CUMBERLAND

Second Quarter Review and Outlook
Cumberland Income Fund
July 2014

The Cumberland Income Fund gained +1.7% during the second quarter of 2014 compared to the gain of +2.0% posted by the FTSE TMX Canada Universe Bond Index during the same period. The Fund has gained +3.9% year-to-date and +6.8% year-over-year, while the FTSE TMX Index has gained +4.8% year-to-date and +5.3% year-over-year. Bond yields (interest rates) continue to defy expectations as we progress through 2014 with the divergence between the economic data and the direction of bond yields widening during the quarter. Despite evidence that the first quarter slowdown in the North American economy was a weather-related phenomenon, and therefore temporary, bond yields continued their descent lower during the second quarter. That is, economic data in general improved greater than the market expected, yet contrary to a typical bond market reaction, bond yields declined (and bond prices increased). The Fund's positioning remained skewed to a rising rate environment throughout the quarter with the expectation that the ending of the first quarter's "polar vortex" would reveal that the economy is on a much more solid footing than recently reported. The data did come in stronger than expected, yet bond yields failed to react. However, Cumberland's strategy of holding a diversified set of asset classes in addition to investment grade bonds, including high yield bonds, preferred and dividend-paying common stocks was instrumental in offsetting the reduced exposure to interest rate risk within the portfolio.

The decline in interest rates during the quarter was inconsistent with the strength in economic data that had been released over the past three months. For example, the U.S. has now created over 200,000 jobs in each of the past five months and has "officially" regained all the jobs that were lost during the recession brought on by the credit crisis (although some of those jobs are just part-time jobs, and therefore of lower "quality" in terms of contributing to growth). Despite this improvement in the economy, government bond yields have remained stubbornly unresponsive. The Government of Canada 10-Year bond yield declined from 2.55% at the beginning of April, but spent much of the quarter hovering between 2.25% and 2.35%. In the U.S., the 10-Year Treasury yield was at 2.8% at the beginning of the quarter, but traded in a range of 2.5% and 2.65% for most of May and June. In addition, volatility in both the bond and equity markets collapsed during the quarter as measured by Merrill Lynch's MOVE index and the VIX respectively. This drop in volatility came about despite 1) an improving economy which normally drives interests higher, 2) an approaching pivot-point in U.S. monetary policy with the Fed's QE program on-track to end as early as this October, and 3) the market's expectation that the US Federal Reserve might start raising its policy rate by next summer, all of which seems counterintuitive. We've also seen inflation and wages start to rise, which also typically leads to higher interest rates. The muted effect of these events on interest rates is almost astonishing.

There are several possible explanations that could be contributing to this drop in volatility and the gradual trend of declining bond yields:

Possible explanation #1: There is no one left to sell their bonds. By the end of 2013, after the Fed had already begun reducing its bond purchasing program (QE), asset managers had already sold their longer duration bonds in anticipation of higher interest rates due to a stronger economy and the tapering of QE. The peak of the selling likely came when the U.S. 10-Year Treasury bond yield reached the recent high of 3.03% on December 31, 2013.

Possible explanation #2: Some investors are less concerned about high prices / low yields. For example, global central banks' key motivation to buy and sell government bonds is to implement monetary policy, not to make an investment return. Central banks are less concerned about the market prices of bonds purchased (and sold), but are more concerned about managing interest rates and inflation expectations. So if foreign central banks need to park U.S. dollars they will buy U.S. Treasuries regardless of yield. Pension funds and life insurance companies also fall into this category. These two investors' primary concern is with matching their assets with long term liabilities (or obligations). If current bond yield levels match the required rate of return deemed by the actuaries then they will purchase

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bonds at current levels. Pension funds and life co's have also benefitted from the strong equity returns in 2013 and therefore there may be some "profit-taking" as equities are sold and redeployed into bonds.

Possible explanation #3: U.S. Treasuries look cheap compared to other AAA rated (high quality) sovereign bond issuers. Recall, the U.S. 10-Year Treasury bond traded with a paltry yield of 2.52% at the end of the second quarter, but the Canada 10-Year bond and the German 10-Year "bund" (also both rated AAA) yielded just 2.25% and 1.25% respectively. So given the choice of buying a AAA government bond that yields 2.52% or 1.25%, the choice is clear to buy the bond that yields 2.52%. Furthermore, to put Treasury yields further in perspective, Spain, rated just BBB and sporting a 25% unemployment rate, had their 10-Year bonds yielding just 2.66% at quarter-end, only 0.14% higher than the U.S. The relative attractiveness of U.S. Treasuries likely kept investors buying the bonds, thereby keeping yields low.

Possible explanation #4: The bond market is pricing in that the current upside surprises in economic data are transitory, and over the medium-term the economy will grow slower than what forecasters expect. This would mean the U.S. (and Canada) approaching anemic growth rates like those in the Europe and Japan where slow growth has lead to an extremely low interest rate environment as mentioned in the case of Germany above.

