CUMBERLAND

Global Equity and International Fund Strategies
Fourth Quarter 2014 Review

Global Macro Review

The world in 2014 was turbulent and challenging. Key events included: the militant group Islamic State (ISIS) creating terror with their conquests and displacing hundreds of thousands of people, the Ebola virus causing a global health crisis, conflict between Israel and Hamas erupting once again, and the Ukraine exploding into military conflict. The unfortunate thing about these issues on an ongoing basis is that they may challenge sustainable global growth.

Volatility increased during the fourth quarter due to the uncertainty posed by some of the events mentioned above. In fact, the market experienced its biggest bout of volatility since June 2012 with stocks dropping as much as 9.8% in the U.S. in October. This occurred when the sovereign debt crisis in Europe was at its height along with fears about the spread of the Ebola virus, leading to concerns about global growth.

The key event that shocked the market during the fourth quarter is the sharp drop in the price of oil. With the Saudi government agreeing not to cut production post the OPEC meeting at the end of November and worries of excess supply alongside fears of weak global growth, the WTI oil price went into a free fall, from the high of U$107 in June to U$53.27 at the close of the year. This would be the largest drop in oil prices in absolute terms and on a percentage basis since 2008. If we assume the basic cost of production to be U$50, then we should not be surprised to see marginal producers, including those in Canada, to cut back on production or take more drastic measures if the oil price continues to descend. Companies with strong balance sheets will have the opportunity to buy assets or companies outright as the leveraged and high cost producing companies need to find different ways to stay afloat. The energy sector landscape is extremely dynamic, and we expect this to be the case until we see some sort of resolution on the political front, spearheaded by Saudi Arabia. Obviously, for the consumer, the decline in oil prices has led to lower gas prices. This is positive, at least in the short-term. However, the longer term implication is more worrisome, especially if the current oil price reflects the view on global growth or brings with it a decrease in capital expenditure and loss of jobs.

The events that gripped the world this year may still prove to be "grey swans" in 2015. An additional concern is the current political situation in Greece where the anti-austerity Syriza party is poised to sweep into power. If this happens, whether Greece will leave the Euro zone is back in the headlines. The difference this time as compared to the Euro crisis in 2011 is that a Greek exit would potentially be manageable and should not lead to contagion to countries such as Spain or Ireland. If oil continues to drop and the Fed does start to increase interest rates, several emerging market currencies can destabilize, with Russia likely being impacted the most. With the possibility of political instability in the region worsening, we can expect a currency crisis.

During the second half of 2014, we observed a divergence of economies between the U.S. and the rest of the world. U.S. GDP grew by 5% in the third quarter, the strongest that we have seen in more than a decade, while there was deceleration in Europe, China and Japan. This strong U.S. performance was reflected in the rise of the dollar against every developed-market currency in 2014, +13.6% against the Euro and +13.7% against the Yen. Meanwhile, emerging market currencies posted their worst year since 2008, with the currencies of the countries in MSCI Emerging Market Index constituents falling by more than 7%. The drop in oil prices also exacerbated the fall in currencies of oil-exporting countries, leading to a broad selloff in emerging market currencies.

Asia

Post the financial crisis, the world has looked to China to provide global growth; however, data shows this is no longer the case. China requires at least 7.2% growth to create around ten million jobs annually for its huge population. China's producer price index (PPI) has

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stayed negative for 33 months in a row while the decline in its consumer price index (CPI) appears to have accelerated from May 2014. The scenario is similar to the time when the Chinese government attempted to stimulate the economy post the Asian financial crisis in the late 1990's. While it took six years for China to get out of the deflation spiral the last time, it may take longer now as the investment as a percentage of GDP is much higher. Hence, the issue of over-capacity may be a larger problem this time and if so, it will take a longer time to resolve given a weaker global growth scenario on a comparative basis.

