CUMBERLAND

Fourth Quarter Review and Outlook
Cumberland Income Fund
December 2014

In the fourth quarter, the Cumberland Income Fund was positioned to protect capital from the impact of rising interest rates. However, interest rates instead headed lower during the quarter defying a strengthening U.S. economy and rewarding holders of low yielding, long-dated government bonds with capital gains. The Cumberland Income Fund gained +0.7% during the fourth quarter of 2014 compared to the gain of +2.7% posted by the FTSE TMX Canada Universe Bond Index during the same period. For the year ended 2014, the Fund gained +5.3% while the FTSE TMX Index gained +8.8%. The persistent decline in long-dated bond yields, of which the index is much more heavily weighted, was the main contributor to the difference in performance. During the fourth quarter, there was a significant divergence amongst the different bond market sectors for the first time in 2014. For example, government bonds[1] returned +3.0% during the quarter as ultra-low government bond yields drifted even lower thereby driving bond prices higher. On the other hand, high yield bonds[2], typically identified as bonds issued by "riskier" companies, posted their first quarterly loss since the third quarter of 2011. The difference in returns can be explained by the "global growth scare" experienced during the quarter. The obliteration of global oil prices, weak economic data out of Europe and a deceleration of growth in China all led to a flight-to-safety into government bonds. The Cumberland Income Fund continues to structure the portfolio in a way that is somewhat agnostic to this volatility in fund flows by concentrating holdings in shorter-dated investment grade and high yield bonds and to a lesser extent, dividend-paying common stocks with attractive risk-reward characteristics. Consequently, during outsized moves in longer-dated bond yields (and hence prices) such as the move experienced this quarter, the Fund's performance will deviate from that of a reference bond index.

The decline in government bond yields was relentless during the fourth quarter. We use the term relentless since the decline occurred despite evidence of strengthening U.S. economic growth, an improving unemployment situation, and comments from the U.S. Federal Reserve (the Fed) in December strongly suggesting that they intend to raise the policy interest rate (fed funds rate) sometime in the middle of 2015. In this kind of backdrop government bond yields typically rise (bond prices fall) since these conditions signal a tilt toward a healthier economy over the medium term. However, bond investors around the world collectively said "I'm not buying it" ("it" being the economy will be healthier over the medium term) and proceeded to buy longer-dated government bonds driving up bond prices and driving already low bond yields down even lower. For example, the yield on the U.S. 10-Year Treasury and the Government of Canada 10-Year bonds declined by over 0.3 percentage points (30 basis points) to 2.17% and 1.79%, respectively. The factors contributing to the "growth scare" mentioned above have converged under one risk identified by the bond market: deflation. With commodity prices declining and wage growth elusive, inflation data (i.e. Consumer Price Indices) reported globally has been below global central banks' targets of around 2%. Moreover, the market for inflation expectations has also declined precipitously putting further downward pressure on sovereign bond yields. The final main contributor to the downward pressure in North American bond yields, in our view, is that U.S. Treasury and Government of Canada bond yields remain higher than those of other developed countries (Germany, France, Japan) making them attractive on a "relative" basis thereby continually attracting buyers and driving yields even lower.

Bonds issued by corporations did not fare as well as those issued by governments in the fourth quarter. Investment grade corporate bonds[3] underperformed government bonds by almost 1.2% during the quarter despite having a greater yield/coupon. This occurred because corporate spreads (the premium in yield investors demand for owning corporate bonds over government bonds) increased by 0.13 percentage points (13 basis points) – putting pressure on corporate bond prices. This spread widening is consistent with a flight-to-quality trade. The cautious sentiment also made it more difficult for corporations to issue new bonds. In Canada, corporations only issued $17 billion new bonds compared to over $19 billion last quarter and $27 billion in the same quarter a year

Cumberland Income Fund
December 2014

ago. Nevertheless, during the quarter we added three new investment grade bonds to the Income Fund that were issued at attractive spread levels, in our view. We purchased a subordinated bond issued by CIBC with a coupon of 3.0% that should get called on October 28, 2019. We also initiated positions in a Citigroup bond maturing November 18, 2021 with a coupon of 3.39%, and a Suncor Energy bond with a 3.1% coupon that matures November 26, 2021. With corporate spreads widening (corporate bonds cheapening) into the end of the year, we expect some more opportunities to present themselves in 2015.

