CUMBERLAND

Global Equity and International Fund Strategies
Third Quarter 2014 Review

We had the opportunity to spend part of September meeting with companies in Tokyo, Seoul, London and Paris to conduct our due diligence on potential investments and obtain updates on a number of our current holdings. We thought we would focus this quarterly review on the highlights from these meetings as well as our observations.

Korea

In the world of sound bites and short attention spans to any major headlines, it is difficult to fathom that a deadly ferry accident gripped Korea in mourning for months. The impact was so profound, retail sales almost came to a halt with the economy logging its weakest second quarter growth in more than a year with a seasonally adjusted 0.6% growth. The strong Won also hit exporters. Not only was the ferry accident a tragedy, it was an embarrassing incident for a country that prides itself on having the best shipping industry in the world.

In order to revitalize the economy, since July the Korean government has been encouraging responsible capital allocation for corporations to increase both capital expenditures and dividends from their existing cash holdings; otherwise, there would be a tax implication on the cash balance. Subsequently, on October 6, 2014, sixteen major Korean corporations unveiled plans to invest 28.3 trillion Won in capital expenditures. Based on an analysis conducted by an investment bank, it appears the aggregate capital available for deployment of these sixteen major companies amounted to over 100 trillion Won; thus, with the additional free cashflow and existing cash balances, they will be in a position to increase their dividends to satisfy the mandate of the government.

Korea, in a span of only a generation, has nurtured world-class companies, such as Samsung Electronics and Hyundai Motor. We met with both companies in Seoul. Samsung Electronics, as the largest Smartphone producer, is undergoing certain growing pains, as they are being attacked on both the high end by Apple and on the low end by Chinese manufacturers. They admit they misjudged the pulse of the market and as a result, priced their products incorrectly in China and are now actively trying to correct this misstep.

Hyundai Motor is one of the companies that can increase its dividend with its large cash balance, and there was an expectation in the market that they would do this. In late September however, Hyundai made the shocking announcement they, along with their sister companies, Hyundai Mobis and Kia Motor bought a landbank in Gangnam, the most attractive and expensive area of Seoul (yes, the same Gangnam made famous by the Korean popstar Psy). Although this announcement was disappointing, with their cash balance and cashflow generation, they do in fact have the ability to meet the market's demand of a higher dividend.

The drive of Samsung Electronics and Hyundai Motor is a microcosm of the companies we met in Seoul, where they are trying to establish themselves on the world stage as leaders in their respective industries. The Korean market still commands a discount to other developed markets due to its classification as an emerging market, an overhang of a potential attack from North Korea and a usually less than friendly stance to shareholders with their capital allocation, which the government is addressing.

The income disparity trend that has become a prevalent global trend and more subsequent to the financial crisis has emerged in Korea. When you peel back the glamor and glitz that is evident in the bustling streets of Seoul, the income disparity is widening. Although the unemployment rate is statistically low at 3%, the unemployment level is disproportionately high among the youth. While it may not be as horrific as it was in Spain when it reached 50% at its peak, policymakers globally will need to take this structural change into consideration as they try to stimulate the economy.

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Japan

Then, we have the case of Japan which has been struggling to exit deflation for nearly two decades. We witnessed a burst of enthusiasm when Prime Minister Abe announced his three arrow policy at the end of 2012. Yet, the two arrows of "Abenomics" have not made sufficient inroads to Japan's economic growth. In a recent Bank of Japan survey, more Japanese felt they were worse off than three months ago as the cost of living rose and earnings fell, casting doubt on Abe's growth strategy. The general gloom among households does not bode well for Abe as Abenomics rely on boosting businesses and households to spend more. Furthermore, Abe must decide by year end whether to proceed with the second stage of the sales tax hike to 10% next year after having raised it to 8% from 5% in April.

Japan may be able to show growth if and when the third arrow is successful. In discussing this issue with Japanese corporations, they are not convinced the third arrow will be successful, perhaps due to the overwhelming headwinds and the government's inability to address key structural issues. Whatever the case may be, Japan has once again entered a triple-dip recession which leads us to question the use of their unprecedented stimulus. The Bank of Japan did not achieve its 2% inflation target but it did drive the Yen down to a six-year low against the dollar which can push up import costs.

Europe

In Europe, we had the opportunity to meet over twenty leading corporations at an investment conference and some at their offices. From our conversations, it is obvious to us that the tone and expectations for growth in Europe remain subdued, and this is resulting in cautious sentiment towards investment for corporates and consumers alike. Although there remains a notable contrast in growth prospects between northern and southern Europe, with the former stronger than the latter, we note that the trajectory may be starting to narrow. Whereas the general commentary suggested that demand in southern Europe was bottoming, we picked up on increasing signs of softness in northern Europe, most notably in France and Germany.

Germany's economy is being dramatically impacted by the Ukraine crisis and the sanctions imposed against Russia where manufacturing orders dropped 5.7% month over month during August to the lowest level since May 2013 and industrial production (excluding construction) decreased 4.3% during the month to the lowest level since January 2013. As for France, unemployment has edged up to over 10% and confidence has collapsed, placing investment on hold. With the lack of discipline in structural reform, France's budget deficit is expected to rise to 4.4% of GDP from 4.3% in 2013 with public debt exceeding €2 trillion or 95% of GDP. It is frustrating, yet apparent that President Hollande and his government will not meet the deficit ceiling of 3% that is imposed on members of the Eurozone.