China's President Xi Jinping is facing an environment with lower growth and higher leverage. As China attempts to deleverage, it is trying to deflate their US$25 trillion credit boom and as a result, we may witness an increase in bad debt defaults and have resistance to lowering interest rates. However, they are faced with an uncertain outlook in areas where growth has historically been strong. China's economy, the world's second-largest after the U.S., grew by 7.3% in the third quarter which is its slowest pace in more than five years. With this backdrop, China's central bank cut a key interest rate in late November to 5.6% to make it more attractive for businesses to borrow in order to hire and expand.

In Japan, Prime Minister Abe called a snap election in mid-November and was reelected one month later with a mandate to kick-start its economy (again). Abe's economic policy launched in 2013 involved a monetary policy, fiscal stimulus, and structural reform. Japan experienced economic growth briefly from a weaker Yen but the country is back in a recession, for the first time since 2012. Abe called an election one day after quarterly GDP figures showed Japan had declined by 1.6% in the third quarter and after plunging 7.3% in the second quarter. The dismal state of the economy has led Abe to delay an increase in the consumption tax from 8% to 10% until April 2017, 18 months later than planned.

A couple of weeks prior to the election announcement, Japan's central bank announced it would expand its asset-buying program by as much as 33% and buy stocks, real estate funds in addition to government bonds. Yet, even with this, the ability to break the vicious cycle of falling prices, wages, spending and investment is difficult. Furthermore, the economy has not benefited from the sharp Yen devaluation. What has resulted are higher costs and Japan's debt is more than twice the size of its economy, currently it has the highest debt to GDP ratio in the world.

With success at the polls, Abe now has four more years to get Japan out of its deflationary spiral.

Europe

The Euro reached its lowest level against the dollar since 2010 with its European Central Bank (ECB) President, Mario Draghi hinting that he is preparing to start pumping cash if the economic outlook continues to stay sluggish. It is not surprising that Draghi has a gloomy assessment of the region given the Markit survey of purchasing managers showed a sluggish end to the year for manufacturers where it reflected the slowest quarter in more than a year. In fact, France and Italy reported a downturn while output rose modestly in Germany. The UK's manufacturing sector outperformed the Euro zone with a Purchasing Manufacturers' Index (PMI) of 52.5 in December compared to 50.6 for the latter.

The ECB has already cut interest rates to 0.05% and bought covered bonds, backed by bundles of loans. These are all short of a full quantitative easing (QE) program taken up by other major economic nations because of opposition from Germany. Some economists are expecting the Euro zone to descend into deflation in early 2015, which would be its first since 2009. The loss of the Euro versus the U.S. dollar of 13% in 2014 reflects the divergence in the recovery in the U.S. economy and Europe's extended woes such as the potential exit of Greece from the Euro zone.

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Emerging Markets

The emerging markets are a much bigger part of the world economy today compared to the time of the Asian crisis in 1998, and therefore they potentially make a larger impact. A disturbing statistic is their combined debt ratio of 175% of GDP. And with a strengthening dollar and having $5.7 trillion in dollar debt, we expect the emerging markets to experience some volatility and weakness. Another risk is the impact of a potential increase in U.S. Treasury yields in 2015 that may intensify the pace of money flowing out of the developing countries and strain their financial systems.

Russia's situation is a distinct case, with the U.S., the European Union and others denouncing Russia's annexation of the Ukraine's Crimea peninsula as illegal and responding with asset freezes and travel bans. Furthermore, sanctions were placed on Russia's financial, defense and energy sectors after Malaysia Airlines Flight 17 was shot down in eastern Ukraine in July. With the energy sector being a major source of revenue for Russia, the decline in oil prices have further impacted their currency reserves. With their economy and currency hard hit by the crisis, its central bank raised its key interest rate to 17% in December in a bid to stem the ruble's drop.

Portfolio Review

Despite the volatility we experienced, both the Global Equity and International Fund strategies outperformed during the quarter. The outperformance in both the Cumberland Global Portfolio and Cumberland International Fund was attributed from sector allocation with low exposure to the Energy and Materials sectors, partially offset by our higher cash levels. Although the outlook for global growth is muted, the companies in our portfolios have managed to maintain a strong growth profile. The objective of the portfolio is to maintain a lower risk profile and our minimal exposure to commodities has aided in keeping the low volatility of the portfolios. We were successful in preserving capital in a challenging investing environment as well as providing growth.

