CUMBERLAND

Global Equity and International Fund Strategies
Second Quarter 2014 Review

The U.S. market had much to celebrate on Independence Day given that the Dow had reached a new record high of 17,000. And yet, five years after the global recession of 2009, global growth is low and a high level of caution still exists among both investors and corporations.

When we review the issues we discussed in the first quarter, we see that circumstances in the market are no longer dire, which may explain why the levels of volatility in the markets are at an all-time low. Yet, the geopolitical risks have not gone away, with the Middle East and Russia being omnipresent in crisis mode. However, the markets appear to have priced in the risks and thus, they are no longer front page news each day. The negative stance towards emerging markets has also subsided.

The companies in the Global and International portfolios released their first quarter numbers in late April and early May and generally, they reported results that exceeded expectations. The companies continued to maintain strong cost controls and were cautious in increasing capital expenditures. Geographically, better momentum was experienced in the U.S. and Europe compared to the emerging markets. Overall, the tone from management was more positive and confident than in recent discussions, yet reserved the right to be cautious.

Economic Review

Europe

Eurozone inflation remained at its lowest level for more than four years this month. Annual eurozone inflation at 0.5% in June is far from the European Central Bank's (ECB) target of 2%. However, there is a divergence in inflation rates among the countries within the eurozone, which makes the task for the ECB more difficult. For example, the most recent figures released for Germany showed that inflation accelerated to 1% in June from 0.6% in May while in Italy, inflation fell from 0.4% to 0.2% and prices in Spain remained flat for the last twelve months. The ECB was among those that cut rates in the second quarter and the negative rate on bank deposits is supposed to encourage banks to lend to each other rather than leaving surplus funds with the central bank.

Another concern in Europe is the slowdown in growth in France, eurozone's second largest economy with its business climate being at their lowest level since last August according to France's statistics authority, Insee. There is speculation of job cuts in France given the uncertainty in the political and economic environment.

After announcing a number of exceptional measures, such as the negative rates mentioned above as well as an offer of up to €400 billion in four-year loans in June, the ECB will be expected to take up even more extraordinary measures if inflation remains subdued. After the governing council's June vote, ECB president Mario Draghi promised that officials would prepare work on a programme of purchases of asset-backed securities backed by loans to the currency bloc's companies. Whether the central bank will have to resort to mass bond-buying, known as quantitative easing, following in the footsteps of the U.S., U.K. and Japan or to a smaller programme in a structure resembling its covered bond purchase scheme between 2009 and 2012 is currently the subject of debate. Quantitative easing is more complicated in the eurozone given its eighteen national bond markets, which makes it hard to target such stimulus where it is needed.

Asia

At the end of June, Prime Minister Abe of Japan formally outlined his vision of the "third arrow" of reform in order to revive Japan's economy. He also wrote about his personal commitment to enforce the structural reforms in an international paper, yet we question whether there is sufficient substance for the policies to be successful. For example, while one of Japan's largest obstacles to growth is their ageing population and falling birthrate, they will not acknowledge an overhaul of their immigration policy as one of the potential solutions. Abe has proposed that they make it possible for working mothers to hire foreign workers as housekeepers in the special zones. However, this surely

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falls short in terms of offsetting the steep decline in population growth, especially given that the quantum of the special zones has not been identified.

Although the market is lukewarm on the success of Abe's "third arrow", there has been steady buying into Japan's equity market by the domestic pension funds as well as from very long-term foreign buyers. Japan is trying to emulate Germany and the U.K. in reducing corporate tax rates from the current level of 35%, although 70% of the companies pay no tax at all. In Abe's announcement, the corporate tax will be reduced by 2.4% this year with the aim to reduce it to 20%-30% range over several years to help growth and draw international investors.

Japan's quarterly Tankan survey which measures the pulse of more than 10,000 companies across the country showed that confidence among businesses slipped after April's consumption tax increase, marking the first drop since Abe came into power. There was a 5% drop among the large manufacturers' assessment of their business conditions, which is the most closely watched of all the data points in the survey. Thus, the softness in demand is weighing on the outlook for consumer price inflation (CPI), which the Bank of Japan predicted would hit 2% in the fiscal year starting March 2015. The CPI is expected to decline to about 1% over summer from the current level of 1.5%, but if inflation falls below 1%, the consensus is that the Bank of Japan will do another round of quantitative easing.

Despite the patience that will be required to see the impact from the "third arrow", the Japanese market's valuation is more attractive on a relative basis than the U.S. market currently. However, we are investors in companies rather than buyers of the markets, so each company would have to be analyzed on its own merit, both on a quantitative and a qualitative basis.

Americas

The Federal Reserve, while reducing its monthly bond purchases by $10 billion per meeting has promised to keep rates low for the immediate future. The key decision is when and how to start raising interest rates. Fed Chairwoman Janet Yellen has made it clear they want to see more job growth and inflation move closer to its 2% target. The market's expectation is that the first hike will take place sometime in 2015.

While sluggish, U.S. stocks have been supported by expectations that the U.S. economy will grow fast enough to keep corporate profits expanding. However, there is risk if the Fed raises interest rates sooner than expected in response to stronger growth or higher inflation.

Performance and Portfolio Changes

The second quarter produced returns that were much better than anticipated, given our concern over the rich valuations going into the quarter. There was relatively low volatility with little worry about inflation, thus giving reasonable assurance that interest rates would remain low in the near-term. In fact, the 10-year U.S. Treasury yield went down to 2.53% from 2.72% at the end of the first quarter. Despite the lack of resolution of many of the geopolitical issues discussed in our last quarterly review, and given that there were no new ones, markets were calm on a relative basis.

