerned that global growth is faltering.

Similar to Atlas, Chancellor Merkel at times holds the weight of Europe on her shoulders. From the Greek crisis to the migrant issue, the world looks to see what Angela Merkel will do. It seems like a lifetime ago that the word "Grexit" entered our everyday vocabulary. We also noted last quarter that the Greek crisis was not the key crisis to dwell our time; it was China. After marathon sessions, Greece received its bailout package, but Greece must continue implementing austerity measures, including tax increases for farmers, changes to personal bankruptcy rules, pension cuts and the privatization of state-owned utilities. Incidentally, Syriza won the re-election this past month which helped calm Grexit fears, once again.

Unfortunately, like many things in history, we are witnessing a situation that has taken place many times before, where destruction is created by man. According to the UN Refugee Agency (UNHCR), the number of forcibly displaced people worldwide reached 59.5 million at the end of 2014, the highest level since World War II, with a 40% increase taking place since 2011. And while we face this monumental issue, the nations were commemorating the 70th anniversary of the end of the Second World War.

Furthermore, Japan's Diet (parliament) has been debating one of the country's most important legislative changes since the Second World War. Amidst public protests against Prime Minister's desire to make it easier for Japan's armed forces to join military activities abroad and defend allies under attack, the legislation passed given the ruling coalition's strength in both chambers of the Diet. We can mark anniversaries and celebrate them, but we also know that history has a way of repeating itself. It does not appear that mankind has ever learned or found a solution for this sort of atrocity. We shall continue to monitor this situation for any economic impact of this atrocity on Europe and the rest of the world, especially given the current fragility of the union.

We had the opportunity to attend a key Japan conference in early September. We have been underweight in Japanese securities and we wanted to meet with corporate management before adding any companies to our portfolio. One of the keynote speakers at the conference was the Deputy Minister of Finance Isshu Sugawara outlining his government's initiatives for their second three-year term in office. Japanese Prime Minister Shinzo Abe 2.0 includes an ambitious target of boosting Japan's economy from ¥491 trillion to ¥600 trillion without providing a timeframe for the new target. Similar to his three arrows from his first term in office, his three goals this time around would be a "strong economy", "support for families" and "social security". This would involve expanded investment, increase consumption, reform programs in agriculture, fishery, medical and loosen up labor markets for women and foreign workers. Despite these ambitious goals, Japan fell back into deflation at the end of September for the first time since April 2013. Lower global energy prices outweighed stronger domestic inflation. Given this backdrop and based on Bank of Japan's target of 2% inflation, we should not be surprised if they unleash another round of quantitative easing (QE) at the end of October after it updates its economic forecasts.

Corporate profits in Japan are at all-time highs and unemployment at all-time lows, so wage increase remain a key focus of the administration. Other themes of the government include smart mobility, renewable energy (hydrogen), robotics technology, medical services, medical technology, and inbound tourism (especially in preparation for the 2020 Olympics). The

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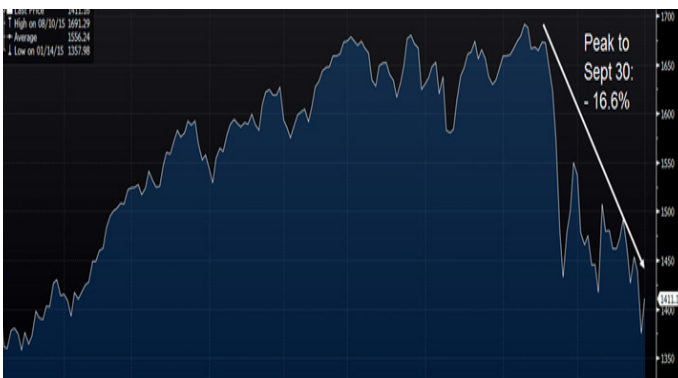
Basic Plan over the next five years is to draft reforms that contribute to economic revitalization, including spending and revenue reforms. Basic reform plan includes corporate tax reform to encourage growth. Historically, Japan has a poor record of female participation compared to many other developed countries as well as a closed immigration policy. Efforts are underway for labor market reform including allowing more foreign workers, promoting inclusion of women in the workforce and encouraging more varied and flexible workstyles.

The August order data released in September by the Japan Machine Tool Builders Association points towards a marked slowdown, affirming the trend hinted at by the previous quarter's GDP capital expenditure data. The concerns related to a slowing Chinese market and its direct and indirect impact on the Japanese economy was reflected in Japan's equity markets. After reaching a new multi-year high on August 10th, the Topix has been continuously declining –8.2% in local currency (-5.7% in C$) for the month of September and sentiment towards Japan was rather bearish. The short-sell ratio reached a historical record high level at 43.4% on September 29. Although it registered outstanding performance earlier in the year, the Japanese market was down 13.4% in local currency (-5.2% in C$) during the quarter, though earnings revisions remain positive and EPS are expected to grow 15% for the full year versus a global average of 3%. This negative sentiment may provide a buying opportunity.