As a follow-up to what we wrote on Hyundai Motor last quarter, Korean corporates have been increasing their dividend payouts as a response to the introduction of the penalty tax of carrying high cash balances. Samsung Electronics announced a 50% increase in their dividends but it still remains at a low dividend yield of 1.7%. Similarly, Hyundai Motor has a 2.4% dividend yield and a low payout ratio. With both companies having a solid cash position and strong free cash flow generation, we expect a further increase in dividends. We believe this shareholder friendly move should lead to better stock performance for these Korean companies.

2014 was an active year in terms of mergers and acquisitions. The value of global mergers and acquisitions rose to the highest since 2007 while the number of initial public offerings (IPO's) was the highest since 2000. One of the larger deals announced in 2014 was by Comcast's offer to buy Time Warner Cable for $45.2 billion in February. We are still waiting for regulatory approval of the deal, which we still believe to be positive for Comcast's future growth.

Another trend in 2014 was for U.S. based companies attempting to buy foreign companies to move overseas and take advantage of a lower tax jurisdiction, called inversions. When the U.S. government saw a decline in their tax revenue base, the inversions came to a stop with a change in tax laws in the fourth quarter. For example, over half of the more than $648 billion of the healthcare deals announced in 2014 were inversions. On September 22, the Treasury Department announced new rules that made the deals less lucrative. Generally, we do not buy companies in anticipation of a deal or that require a deal for growth. Rather, we prefer companies that have strong fundamentals and in the event there is an opportunity, the given company's strong balance sheet will allow it to take advantage of the environment.

We find it is essential to distinguish between companies reporting better profitability from buying their own

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shares versus from better productivity gains and reinvest then in their capital for future growth. Based on FactSet, companies in the S&P 500 bought back $438 billion of their own stock in 2014 which was 93% of the amount spent on their own capital expenditures and the highest level since 2007. The companies in our portfolio have been involved with both strategies, but our preference lies with companies that have a sustainable strategy of providing improvement in their margins and productivity.

We also need to be cognizant of strength in the U.S. dollar, with S&P 500 companies generating more than 30% of their sales outside of North America. The weakness in the U.S. dollar for the past several years was a tailwind for many U.S. companies with international operations. However, this will turn into a headwind in 2015 where their revenue from abroad will translate to lower earnings when converted back to the dollar. We shall be watching more carefully our companies as to how they will be dealing with this headwind. However, for companies based in the Euro zone, the weaker Euro will be a tailwind.

Based on Bloomberg, the S&P 500 is trading at 16.4x the next 12 month expected earnings while it traded at an average of 13.5x over the past five years and 13.8x for the past decade on the same metric of expected earnings. By comparison, the MSCI EAFE is similarily trading at a premium compared to its long-term average; 14.0x the next 12 month expected earnings versus 12.2x for the past five years and 12.5x for the past decade. In terms of value, MSCI EAFE is trading at a lower multiple compared to the S&P 500, but this is reflecting the lower growth profile of its constituents. The U.S. market is also trading in line with its historical average. In this environment where there are not many bargains, fundamental performance of companies will be crucial.

Performance

Fourth Quarter Index Performance

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

	Q4 2014 USD Total Return (%)	Q4 2014 Local Total Return (%)
MSCI World	1.2	1.2
S&P 500	4.9	4.9
Canada S&P/TSX	-4.9	-1.5
Euro Stoxx	-6.1	-2.0
MSCI Emerging Markets	-4.6	-4.6
Germany DAX	-0.4	3.5
UK FTSE 100	-4.1	-0.2
France CAC 40	-6.9	-2.8
Switzerland SMI	-1.8	1.7
Japan Topix	-2.5	6.2
Hong Kong Hang Seng	3.4	3.2
Korea KOSPI	-8.5	-5.2

The key benchmark, the MSCI World Index, had a total (price and dividend) return of +1.2% in US$ and +4.8% in C$ for the fourth quarter. The other key benchmarks of MSCI EAFE had a total return of -3.5% in US$ and +0.1% in C$ while the S&P 500 had a total return of +4.9% in US$ and +8.7% in C$. Global markets outperformed the Canadian market once again this quarter which returned -4.9% in US$ and -1.5% in C$. The Canadian dollar depreciated by 3.7% against the U.S. dollar in the quarter, continuing a trend of the third quarter. Thus, with the depreciation of the Canadian dollar, the returns increased when translated back to the Canadian dollar.

