Second Quarter Review and Outlook
Cumberland Income Fund
June 2015

The second quarter of 2015 can be primarily characterized by the reversal of the outsized gains generated by major global bond markets in the first quarter of 2015. Moreover, in Canada, other than high yield bonds generally, all income producing sub-asset classes generated negative returns during the quarter. Government bonds, investment grade corporate bonds, preferred shares, and dividend paying common stocks were all under pressure. Uncertainty over both the strength of the Canadian economy and the potential policy response by the Bank of Canada permitted the high level of volatility experienced in the first quarter to persist during the second quarter. The peak of the Greek crisis and jarring selloff of the Chinese stock market then punctuated quarter end causing a flight-to-safety into sovereign bonds globally, including Canada. Cumberland continues to be positioned to reduce the level of volatility currently experienced in fixed income markets generally by keeping duration low and by holding a diversified portfolio of income-generating securities.

Government bond yields increased virtually across the board globally as investors were net sellers of government bonds during the second quarter. For example, the yield of a U.S. 10-Year Treasury bond increased from 1.92% at the beginning of the quarter to 2.35% by June 30th. In Canada, the Government of Canada 10-Year bond yield (GCAN10YR) went from 1.36% to 1.68%. One of the key reasons for the increase in North American bond yields was the linkage to the rise in German bond yields. With the implementation of the European Central Bank's (ECB) bond buying program fresh out the gates in March and the fear of Germany and the rest of Europe heading into a deflationary environment, short-term German bond yields (maturing in 7 years or less) had turned *negative* at the end of the first quarter. By mid-April German bond yields bottomed after the German 10-Year "bund" reached a low yield of just 0.075%. As the quarter progressed, economic data released implied Europe was in fact not entering a deflationary tail spin and fears of economic contraction abated. Investors consequently were quick to sell their German bonds as they concluded negative bond yields were unlikely to go "more negative", and holding bonds comprised of the bondholder notionally *making* interest payments was no longer attractive. This change in sentiment drove the German 10-Year yield back up to as high as 0.98% (13x higher!) by June 10th. Selling pressure migrated into Canadian and other "AAA" rated government bond markets and yields collectively moved higher. The FTSE TMX Canada Government Bond Index declined by -1.9% as bond yields increased and bond prices declined.

In addition, fixed income investors remained fixated on handicapping the timing of the first policy rate hike by the U.S. Federal Reserve in 11 years. The question currently at the heart of the matter is not one of "if", but of "when". However, the decision ultimately falls onto the shoulders of Fed Chair Janet Yellen, and she proposed the question investors should be focused on is not "when will there be lift-off in the fed funds rate" but on "what will the trajectory of the rate hike cycle look like after the initial rate hike?" Yellen continues to insist that once the Fed starts to increase rates, subsequent rate increases will be infrequent and of a low magnitude, implying a low policy rate environment for several more years. In contrast to the U.S., fixed income investors in Canada are handicapping whether the Bank of Canada will continue to *cut* its policy rate, a process that the Bank started in January as a reaction to the drop in crude oil prices. The most recent GDP data released (as of April 2015) shows the Canadian economy has now contracted for the last four months in a row, and 5 out of the last 6 months. It is therefore somewhat understandable to see why the Canadian bond market reached its peak level of volatility (as per GCAN10YR 90-day volatility) during the quarter: Conflicting signals from other AAA rated government bonds (Germany and U.S.) suggest that bond yields should be on the rise, yet weakness specific to the Canadian economy suggests otherwise.

Investment Grade corporate bonds (credit rating BBB+ or higher) were not unscathed by the increase in underlying government bond yields during the quarter as the FTSE TMX Corporate Bond Index returned -1.27%

compared to the broad FTSE TMX Canada Universe Bond Index return of -1.71%. The outperformance of the corporate bond index was mostly attributable to a lower duration (less price sensitivity to change in bond yield due to a shorter average term to maturity) and a higher coupon/yield. The bulk of the rise in rates (decline in price) during the quarter occurred in April keeping investors' appetite for new corporate bond issuance constrained during both April and May. The supply of new bonds was therefore subdued keeping corporate spreads (the extra yield bond investors demand for holding corporate bonds over government bonds) stable. However, by June the new issue machine fired back up and the amount of activity made it the most active June ever with C$12.8 billion in new issuance. The volume of new deals combined with investors reluctance to deploy cash in such a volatile market caused corporate spreads to widen (cheapen) by 9 basis points (0.09%). The Cumberland Income Fund took advantage of the cheapening of the corporate bond market by selling the Fund's short-term bond holdings in Ford and GM (maturing in 2018 and 2017 respectively) at a premium, and redeploying the proceeds into newly issued 5-Year bonds for a pick-up of 0.50% to 0.90% in yield. The Fund also deployed cash into a new 5-Year bond issued by Royal Bank of Canada.

As mentioned above, the Canadian High Yield Bond market (credit ratings BB+ or lower) was the sole sub-asset class able to diverge from the trend of negative returns in the income sector this quarter. The resource-heavy FTSE TMX High Yield Bond Index posted a return of +2.70% for the quarter as the high yield bond market continued to claw back the substantial losses that transpired in the fourth quarter of 2014 brought on by the collapse in price of crude oil. The Fund's activity in the high yield bond sector was muted during the quarter.