During the second quarter, we witnessed a return of merger and acquisitions (M&A) activity with global deals totaling US$1.06 trillion, the highest level since 2007. There are a number of reasons behind this increase: (1) low interest rates that allow acquirers to finance an acquisition more easily; (2) high stock prices that provide acquirers a strong currency to pay for the deal; (3) companies looking externally to use the cash that has built up over the past several years; and (4) fewer macro headwinds.

Another milestone that was reached during the second quarter was the record number of U.S. dividend increases since 1979, helping the S&P 500 reach new highs. Within the S&P 500, dividend-paying stocks have outperformed the non-payers by a percentage point so far this year, providing a return of 9.8% versus 8.8% for the latter. With the current payout ratio for

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S&P 500 at about 36% compared to the long-term rate of 52% and the high cash balances of many corporations, we can expect companies to continue to increase their dividend. That said, the low payout ratio reflects the cautious outlook that companies still have and their desire to hold on to higher levels of cash.

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

	Q2 2014 USD Total Return (%)	Q2 2014 Local Total Return (%)
MSCI World	5.1	5.1
S&P 500	5.2	5.2
Canada S&P/TSX	10.1	6.4
Euro Stoxx	3.9	4.5
MSCI Emerging Markets	6.7	6.7
Germany DAX	2.3	2.9
UK FTSE 100	5.9	3.3
France CAC 40	2.4	3.0
Switzerland SMI	1.7	2.1
Japan Topix	6.9	5.0
Hong Kong Hang Seng	6.9	6.8
Korea KOSPI	5.9	0.8

The key benchmark, the MSCI World Index, had a total (price and dividend) return of 5.1% in US$ and 1.5% in C$ for the second quarter. The other key benchmarks of MSCI EAFE had a total return of 4.3% in US$ and 0.8% in C$ while the S&P 500 had a total return of 5.2% in US$ and 1.7% in C$. International markets underperformed the Canadian market which returned 10.1% in US$ and 6.4% in C$. The Canadian dollar appreciated by 3.6% against the U.S. dollar compared to the prior quarter, a trend that nearly reversed the depreciation of the dollar in the first quarter. Thus, with the appreciation of the Canadian dollar, the returns decreased when translated back to the Canadian dollar. Within the MSCI World benchmark, Energy (+12.1% US$) and Utilities (+7.3% US$) were the top performing sectors in the quarter. All sectors had a positive return in US$ but the Financials and Industrials had a slightly negative return when translated into C$. The conflict in Iraq contributed to the strength in oil prices and thus contributing to the strength in Energy. With interest rates remaining low, investors are seeking yield and as a result, driving up the prices of these sectors that generally have a higher yield, particularly the Utilities sector. Although the benchmark returns were all positive, with Consumer Discretionary at 3.5% (US$), Financials at 3.1% (US$), and Industrials at 3.4% (US$), they were below the benchmark's total return of 5.1% (US$).

Cumberland's overweight in Consumer Discretionary detracted from performance while the sector's exposure to Hyundai Motor contributed to performance. Although the Global and International portfolios were underweight in Energy, their position in Schlumberger had a positive impact on performance. Their underweights in Utilities also detracted from performance. Furthermore, the portfolio's overweight in Healthcare contributed to performance. Finally, based on our prudent approach, both the Global and International portfolios held a relatively high level of cash, which was a key detractor from performance with equity markets reaching new highs each day.

Based on Bloomberg, the S&P 500 is trading at 15.7x the next 12 month expected earnings while it traded at an average of 13.3x over the past five years and 13.8x for the past decade on the same metric of expected earnings. Although the S&P 500 is trading closely in-line with its 25-year average multiple which would make the market fairly valued, we have concerns the projected earnings are based on growth assumptions that are on the aggressive side. By comparison, the MSCI EAFE is similarly trading at a premium compared to its long-term average; 14.4x the next 12 month expected earnings versus 12.2x for the past five years and 12.4x for the past decade.

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During the second quarter, Cumberland's Global and International portfolio purchased Publicis, the world's third largest advertising company based in France. Publicis is one of a small group of advertising companies that has a global reach and product breadth that is able to provide services to the Fortune 500 companies. The Company has been an early mover in developing digital advertising capabilities, both organically and through acquisitions, and is well positioned to take advantage of the evolution of the advertising industry from an analog to a digital platform. We expect secular rise in consumption in emerging markets as well as the increasing fragmentation of media to drive growth of advertising and increase the role of agencies. Cyclically, Publicis will also benefit from an improving economic backdrop in the developed markets. The Company is highly cash generative and has a clean balance sheet, both characteristics of our current portfolio investments.

Outlook

Equities are trading at their highest levels in seven years and as we reviewed above, the earnings multiples based on future Price/Earnings are close to 20% higher than their ten-year averages. As such, we will carry forward our prudent approach awaiting further evidence of an acceleration of corporate revenue and profits. With the market in a lull before earnings reports over the coming weeks, we continue to conduct our due diligence on watchlist companies and will wait for the right opportunities to add investments at prices that provide substantial upside to intrinsic values. With improving fundamentals and a slowly improving macroeconomic environment, overall we shall continue to concentrate on companies that have a global reach with a competitive advantage and attractive growth prospects.

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July 4, 2014