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In the MSCI World benchmark, Consumer Discretionary with +6.2% (US$) and Information Technology with 4.1% (US$) were the top performing sectors in the quarter. The two worst performing sectors in this benchmark were Energy with a -14.8% return and Materials with -4.7%.

The two best performing sectors during the fourth quarter in the MSCI EAFE benchmark were Consumer Discretionary with +2.8% performance and Technology with -0.7% while the two key detractors were Energy at -19.8% and Healthcare at -5.5%.

Annual Index Performance

Despite all the challenges the market faced in 2014, the S&P 500 posted a solid year with gains of +13.5% (US$) and +24.1% (C$) including dividends. This is the third consecutive year that the market benchmark has risen by more than 10% and this year, it posted new highs. U.S. companies benefited from low interest rates and a gradually improving economy which drove their profits higher. The run-up in the U.S. market is now 70 months, making it the fourth longest bull market since World War II. The best performing stock in the S&P 500 was Southwest Airlines, increasing 126% while the worst performer was deepwater driller Transocean with a 60% decline, including dividends. Small-cap stocks trailed large-cap stocks since the end of the first quarter. The best performing U.S. sector was utilities and the worst sector, as in other regions was the energy sector. Utilities was the beneficiary of lower bond yields given investors were still seeking a source of income and utility companies in the U.S. were providing an average yield of 3.4%. The surprise in the U.S. market was the strength in bonds. There was a universal expectation that economic strength in the U.S. would drive down bond prices and push their yields up. Yet, the yield on 10-year Treasuries fell to 2.17% from 3.03% at the end of 2013. For 2015, the consensus is for a rise in yields based on a strong economy and the impact that will be felt from the end of the Federal Reserve's stimulus program.

With the U.S. market being a large part of the MSCI World Index, this benchmark also had a good return with a total return (price and dividend) of +5.5% (US$) and +15.1% (C$) for 2014. The sectors that contributed the most in 2014 to the performance in the MSCI World Index were Healthcare with +16.3% (US$) and Technology with +14.7% (US$). As has been the case for most of 2014, Energy with a -13.7% (US$) and Materials with -7.1% (US$) were the two worst performing sectors.

The MSCI EAFE Index had a return of -4.5% (U$) and +4.2% (C$) for the year, which is below both the World and U.S. returns given this Index does not include the U.S. yet has the U.K. as the largest constituent which went down in the year. The two best performing sectors in the MSCI EAFE benchmark were Healthcare with 3.7% and Utilities with 0.4% while the two key detractors were Energy at -21.9% and Materials at -12.9%.

Portfolio Transactions

During the fourth quarter, Cumberland's Global Equity portfolio purchased Liberty Interactive, McKesson Corp. and United Technologies without making any dispositions.

Liberty Interactive, also known as the QVC Group is one of the largest television and e-commerce retailers in the world with over 13 million customers and US$8 billion in sales. Although 72% of their EBITDA is derived in the U.S., they have successfully expanded into new markets such as Germany, Japan, the UK and China. QVC sells mostly exclusive branded products (75% of sales) across a variety of merchandise categories. The Company enjoys one of the strongest customer bases in retail with a steady 90% retention rate. QVC is now the fourth largest online retailer and the second largest in mobile in the U.S. with digital penetration at 43% of sales. We expect double digit e-commerce growth that will help drive overall revenue growth over the medium-term.

