CUMBERLAND

Third Quarter Review and Outlook
Cumberland Income Fund
October 2014

The Cumberland Income Fund gained +0.7% during the third quarter of 2014 compared to the gain of +1.1% posted by the FTSE TMX Canada Universe Bond Index during the same period. The Fund has gained +4.7% year-to-date and +6.4% year-over-year, while the FTSE TMX Index has gained +5.9% year-to-date and +6.3% year-over-year. As evidence of an improving economy continued to build up during the quarter, and in particular an improving labor market, speculation of "when", not "if", the U.S. Federal Reserve (the Fed) would increase the federal funds rate took center stage. Yet commentary from both Fed officials and market participants seemed to bring little consensus as to when we could expect that change. The fixed income markets seemed to have settled on there being a 50/50 chance of the Fed moving next summer, while the Federal Reserve Committee members' forecasts imply a move as early as next spring. At Cumberland, our fixed income strategy has been positioned for continued modest North American economic growth, precisely what the reported economic indicators had been suggesting throughout the quarter. However, as was the case in the second quarter, longer-term interest rates, which are less impacted by direct Fed interest rate policy, continue on a downward trend, contrary to an upward trend that would be typical with the back drop of an improving economy.

We have long held the view that bond yields have been hovering at historic lows due to global central banks' unconventional monetary policies, such as the Fed's bond buying program (Quantitative Easing or QE). Accordingly, we view the downside risk to bond portfolios is stronger economic data and the upcoming end of QE in October could result in higher bond yields which in turn means lower bond prices. In order to achieve our objectives of preserving capital and generating income our portfolio positioning has favored shorter-term bonds over long-term bonds since the prices of shorter-term bonds are less sensitive to changes in interest rates. However, as longer-term bond yields decline (as described above), the price of the bonds increase by a greater percentage than those of shorter-term bonds held at Cumberland. These larger marked-to-market capital gains in longer-term bonds (held in greater amounts in broad bond indices such as the FTSE TMX Canada Bond index) were a key contributor to the quarter and the year-to-date performance differential between the Income Fund and the Index. By positioning the portfolio to reduce volatility on the downside (when bond yields rise and prices fall), we forego the volatility on the upside (when low bond yields head even lower and prices increase like they did during this quarter).

The primary source of declining longer-term bond yields stems from outside North America, in our view. As an example, despite the U.S. unemployment rate dropping from 6.3% to 5.9% during the quarter, the U.S. 10-Year Treasury bond yield declined slightly from 2.53% to 2.49% during the quarter – signaling weaker unemployment, not stronger unemployment as was reported. Therefore, we believe the evidence of a slowing European economy, Germany in particular, and concerns over China's ability to maintain its resilient rate of growth has put pressure on expected global growth rates and consequently has kept downward pressure on bond yields. Consistent with this, the German 10-Year Bund yield also continued to decline and settled at a meager 0.94% at quarter-end signaling growth and deflation concerns. At a 2.49% yield for a comparable U.S. 10-Year Treasury, as mentioned above, the U.S. Treasury looks downright cheap on a relative basis. The secondary cause preventing bond yields from rising is somewhat related: the difference in growth profiles of the U.S. compared to Europe has resulted in contrasting monetary policies. As the Fed winds down QE and ponders policy rate hikes, the European Central Bank (ECB) conversely lowered its policy interest rate to virtually zero this quarter and initiated its own bond buying program. In June, the ECB launched the TLTRO (targeted longer-term financing operation) program to inject liquidity into the European banking system in order to stimulate more lending to the private sector. This was followed up with a September announcement of a new program to purchase asset-backed securities and other collateralized bonds from European banks to provide even more liquidity. Likewise, these contrasting monetary policies (including the possibility of a higher U.S. fed funds rate) have made the U.S. dollar more attractive thereby causing the U.S. dollar to appreciate

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considerably against other major currencies during the quarter. Unfortunately, a stronger U.S. dollar and higher interest rates are not friendly to a growing U.S. economy. A stronger dollar makes U.S. exports more expensive for other countries, and higher interest rates increase the financing costs for consumers and businesses. It is these headwinds that we believe are preventing longer-term bond yields from climbing globally.