Topix Index Year to Date



Source: Bloomberg

The Shanghai Composite Index tumbled 40.9 percent in local currency (-37.4% in C$) by the end of September since reaching a seven-year high on June 12. It is estimated that approximately $5 trillion in value was lost in global equity markets since the yuan devalued to the end of August. Chinese state media has called August 24th "Black Monday" and with good reason. China's stock market endured its biggest one-day fall since 2007. Emerging market currencies and commodity prices fell along with the Chinese market and the contagion spread to Europe and the US. Oil is at six-and-a-half year lows and commodities ranging from steel to wheat have fallen to its lowest level this century. Many feared that this would be a repeat of the Asian crisis we experienced in 1997-1998. While we agree the past two months have been painful with volatility reaching new highs, we do not believe this is a repeat of the Asian crisis, mainly because the emerging markets allow their currencies to float, have larger foreign exchange reserves and healthier current account balances compared to the 1990's.

Shanghai Index Year to Date

Source: Bloomberg

The fear is that China is heading to a hard landing reflected by bad economic numbers and an unsuccessful attempt to halt the slide of the Chinese bourses. The Bank of China governor, Zhou Xiaochuan was of the opinion that state intervention in the equity market was necessary to prevent systemic risk and stop the free-fall in shares.

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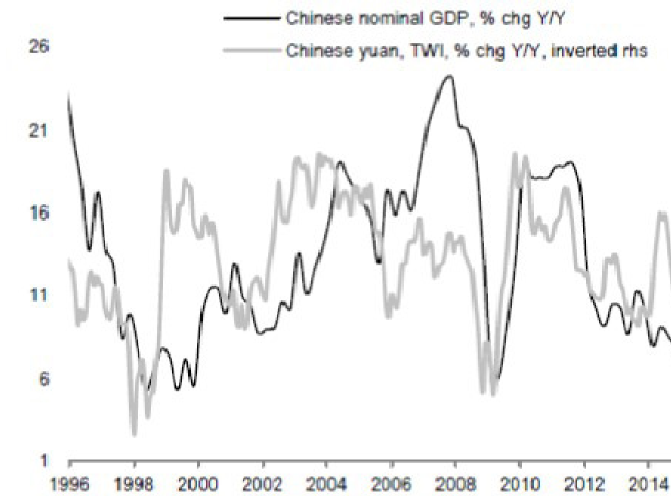
The shock devaluation of the yuan in August rattled world markets and sparked exchange-rate declines in emerging economies. Historically, there has been a close negative correlation between the strength of the yuan and nominal GDP growth and exports are about 22% of their GDP. This move along with their intervention in the markets has undoubtedly tarnished China's reputation. A slowdown in China has definitely dragged down emerging markets that have supplied China's appetite for commodities. While exports to China accounts for less than 1% of United States' GDP last year, not all Western economies are immune. For example, Germany exports more to China than any other European Union member state. The issue for the U.S. however, is their strengthening currency where 48% of the S&P500's sales are sourced from abroad.

Figure: The strong Yuan has led to weak nominal GDP growth



Source: Thomson Reuters, Credit Suisse research

The reduced appetite for commodities by China is not welcome news for many countries, including Canada. It is evident by what we witnessed this past quarter that China's transition from an export-led economy to one led by consumption will be a bumpy one, no matter how much control the Chinese government has over its people.

Portfolio Review

Third Quarter Index Performance

The total returns of the global markets for the third quarter in US$ and local terms are:

	Q3 2015 USD Total Return (%)	Q3 2015 Local Total Return (%)
MSCI World	-8.5	-8.5
S&P 500	-6.4	-6.4
Canada S&P/TSX	-14.2	-7.9
Euro Stoxx	-9.0	-9.2
MSCI Emerging Markets	-17.8	-17.8
Germany DAX	-11.5	-11.7
UK FTSE 100	-9.7	-6.1
France CAC 40	-6.6	-6.8
Switzerland SMI	-6.9	-2.9
Japan Topix	-11.1	-12.9
Hong Kong Hang Seng	-19.8	-19.8
Korea KOSPI	-10.8	-5.4

The key benchmark, the MSCI World Index, had a total (price and dividend) return of -8.5% in US$ and -1.7% in C$ for the second quarter. The other key benchmarks of MSCI EAFE had a total return of -10.2% in US$ and -3.7% in C$ while the S&P 500 had a total return of -6.4% in US$ and +0.4% in C$. Global markets outperformed the Canadian market once again this quarter which returned -14.2% in US$ and -7.9% in C$. The Canadian dollar depreciated by +6.1% against the U.S. dollar in the quarter. Thus, with the depreciation of the Canadian dollar, the returns increased when translated back to the Canadian dollar.

In the MSCI World benchmark, Utilities with -0.6% (US$) and Consumer Staples with -1.6% (US$) were the top performing sectors in the quarter. The two

worst performing sectors in this benchmark were Materials with a -20.2%(US$) return and Energy with -18.7%(US$). The two best performing sectors during the third quarter in the MSCI EAFE benchmark were Consumer Staples with -2.0% (US$) and Utilities with -4.8% (US$). Similarity to the Global benchmark, the two worst performing sectors in the EAFE benchmark were Materials at -20.5%(US$) and Energy at -17.9%(US$).