The weakness in the Canadian preferred share market during the first quarter carried into the second quarter with the TSX Preferred Share Index posting a negative return of -3.9% for the quarter. The volatility in underlying government bond yields seemed to have been magnified in the preferred share market. With uncertainty in the near-term direction of interest rates in Canada there was a buyer's strike on preferred shares. Demand for perpetual preferred shares, shares which have a fixed coupon, waned as rising rates would cause downward pressure on share prices, similar to a bond. Simultaneously, rate-reset preferred shares, shares which have the coupon reset every 5 years at a fixed spread to the GCAN5YR yield, were also under pressure since a second policy rate cut by BoC this year could cause the GCAN5YR yield to decline therefore causing dividends to be reset at a lower than expected coupon. Although pockets of value in the preferred share market certainly seem to have surfaced, we remain patient in adding to our preferred share holdings until we get greater clarity on the direction of the BoC's monetary policy.

In general terms, dividend-paying Canadian equities underperformed the bond market this quarter. The TSX Dividend Composite Index declined by 2.4% during the quarter as higher bond yields coupled with concerns over the Greece crisis caused interest-rate sensitive equities to come under pressure. Cumberland Income Fund took advantage of the pullback and added to two existing holdings and initiated a new position in a third holding. The Fund participated in secondary offerings of Alaris Royalty and American Hotel Income Properties (AHIP). Both companies issued stock to fund accretive acquisitions. In the case of Alaris, the company made two new investments which have now allowed for two dividend increases this quarter totaling an 8% increase in the dividend since the beginning of the year. In the case of AHIP, they continue to add new hotels to their portfolio. As always, the acquisitions were accretive on a cash flow per share basis thereby increasing their cash available for distribution and reducing their dividend payout ratio. Thirdly, the Fund initiated a position in Morneau Shepell Inc. (MSI.TO). MSI is a pension and benefits consulting firm that also offers administration outsourcing solutions (e.g. call centers) to corporations. The majority of MSI's revenue is growing organically in the mid-to-high single digit (%) range and is either recurring in nature or under long-term contracts with many blue-chip corporate clients. MSI currently pays a monthly dividend of $0.065 and entered the portfolio with a 4.7% dividend yield. We expect MSI to be in the position to increase the dividend by the end of 2016 or early 2017.

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Cumberland Income Fund
June 2015

Outlook

Continued heightened volatility in the fixed income markets is a key underlying assumption in our security selection and portfolio construction. The Canadian bond market is particularly susceptible to continued elevated levels of volatility for reasons that include:

1) The negative residual effects of the oil price shock on the Canadian economy has now forced the Bank of Canada's monetary policy to conflict with that of the U.S. Federal Reserve. Whereas, Fed Chair Janet Yellen continues to hint that a rate increase may be coming soon, BoC Governor Stephen Poloz has indicated further policy rate cuts may be necessary if growth forecasts fall short. This two-speed monetary policy scenario should keep volatility elevated since it is rare that these countries have such diverging policies.
2) Stricter bank regulations have reduced liquidity in fixed income markets. Bond dealers are now more reluctant to use their own capital to facilitate a bond transaction. This makes it more challenging for investors to buy and sell bonds potentially leading to greater price swings.
3) The impact of Europe and China on global capital markets is unclear. Uncertainty over the final resolution of Greece, the economic recovery in the Eurozone, and concerns of slowing growth in China and the effects of their loosening monetary policies have ramifications on bond yields/prices in commodity sensitive economies such as Canada.

At Cumberland we continue to be focused on managing the risk inherent during levels of high volatility. Specifically, the Fund's bond holdings average duration remains low at 3.1 years compared to that of the FTSE TMX Canada Universe Bond Index at 7.4 years. Bonds with lower duration have a shorter term to maturity and less price sensitivity to changes in interest rates. This positioning is designed to preserve capital in the event of bond yields rising. However, given the lower probability of bond yields rising materially in Canada, we do not anticipate that the Fund's duration falling lower than current levels. In addition, to generate income greater than inflation the Fund continues to invest in a diversified set of higher yielding securities including high yield bonds, preferred shares, and dividend-paying common equities. Differentiating between volatility and permanent loss of capital is essential during spells of volatility. In managing the Cumberland Income Fund, we remain focused on credit analysis to ensure the income streams generated within the portfolio are sustainable and valuations paid for those income streams offer an attractive risk/reward profile.

R. Schulte-Hostedde

Portfolio Manager, Fixed Income

July 2015

Asset Allocation as at June 30, 2015

Asset Class	% of Portfolio
Cash and Cash Equivalents	8.4%
Government Bonds (incl. Floating Rate Notes)	17.7%
Corporate Bonds	54.3%
Preferred Shares	7.3%
Equities/Income Trusts	12.4%

Yield[1] Comparison as at June 30, 2015

FTSE TMX Canada Universe	2.0%
FTSE TMX Canada Government	1.8%
FTSE TMX Canada Corporate	2.5%
Cumberland Income Fund[2] (today)	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.