This low interest rate environment continues to make it attractive for corporations to borrow via bond issuance. Despite a slow start to the year, corporate bond issuance has been similar to the record-setting pace of 2013. The first half of 2014 issuance reached $49 billion, just $3 billion shy of the first-half of 2013. This supply of bonds was absorbed quite easily by bond investors thereby keeping corporate spreads in a very narrow range. We have viewed much of the new bond issuance being offered as not adequately pricing in the risk of interest rates rising. However, we did add one new position in an investment grade issuer. Transcontinental Inc. is Canada's largest printer of flyers and newspapers. With the proliferation of digital media, the company decided to issue bonds to fund the acquisition of a food packaging plant, thereby diversifying their business. The 5-year bond was issued with a 3.897% coupon which we deemed attractive in this environment.

The Canadian high yield sector was also quite active during the quarter. High yield continues to offer pockets of value in this interest rate environment, in our view, however the market in general appears to be less discerning about distinguishing between the credit quality of individual corporate issuers. The reach for yield by investors has resulted in pricing being clustered within a tight range irrespective of the riskiness of the credit. During the quarter, we initiated positions in three new high yield bond issues that are attractive from a risk/reward perspective. The first two, both 7-year bonds issued by AutoCanada Inc. and Parkland Fuel Corp. have a similar investment thesis: consolidating a fragmented industry. AutoCanada has been successfully acquiring auto dealerships across Canada and Parkland Fuel has been successfully consolidating non-urban gas stations while also supplying gasoline, propane and other refined products to commercial customers. Both bonds were issued with a mid-5% coupon. The third position added was an inaugural issue by GM Financial Canada Ltd. This 3-year bond was priced with a 3.25% coupon and should have low sensitivity to general interest rate movements due to the short term-to-maturity. Furthermore, we expect GM's credit risk profile to improve as they benefit from current strong auto sales.

The Income Fund also added to two existing dividend-paying common stocks. Both American Hotel Income Properties REIT (HOT-U.TO) and Alaris Royalty Corp. (AD.TO) funded acquisitions during the quarter with new equity issuances. Alaris Royalty also announced a dividend increase during the transaction. Alaris' dividend has now increased 25% from $1.20 to $1.50 since the Fund first initiated the position in December 2012.

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OUTLOOK

At Cumberland, we remain focused on the fundamentals. We expect that the employment gains that have been made on both sides of the border should continue to be a driver of economic growth. That, in turn, should lead to a pick-up in inflation and consequently higher interest rates. We have already seen inflation pick up over the past several months: In Canada the headline Consumer Price Index (CPI), a common measure of inflation, went from 1.5% year-over-year in March to 2.0% in April, 2.3% in May, and 2.4% in June. In the U.S., CPI has also drifted higher: from 1.5% in March to 2.0% in April, and 2.1% in May. The U.S. has also been creating between 200,000 and 300,000 new jobs per month over the past five months. In addition to inflation heating up and new jobs being created; we have also been seeing a necessary precursor to a sustained higher level of inflation take hold: wage growth. U.S. average hourly earnings growth has been accelerating over the past 2 years. In 2012 average wage growth was 1.5%, in 2013 it was 2.1%, and so far in 2014 the average wage growth rate has been 2.3%. Furthermore, a survey conducted by the Nation Federation of Independent Business (NFIB) shows that planned compensation increases by employers is at a 6 year high. With wages, job creation, and prices rising we believe the probability is greater that these conditions are ultimately more conducive to interest rates heading higher, not lower. Accordingly, we have continued to position the portfolio to manage the risk of interest rates heading higher. Consequently, we remain focused on holding income producing securities with attractive risk-reward characteristics. Also, by keeping the duration of the bond portfolio at 2.9 years we have structured the portfolio to keep bond price sensitivity to interest rates movements low. To offset the lower yields that are commensurate with keeping duration low, we continue to hold a basket of select preferred and common shares to enhance the overall yield of the portfolio. Lastly, we are maintaining our cash and floating rate note balances high to preserve capital and provide the opportunity to deploy capital in a higher interest rate environment.

R. Schulte-Hostedde
Portfolio Manager, Fixed Income
July 2014

Asset Allocation as at June 30, 2014

Asset Class	% of Portfolio
Cash and Cash Equivalents	7.5%
Government Bonds (incl. Floating Rate Notes)	21.6%
Corporate Bonds	47.6%
Preferred Shares	10.2%
Equities/Income Trusts	13.0%

Yield[1] Comparison as at June 30, 2014

DEX Universe	2.4%
DEX Government	2.3%
DEX Corporate	2.8%
Cumberland Income Fund[2]	3.7%

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 fees

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.