With respect to corporate bonds, generally speaking, investors appear to be inclined to continue to allocate cash to bonds issued by investment grade corporate issuers. The main reason likely being the search for a yield greater than the meagre yields being offered by government bonds. Although the summer was slow in terms of new issuance, post-Labour Day brought about renewed investor interest in purchasing corporate bonds. The resurgence in September brought $9 billion of new issuance to the market and has put 2014 on track for the second highest year of new issuance - right behind 2013's record year. Despite the apparent strong demand for corporate bonds, it is noteworthy that the demand was created by more attractive pricing. Throughout the quarter, corporate spreads (the difference between the yield of a corporate bond and the yield of a government bond of the same maturity) widened (or cheapened) by 3 to 5 basis points (0.03% to 0.05%). Despite the slight cheapening of the sector, we continue to view the investment grade corporate bond sector as richly valued. It is for this reason we have been keeping our average term to maturity fairly short at just nearly 4 years. This should provide lower volatility to the portfolio if corporate spreads continue to widen (analogous to bond yields increasing). As a result, Cumberland was fairly quiet in participating in the new issue market this quarter. However, we did find value in a new issue from the Bank of Montreal (BMO 3.12% 19Sep2024). New regulatory requirements for Canadian banks have forced them to offer bonds with clauses to protect the Canadian taxpayer in the event of another credit crisis. BMO priced these "new" bonds with a higher and more attractive coupon due to the new guidelines.

The Canadian high yield market was affected by concerns over the sustainability of global growth, as discussed above. The sector did experience a slight decline in price on average, but was more than offset by the interest earned from the coupon, to net out at a +0.6% rate of return for the third quarter, according to the FTSE TSX Canada High Yield Bond Index. The Cumberland Income Fund added one new bond to the portfolio's high yield bond allocation this quarter. Noralta Lodge Limited issued a five year bond with a coupon of 7.5%. Noralta is a company that builds and manages premium lodging accommodations to companies operating in the oil sands in Alberta, the majority of which are signed up under multi-year contracts.

There was little change to our preferred and common equity allocations this quarter with the exception of Bonavista Energy Corp. which we added early in the quarter. Bonavista issued shares to fund the acquisition of full control of a natural gas asset of which they had only partial ownership.

OUTLOOK

The uncertainty created by concerns of growth in Europe will likely prevent bond yields from rising materially over the near to medium term. In addition, we are in a period of monetary policy transition: QE should end at the end of October and the Fed may increase the policy rate for the first time since 2006 as early as this upcoming spring. Meanwhile, the ECB is transitioning to a much more accommodative monetary policy. A transition typically results in greater price volatility and we believe this time will be no different, especially given the unprecedented nature of recent monetary policy, both in terms of time and scale. As of quarter end, volatility in government bond yields picked up somewhat but still remains relatively muted. It appears that the volatility is being expressed in the currency markets as the U.S. dollar has appreciated considerably against virtually all major currencies. It is worth noting that currency movements can have a

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material impact on monetary policy. If we use Canada as an example, several years ago as Canada's economy faltered, investors thought the Bank of Canada would have to reduce the policy interest rate that stood at 1.0%. Instead, the Canadian dollar depreciated by roughly 10% versus the U.S. dollar and the policy rate remained unchanged at 1.0% where it still sits to this day. We can apply this example to the U.S. today. If we assume the U.S. economy is improving to a point where a rate hike might be required, it is possible today's higher U.S. dollar may "act" like an increase in the fed funds rate thereby possibly pushing next year's expected rate hike further out.

Given a persistently low interest rate environment, we continue to think it prudent to hold shorter-term bonds. Although low bond yields can go lower, we continue to focus on our dual objectives of generating income and preserving capital. We therefore continue to believe a portfolio with an attractive risk/reward is one that is constructed with diversified sources of income including high yield bonds and equities (preferred and common), and one that mitigates the possible decline in bond prices due to possible increasing interest rates/bond yields by holding bonds with an average duration of 3 compared to a broad bond index duration of 7. We are willing to forego some of the possible upside that lower bond yields may bring to bond prices in exchange for reduced potential volatility on the downside. And finally, our high cash balance and floating rate note holdings will also allow us to take advantage of attractively priced dividend-paying stocks or bonds in the event of increased volatility to the downside.

R. Schulte-Hostedde

Portfolio Manager, Fixed Income

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Asset Allocation as at September 30, 2014

Asset Class	% of Portfolio
Cash and Cash Equivalents	9.0%
Government Bonds (incl. Floating Rate Notes)	19.5%
Corporate Bonds	50.0%
Preferred Shares	9.4%
Equities/Income Trusts	12.1%

Yield[1] Comparison as at September 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.