CUMBERLAND

International Fund and Global Equity Strategy
Third Quarter Review

This quarter marked the fifth anniversary of the financial market collapse. Rather than just merely surviving, the global financial markets have thrived. While there continues to be a cautious sentiment toward the health of the global economy, U.S. stock markets were just shy of all-time highs in the third quarter. The market continues to focus on the Federal Reserve's policies and actions, which was evident in the recent positive reaction to the Fed's decision to maintain its current program of purchasing of bonds and keep interest rates from rising.

In our last quarterly review, we had written that Europe was demonstrating more positive momentum and signs of stability. Indeed, Europe moved from recession into recovery as the second quarter GDP rate turned positive for the first time since 2011. The European Central Bank left its interest rates unchanged for the third consecutive month in August. However, it is not clear sailing, with the unemployment rate in the Euro zone remaining high, risk of Greece requiring additional funding looming in the background and instability of Italian politics. The market, however, responded positively to the historical third term re-election of Chancellor Angela Merkel in Germany and to a continuation of its current policy towards the European union. Industrial production and purchasing manager surveys seem to indicate that Europe will continue to show improvement.

Japan's first and second quarter annualized GDP growth was 4.1% and 3.8%, respectively. The second quarter upward revision from the preliminary 0.6% was due to an improvement in capital expenditure. Yet, the gross national debt stands close to 245% of GDP, the highest ratio in the developed economies. Prime Minister Abe had no choice but to support raising the consumption tax from its current level of 5% to 8% next April. The fear is that the tax increase will halt a recovery in Japan as it did the last time it raised taxes in 1997, although at that time, there was a currency crisis in Asia and credit problems at Japan's banks. It is evident that postponing the increase would have shattered any credibility for fiscal discipline and undermined the program of "Abenomics" to get the economy moving again. So far, the combination of Bank of Japan's monetary easing, a weaker Yen and the potential structural reforms have aided in the growth of Japan's economy.

The emerging markets, on the other hand, had a tough third quarter. With the threat of the Fed ending its bond purchases, the yields on U.S. rates increased dramatically. This led to the luring of capital that had been attracted to the emerging markets for their higher growth rates and attractive yields, back to the U.S. This also led to a decline in many of the emerging market currencies and an increase in inflation. There was even speculation that this would lead to another Asian currency crisis similar to that of the summer of 1997. Given the strength of many of the countries in the region, such as China, Singapore and Korea, the likelihood of an Asian crisis of a 1997 scale is low. While China's growth has fallen from the 10%-12% range to about 7.5% with their government's desire to move to a more consumption-oriented economy, they recently produced encouraging export and manufacturing data.

A new McKinsey Global Institute (MGI) report reveals that emerging markets are increasingly dynamic and prosperous, yet the vast majority of the world's biggest companies remain rooted in developed economies. However, this will not be the case for much longer given the shift in corporate power that is under way and MGI is forecasting emerging economies' share of Fortune Global 500 companies will be more than 45 percent by 2025 compared with just 5 percent in 2000. We appreciate this is some time in the future, but this provides some evidence that we should not be overwhelmed by the daily short-term fluctuations in the market.

While we write this review, the U.S. government shutdown moved into its second week. While we do believe a resolution will be found, the markets will continue to experience volatility in the short-term given the uncertainty. To exacerbate the situation, the latest confrontation over the debt ceiling in the U.S. is like a déjà vu. The last time this took place was in August 2011 where it ended with an 11th hour agreement under pressure from shaken markets and warnings of an economic catastrophe if there was a default. We may see a similar last minute resolution again.

On a recent research trip to Europe, we found the region's recovery could begin to feed on itself. The companies had progressed beyond the stage of bewilderment and helplessness and seem to have become more focused on furthering their strategies. While they were still not exuberant and making money is no longer easy as it was five years ago, the focus has shifted away from government austerity programs to more confident execution of their business plans.

We continue to look to add high quality companies with a growth profile to our portfolios. We met with a number of European financial institutions on this research trip and gained more confidence that the key credit crisis was behind them. Although they may experience some bumps along the way, stronger balance sheets, capital discipline and focused business plans may lead to possible additions in this area of the portfolio. The first such addition is the Lloyds Banking Group, which is profiled below. Valuations vary in the different markets and therefore, we expect to seize opportunities to capitalize on these differences.