In addition to our company meetings, we also attended a speech by Mervyn King, the former head of the Bank of England who had a front row seat during the global financial crisis and the European debt crisis. Given his perspectives, we paid particular attention to his somber message. In summary, he is skeptical as to whether the European Central Bank's most recent round of quantitative easing can stimulate demand. He believes further monetary policy is not necessarily the solution as this only works to a point and unfortunately, the European Union appears to have gone beyond it. Japan, as we have discussed, is in a similar situation. His speech also served as an important reminder that there are serious structural questions with the European monetary union and banking systems that remain unaddressed. Supply reforms that boost confidence and increase consumption will still be required to boost investments for the future.

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As we write this quarterly review, the International Monetary Fund cut its world growth projection to 3.3% in 2014, down 0.1% from its July forecast and 3.8% in 2015, down 0.2% from three months ago. In addition, they raised the issue of increased geopolitical tensions and the possible macroeconomic effects on a larger scale in the future. It is evident that the pace of the global recovery has been disappointing, despite the level of quantitative easing that has taken place. The Eurozone is on course to grow by 1.1% this year and 1.5% in 2015, both numbers being sub-par indeed. One bright spot within the Eurozone is the U.K., with its strong domestic spend. It is expected to be the world's fastest-growing advanced economy this year, with a growth rate of 3.2% in 2014.

We shall continue to monitor the ongoing developments in Europe as well as the stocks in our portfolios which are so exposed. One of the alarms that may sound off if the monetary and fiscal policies do not work is for foreign exchange tensions to increase. While our portfolios are overweight European equities, we remind our investors that our European investments are predominantly global enterprises by nature, with strong franchises not only in Europe but also in the faster growing U.S. and emerging markets.

Performance and Portfolio Changes

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

	Q3 2014 USD Total Return (%)	Q3 2014 Local Total Return (%)
MSCI World	-2.0	-2.0
S&P 500	1.1	1.1
Canada S&P/TSX	-5.4	-0.6
Euro Stoxx	-7.5	0.3
MSCI Emerging Markets	-3.4	-3.4
Germany DAX	-11.1	-3.6
UK FTSE 100	-5.9	-0.8
France CAC 40	-7.7	0.0
Switzerland SMI	-3.9	3.4
Japan Topix	-2.4	5.7
Hong Kong Hang Seng	-0.1	0.1
Korea KOSPI	-3.5	0.9

The key benchmark, the MSCI World Index, had a total (price and dividend) return of -2.0% in US$ and +3.0% in C$ for the second quarter. The other key benchmarks of MSCI EAFE had a total return of -5.7% in US$ and -0.9% in C$ while the S&P 500 had a total return of +1.1% in US$ and +6.3% in C$. Global markets outperformed the Canadian market which returned -5.4% in US$ and -0.6% in C$. The Canadian dollar depreciated by 4.7% against the US dollar compared to the prior quarter, a trend that reversed the appreciation of the dollar in the second 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, technology with 3.4% (US$) and healthcare with 3.2% (US$) were the top performing sectors in the quarter. In fact, these were the only two sectors that had a positive return while all other sectors had a negative return. The two worst performing sectors in this benchmark were energy with a -10% return and materials with -7.2%.

The two best performing sectors in the MSCI EAFE benchmark were healthcare with flat performance and technology with -1% while the two key detractors were energy at -12% and materials at -10%.

While both the Cumberland Global Portfolio and Cumberland International Fund had positive attribution from sector allocation with low exposure to the energy and materials sectors, the performance was negatively impacted from its holding in Hyundai Motor. The stock market reacted negatively due to the questions about the Company's ability to allocate capital in the best interest of shareholders. As mentioned earlier, management announced a purchase of a land base in Seoul and a plan to build an auto theme park and a hotel as well as new offices. Currently, about 30 Hyundai Motor affiliates pay a combined 220 billion Won in office rent, which is roughly equal to the amount of interest one can get on 10 trillion Won in bank deposits. Although management did pay a high price for the land, we believe there is long-term merit to this decision and this does not preclude them from raising dividends in the short-term.

Based on Bloomberg, the S&P 500 is trading at 15.0x the next 12 month expected earnings while it traded at an average of 13.4x 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; 13.5x the next 12 month expected earnings versus 12.2x for the past five years and 12.4x 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.

During the third quarter, Cumberland's Global Equity portfolio purchased Walgreens. This Company is currently undergoing a merger with Alliance Boots to create one of the largest drug retail and health care distribution companies in the world with over 11,000 stores, 180,000 points of distribution and 100 million retail loyalty card members. The newly formed company will still be primarily U.S. driven with 65% of its sales derived from the U.S. and the remainder mainly from the U.K. Alliance Boots also has a fledgling but rapidly growing international division with exposure to Thailand, China, the Middle East and Latin America.

We made two dispositions in both the Global Equity portfolio and the International Fund: BNP Paribas and Elekta. We divested our holdings in BNP Paribas as recent regulatory and macroeconomic developments led us to reduce our expectations for a recovery in their businesses and their ability to execute on capital returns to shareholders. As for Elekta, we were disappointed that Elekta reduced their fiscal year guidance shortly after guiding downwards only three months prior which damaged our view and credibility of management. Although Elekta operated in an industry that has high barriers to entry with only a couple of key players in radiology technology, the growth profile had become more muted in recent years.

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Outlook

Based on guidance provided by companies, the outlook for growth remains challenging and hence, we are set for tepid global growth. It appears the decline in global stock markets is reflecting this slowdown and the anticipation of the rise in interest rates by the Fed later next year. In this sort of environment, we are convinced that we need to continue investing in quality companies that can continue to grow organically without reliance on a monetary policy for their survival. We shall continue to seek companies that reinvest their cashflow and capital in innovation so they maintain their competitive advantage in businesses that have secular growth themes that include an aging population (healthcare companies), desire for luxury (Richemont) and value for money (TJX).

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