Cumberland Global Equity Portfolio

Our portfolio fared better than its benchmark index, benefitting from having no direct exposure to the raw materials sector and very little to the energy sector, with both of these being the worst performers during the quarter as a result over fears of falling emerging market demand.

The Global Equity portfolio had a total return for this quarter of +0.3% (C$) compared to its benchmark return of -1.7% (C$), for an outperformance of 2.0%. In US$ terms, the portfolio had a return of -6.6% (U$) vs. the MSCI World at -8.5% (U$). However, year to date, the Global Equity Portfolio's return of 6.5% is trailing its benchmark's return of 8.4% by 1.9%. For the past twelve months, the Global Equity Portfolio is trailing the benchmark slightly, with a return of 12.4% vs. the benchmark return of 13.5%.

We wrote last quarter that we are strong believers in purchasing companies with strong growth and better quality earnings over the long-term. This has been our strategy since the inception of this strategy over ten years ago. Despite having a zero weight in Utilities which was the best performing sector this past quarter, our holdings in healthcare contributed substantially to the performance. Other long-term holdings such as Air Liquide, Visa, and TJX were the other contributors during the quarter.

In terms of specific stocks that detracted from our performance, it was our two holdings in South Korea: Hyundai Motor and Samsung Electronics. We have written about both these companies over the last few quarters and we still believe in the viability and long-term competitiveness of both these companies; however, both these companies were facing headwinds that placed quite a bit of pressure on the share prices. We exited both these holdings during the quarter when it reached our internal risk-management stop loss limit.

Meanwhile, we added SanDisk to replace Samsung Electronics. SanDisk Corporation provides NAND flash storage solutions. The Company designs, develops and manufactures data storage solutions in a variety of form factors using flash memory, controller, firmware and software technologies. SanDisk is one of the main beneficiaries of growth and proliferation of digital data. We replaced Hyundai Motor with Toyota, a holding that has been held in our International Fund for a number of years.

In terms of other transactions, we bought Tyco in Europe. Tyco is a leading global provider of fire safety and security products and services. Our key investment thesis for purchasing Tyco is based on the Company being a beneficiary of cyclical growth in non-residential construction. Approximately 40% of Tyco's business is exposed to this end-market and non-residential construction is one of the strongest end-markets within the industrials universe. They are a leader in a fragmented industry where they have twice the share of its closest peer in installation and services. Tyco continues to derive cost synergies from the integration of its Fire Safety and Security operations, which were formerly operated independently.

We bought eBay in the United States once they spun off their Paypal division. In order to fund the purchase of eBay, we sold Fortis, a Canadian utility. eBay is one of the world's largest retailers with over $83 billion of merchandise sold on its sites in 2014. With 800 million unique items, 157 million active buyers and 25 million sellers, eBay has built a significant platform over the last twenty years that rivals any in e-commerce and which will be very difficult for competitors to replicate. We also sold our position in Berkshire Hathaway, a position we have held since 2011.

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Cumberland International Fund

During the quarter, the Cumberland International Fund had a return of +1.8% (C$) vs. its MSCI EAFE benchmark's return of -3.7% (C$), outperforming the benchmark by +5.5%. In U.S. dollars, the Fund returned -5.2% (U$) vs. the MSCI EAFE benchmark's return of -10.3% (U$). The cash level remained around 15% at quarter-end, which is a similar level we entered the quarter. While the high cash level has been a drag on performance for most of this year, it did aid in protecting the portfolio on the downside this quarter. This quarter's performance has helped the Fund's year-to-date return of 14.8% return to exceed the benchmark's return of 9.3% and similarly, the Fund is outperforming the benchmark by 7.4% for the trailing twelve months, where the Fund has returned 16.6% vs. the benchmark's return of 9.2%.

The key contributors came from many different sectors. The largest contributor was Cheung Kong Infrastructure, an utility based in Hong Kong, Accenture (technology), and Safran (industrial). Our largest overweight in Healthcare also contributed substantially during the quarter with all the holdings in this sector performing well.

As was the case in the Global Equity Portfolio, our two holdings based in South Korea, Hyundai Motor and Samsung Electronics detracted to the Fund's performance. We sold both these positions during the quarter.

Outlook

In light of the heightened volatility and fear in the market, we believe it is important to find companies that can sustainably grow their earnings with little dependence on external factors. We continue to focus on companies that have the following attributes:

1. Operate in industries that have secular growth and resiliency to survive in any type of economic environment;
2. A global footprint;
3. Strength and leadership in a product or service;
4. Lower volatility given the company's overall stability;
5. Limited exposure to commodities;
6. Growth in free cash flow;
7. Attractive valuation.

The MSCI World benchmark is trading at 15.7x next year's earnings, a substantial decline from last quarter's 17.1x but still higher compared to the ten-year average of 14.3x. At these valuation levels and with lower growth prospects, it is natural to be more cautious, but opportunities may arise with continued pessimism in the market.

We expect the companies in our portfolio to grow their earnings strongly for the coming year and overall, we still believe earnings growth of quality companies are the key to performance.

S. Yang
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October 5, 2015