CUMBERLAND

Cumberland Income Fund
Second Quarter 2013 Review and Outlook

The Cumberland Income Fund declined -0.17% during the second quarter of 2013 compared to the decline of -2.36% posted by the DEX Universe Bond Index during the same period. The Fund has gained +1.65% year to date and +4.7% year over year, while the DEX has declined -1.68% year to date and -0.2% year over year. Comments made by U.S. Federal Reserve Chairman Ben Bernanke along with Japan's outrageously aggressive monetary policy of doubling their money supply over the next two years caused a significant pickup in volatility in global bond markets during the second quarter. The Fund's short duration, floating rate note (FRN) holdings, and cash position shielded the Fund from a quarter that was generally characterized by declining bond prices and rising yields.

Government bond yields were at the epicenter of the bond market's weakness this quarter. Using the Government of Canada 10-year bond (GCAN10YR) as an example, the yield on this bond started Q2 at 1.87% and ended the quarter at a yield of 2.44% - a 30% increase. The commensurate decline in the <u>price</u> of that bond was -5.2% thereby erasing 3.5 years of income during the quarter. On an intra-quarter basis, the results were even more dramatic. From the period of May 2nd to June 25th that same government bond dropped -8.2% in price and wiped out 5.5 years of the bond's income. These extreme price swings caused enough pain for retail investors to redeem out of bond funds. According to the most recent data available from The Investment Funds Institute of Canada (IFIC), investors redeemed $3.17 billion out of bond funds in May compared to net purchases of $421 million in April and $1.19 billion in May 2012.

At Cumberland, our portfolio construction has been somewhat atypical relative to other bond and income strategies. Although we cannot forecast the magnitude or exact timing of the rise in interest rates mentioned above, we have been identifying interest rate risk as the single largest risk to bond portfolios for some time now. We concluded that it would not be prudent to construct a bond portfolio with the underlying assumption that ultra-low government bond yields would remain unchanged or stable. Consequently, we have been holding one-third of the Fund in floating rate notes and cash, and we have been keeping our duration (bond price sensitivity to interest rate movements) low at just under 3 years compared to the DEX Universe Bond Index of 6.8.

If there was any doubt whether the central banks around the world still heavily influence the capital markets, that doubt was laid to rest during the quarter. In our view, the significant increase in bond yields and interest rates can be single-handedly attributed to central bank actions or comments. Here is a quick timeline of interest rates' march higher during the quarter (using the U.S. Treasury 10-year benchmark bond as a proxy) and Cumberland's view of the catalysts:

- May 9: The Japanese Yen, which began its large descent at 77 (USD/JPY) in the fall of 2012 due to specific monetary policies initiated by the Bank of Japan to achieve that very goal, finally crested 100 on May 9th. We believe with the Yen at that level, it triggered the unwinding of a widely-held institutional structured product in Japan that involved the mass selling of U.S. Treasury bonds thereby reducing bond prices and increasing yields. The 10-year bond yield went from 1.8% to 2.0% within 8 trading days.
- May 22: Federal Reserve chairman Ben Bernanke presented regularly scheduled testimony to Congress. During the session Bernanke delivered mixed signals. Bernanke first noted that premature monetary policy tightening could slow or end the economic recovery but then later stated that the Fed could begin winding down the bond buying program (QE) at one of its next few meetings if they observe sustained economic growth. Uncertainty increased later that same day when the Federal Reserve released the minutes of their May 1st committee meeting. The minutes mentioned there was a willingness to adjust bond purchases downwards, thereby signaling that the Fed is now contemplating starting down the path of ending QE. Subsequently, the 10-year bond yield reached 2.2% as the bond market started to price in the eventual absence of the largest purchaser of Treasuries in the marketplace.
- June 19th: The last significant move in Q2 came during the press conference after a scheduled interest rate policy announcement by Ben Bernanke. Bernanke went as far as saying that QE bond

purchases could be moderated as early as later this year and be wound down completely by mid-2014. He also made comments indicating that he was comfortable with rising interest rates due to the stronger U.S. economy and he also added that he believed the U.S. housing market was strong enough to sustain higher mortgage rates. The U.S. 10-year Treasury yield then spiked to 2.5%, which is where it stabilized at quarter-end.

Although bond market participants were caught off guard with the change in interest rate expectations, the repercussions were more muted in the corporate bond market. Similar to the DEX Universe Index, corporate bonds (according to the DEX Corporate Bond Index) posted negative returns on a year to date basis of -0.42% as spreads (the difference between corporate and government bond yields) widened marginally by 2bps (or 0.02%). High Yield bonds fared better during the quarter by essentially staying flat on a total return basis and are the only bond asset class that has remained in positive territory year to date. It is worth noting that the weak performance in corporate bonds is not due to deteriorating credit fundamentals. Quite the contrary, with the backdrop of a strengthening U.S. economy one could view the credit quality as actually improving, generally speaking. In fact, the performance was mainly driven by the rise in underlying interest rates, and offset slightly by the higher coupons attached to corporate bonds. To be sure, corporate bond issuance was little impacted by the movement in rates during the quarter. Corporate bond issuance was virtually unchanged at $30 billion in Q2 compared to Q1 and compared to $22 billion in the second quarter of 2012. At Cumberland, we continue to prefer corporate bonds offered by both investment grade and high yield issuers with attractive credit characteristics over government bonds.

As discussed above, bonds sold off on Bernanke's comments, but so did equities, specifically high dividend paying equities such as utilities and REITs whose stock prices are generally affected by changes in interest rates. For instance, between April 30 and June 20 the TSX Utilities and REIT sub-sectors declined 11.8% and 15.7%, respectively. It seems that income investors who were hiding from the "expensive" bond market in traditional high-dividend paying sectors were hit even harder than the very asset class they were trying to avoid. The Fund's equity component strategy has been to hold equities that either have a growth profile to allow for future dividend increases or a low enough payout ratio so the company has the financial flexibility to increase the dividend if warranted. In our view, both these attributes will be essential in helping offset the possible headwinds of continuing rising interest rates.

The bond market experienced severe volatility this quarter and our base case assumption is that this volatility will continue until there is clarity over the timing of the QE "taper". Furthermore, despite the volatility, we still expect interest rates to be biased slightly higher which will be a headwind for bonds. The Fund is currently well positioned to take advantage of this environment. The Fund's FRN holdings (25% weighting) and cash (10% weighting) have helped the Fund preserve capital during the most recent quarter, and yet provides ample capital to opportunistically deploy into bonds, preferred shares, or common stocks that are priced to offer more attractive yields. Utilizing a diversified asset class approach and managing interest rate risk and credit risk will continue to be at the forefront of our investment process to help achieve our dual objectives of generating income and preserving capital.

R. Schulte-Hostedde
July 2013

Asset Allocation as at June 30, 2013	
Asset Class	**% of Portfolio**
Cash and Cash Equivalents	9.9%
Government Bonds (primarily FRNs)	29.6%
Corporate Bonds	44.5%
Preferred Shares	7.9%
Equities/Income Trusts	8.1%

Yield[1] Comparison as at June 30, 2013	
DEX Universe	2.66%
DEX Government	2.48%
DEX Corporate	3.11%
Cumberland Income Fund[2]	3.64%

1. Yield is the rate of income generated on an annualized basis. Yield does not represent the total return of the Fund or the Indices shown in the above table.
2. Gross of Management Fees