Market Performance and Transactions

Global equities (MSCI World Index) are up 17.7% (US$) or 21.8% (C$) year to date, and 5.9% (C$) or 8.3% (US$) in the third quarter. The Dow Jones Industrial Average is up 17.6% in the first nine months of the year while the S&P 500 is up 19.7%.

In the MSCI World benchmark, all sectors had positive performance during the quarter. However, the top performing sectors were Materials, Industrials, and Consumer Discretionary while the defensive sectors of Consumer Staples, Utilities, and Healthcare were the bottom performers. It is evident investors have become comfortable with the markets given the cyclical names performing better than the defensive sectors.

During the third quarter, Cumberland's Global portfolios saw the following changes to their holdings:

1. Purchase of Lloyds Banking Group
2. Purchase of Richemont
3. Purchase of ATCO
4. Sale of MTU Aero
5. Sale of IBM

The International Fund and portfolios saw the following changes:

1. Purchase of Lloyds Banking Group
2. Purchase of Richemont
3. Purchase of Telecity
4. Sale of MTU Aero

Purchases:

<u>Lloyds Banking Group:</u> Lloyds has a market share of 25% in UK mortgages and is the purest play in the UK banking sector. The core retail and SME markets are less volatile than other sectors such as investment banking or commercial real estate. They are a beneficiary from an improving UK economy and improving housing with better volumes, lower impairments, and capital relief. Lloyds is regaining market share as funding disadvantage vs. peers is less acute. Lloyds has reduced its reliance on the wholesale funding markets, almost halving it in two years from £300 billion to £160 billion and it has less than £50 billion in short-term debt.

<u>Richemont:</u> Richemont has been built up steadily over the past twenty-five years to become a powerhouse in the hard luxury industry. Jewellery is enjoying a strong performance, anchored by two strong brands, Cartier and Van Cleef & Arpels. Both these brands have a high operating contribution of 35% and Van Cleef & Arpels is now the second largest contributor to Group profits. Richemont is one of the leaders in the watchmaking industry and has a collection of the world's most coveted brands. Richemont's strength is in their brands and their brands continue to outperform the market. This allows them to be able to increase their prices each year, in the range of ~5% per year and the introduction of new products with a higher average price. Their hard luxury represents about 75% of their sales where the market trend is growing at 9% CAGR to 2017 vs. 6-7% for the overall luxury market. Richemont is expanding their

retail operations in Asia and they will be able to take advantage of their operating leverage as a result of pricing power, positive mix effect, and internalization of the manufacturing facilities.

Telecity: Telecity is Europe's leading provider of premium carrier-neutral data centers. Their customers locate mission-critical IT equipment in Telecity's data centers given the high levels of internet connectivity, power, reliability and security provided by Telecity's data centers. Customers are principally charged for the power capacity they have access to along with the actual power used. Growth in demand is strong for carrier-neutral centers in Europe, driven by organizations such as providers of internet content and cloud services that look for premium, highly-connected data center capacity to support the services they offer to their end users. Carrier-neutral data centers are typically selected due to the range of networks available, centrally located close to transport/infrastructure and telecoms networks, proximity to other data center customers and on-site engineering and technical support.

Atco: Atco is a simple company with about two-thirds of their earnings generated by predictable rate base utility growth in the electrical and gas distribution businesses in Alberta and the other third being generated by the original business of providing camp accommodations to resource companies globally. Growth is presently driven by an unparalleled amount of rate base growth providing high voltage electrical power lines in the province of Alberta. They are midway through a 5 year $10 billion build out which provides relatively high and assured earnings growth for the next several decades. In the longer term, they will need to replace and relocate the aging gas distribution grid further away from large population centers such as Calgary.

Sales:

The sale of MTU Aero was precipitated by its disappointing earnings report. We had made gains in the Company and the change in earnings growth was unexpected. We sold IBM given that their recent earnings growth was derived more from tax benefits and changes in accounting rather than organic growth.

S. Yang
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