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McKesson, also based in the U.S. is the largest wholesale drug company by market capitalization (US$48 billion) and sales (US$137 billion). The Company operated two businesses in distribution and healthcare IT (HCIT). The additional scale from recent transactions will provide McKesson greater negotiating strength and lead to more synergies and improved profitability. Although the HCIT business is a very small part of the revenue base, it has significantly higher profitability. McKesson trades at a reasonable valuation and has a track record of generating strong cash flow and steadily increasing dividend.

United Technologies is a leading manufacturer of products for the construction and aviation industry where they have leading margins and leadership positions across most divisions. The Company operates in 5 key business units: (1) Otis – world's leading manufacturer of elevators and escalators and also provides maintenance services; (2) Climate Controls and Security (CCS) as the leading manufacturer of HVAC, fire and safety, and building controls for transportation; (3) Aerospace Systems as the leading manufacturer of aerospace products, including power systems, engine components, aerostructures, and flight control systems; (4) Pratt and Whitney as the leading manufacturer of airplane engines for both commercial, business jet, and military applications as well as maintenance and repair services; and (5) Sikorsky which is world's leading manufacturer of helicopters for both civil and military applications.

United Technologies operates in favorable endmarkets. We expect global growth in air travel to be about 5% per year where their Pratt & Whitney and Aerospace Systems divisions will be beneficiaries. With the majority of its Otis and CCS businesses exposed to non-residential construction spending, we believe UTX will be a beneficiary of an improvement in this depressed endmarket. We expect the Company also to take on initiatives to help drive margins higher.

In the International Fund, we added Safran while making dispositions in Bucher Industries, Sulzer and Japan Tobacco.

Safran is a leading aerospace manufacturer and operates in 4 main segments: (1) Aerospace propulsion where they manufacture and service leading civil and defense aircraft engine programs, including the CFM56 engine for the 737 and A320 narrowbodies, and GE90 for the 777 widebody; (2) Aerospace equipment where they have a leading position in areas including electrical power systems, landing gear and brakes, and nacelles; (3) Defense where they are a leader in optronics for military use and navigation systems; and (4) Security where they are a global leader in biometric technologies and tomographic systems.

Safran has either a duopolistic or an oligopolistic position in growing endmarkets with a large installed base of engines. This enables Safran to have strong growth in a high margin aftermarket. There are growth opportunities beyond the civil aerospace aftermarket and their free cash flow generation will increase as upfront investments tail off.

We sold both Bucher Industries and Sulzer at the beginning of the fourth quarter. Although we still believe Bucher is a well-run company, their source of revenue had a high exposure to areas where there was general softness, including the European farmer and European municipalities. As for Sulzer, we were disappointed in their ability to turn around some of their divisions. Japan Tobacco was gaining market share domestically, but there was increased risk in their international operations, namely in Russia. During a recent meeting with management, they did not provide a sound strategy as to how they were going to deal with the Russian political risk. In addition, the dramatic drop in the Yen had a large negative impact when translated back to the Canadian dollar.

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Outlook

The concerns for 2015 include how corporations are going to see significant sales growth when global growth is lackluster while dealing with the challenges they faced in 2014 that are likely to continue in the coming year. Inflation will be coming off its lows in the U.S. and may prompt the Federal Reserve to raise U.S. rates faster than anticipated and thereby stifling the fragile recovery in the U.S. There will be beneficiaries of a lower oil price and there will come a time where bargains in the energy sector cannot be ignored. The fundamentals of companies are more crucial than ever. Thus, in this sort of environment, we are convinced that we need to continue investing in quality companies that will grow organically without reliance on a monetary policy for their survival. We shall continue to seek companies that reinvest their cashflow in innovation and capital so they maintain their competitive advantage in businesses that benefit from secular growth trends, including an aging population, desire for luxury and value for money.

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Cumberland Private Wealth Management Inc. is a leading independent investment firm that provides discretionary investment management and wealth management services for high net worth individuals, their families and foundations, with $1 million or more in investable assets. All of Cumberland's investment mandates are centered on building and preserving our clients' financial wealth. Founded in 1997, the firm is privately-owned by its employees and headquartered in Toronto, Canada.