Non-investment grade bonds, or high yield bonds, were much more materially impacted by concerns over global growth and the rapid deterioration in commodity prices during the quarter. The FTSE TMX Canada High Yield Index posted a -4.4% return. In particular, the energy sector was hit hard as the price of oil (WTI Crude) declined over 40% from $90 to $53 a barrel. The energy high yield bond sector total return was -11% during the quarter. The Income Fund high yield energy weighting at the beginning of the quarter was 4%, so the impact was minimal in this segment. Although the high yield market struggled, we added two new positions to the high yield allocation – both of which are non-oil & gas producers or servicers. The first is a 5.875% coupon 7-year bond issued by DHX Media. DHX is a producer and owner of children's animated shows. DHX used the bond proceeds to finance the acquisition of Family Channel, Disney Junior and Disney XD channels from Astral Media which had been acquired by Bell Media and forced by the regulators to divest broadcast assets. The second new issue added was a 6.0% coupon 8-year bond issued by Parkland Fuel Corp – a fuel distributor and an operator of gas stations across Canada. Both issuers generate stable consistent cash flows.

The Cumberland Income Fund also opportunistically deployed capital into common shares of existing holdings Northland Power (NPI.TO) and American Hotel Income Properties REIT (HOT-U.TO) during the quarter. As the price of oil cascaded lower in December, NPI and HOT-U sold off in sympathy along with the broader equity markets to very attractive levels. We were able to acquire shares of NPI and HOT-U at dividend yields of 7.3% and 9.1%, respectively.

OUTLOOK

In last quarter's commentary we had identified the uncertainty of growth rates overseas and diverging monetary policies at the U.S. Federal Reserve and the European Central Bank (ECB) as key catalysts for greater bond yield/price volatility. We believe this continues to be a key risk going into 2015. It is worth noting this risk came to fruition on October 15 when the U.S. Treasury Bond yield plummeted 36 basis points intraday from 2.22% to 1.86% in a matter of hours. Volatility of that magnitude is virtually unheard of in the bond market. With the Fed's historic bond buying program (Quantitative Easing or QE) finally concluded in October as expected, the bond market is now focused on discounting the timing of the first interest rate hike by the Fed. By looking at short-term interest rates, market expectations have shifted from a possible June 2015 rate hike to a fourth quarter 2015 rate hike. The shift further out is a result of the absence of a pick-up in the current low levels of inflation; and the assumption that the rapid decline in oil prices will cause a curtailment in domestic oil production thereby leading to negative implications for the U.S. economy. This in turn would force the Fed to delay its inaugural rate hike. Although this scenario is possible, we are leaning towards the scenario that the Fed raises the policy rate in mid-2015 as originally expected for three main reasons. We view the decline in oil prices as ultimately positive for the U.S. economy. Current estimates are such that the reduction in the price of gasoline at the pump is equivalent to a $200-$300 billion stimulus program for the U.S. consumer. In addition, Fed Chair Janet Yellen has also stated that they view the downward pressure on inflation brought on by lower oil prices to be "transitory" thereby signaling the Fed is "looking through" these headwinds when deciding on the path for the fed funds rate. And thirdly, the U.S. created almost 3 million new jobs in 2014, consumer confidence is near all-time highs, and small businesses surveys are showing increased optimism and plans to hire and increase wages. All of which could lead to higher growth and higher inflation and therefore an environment suitable for a rate hike.

Conversely, almost unthinkable a year or two ago, the ECB is now hinting they are possibly preparing to unleash their own version of a "proper" QE program

Cumberland Income Fund
December 2014

(purchasing Eurozone sovereign bonds) early in 2015. This change in ECB monetary policy could have a material impact on longer-term North American bonds which are less influenced by Fed policy. If ECB QE is even remotely successful in increasing inflation expectations amongst investors, bond yields should head higher thus reinforcing the probability of the Fed hiking the fed funds rate in mid-2015. The risk, however, is if ECB QE fails allowing deflation expectations to set-in during the first half of 2015. In this scenario, longer maturity North American bond yields could continue to decline despite a strengthening U.S. economy since they will remain attractive on a "relative" basis from global bond investors' standpoint. In contrast, at Cumberland, we prefer to assess the value of bonds on an "absolute" basis. Our assessment is that with bond yields at historic lows there remains a remarkable, and perhaps underappreciated, amount of capital at risk if interest rates normalize (go higher) causing bond prices to decline. We believe fixed income markets are not properly reflecting the possibility that since the U.S. economy appears to be growing slightly faster than expected, inflation and wage growth may surprise to the upside setting off a rise in bond yields (a decline in bond prices).

The Cumberland Income Fund enters 2015 positioned in a similar manner as it was throughout 2014. The Fund is positioned to significantly reduce the impact of possible rising rates by keeping the bond allocation duration short at just 3 compared to the FTSE TMX Canada Universe Bond Index at 7.4 (the lower the duration, the smaller the change in the bond price for a given change in interest rates). The Fund remains steadfast on staying focused on its two core objectives: generating a reasonable level of income and preserving capital. We continue to manage the Fund by allocating to diversified sources of income comprised mainly of investment grade and high yield bonds, preferred shares, and dividend-paying common stocks, all with attractive risk/reward characteristics, in our view. The Fund also continues to hold a high cash balance and liquid floating rate notes that stand ready to be opportunistically deployed in the event of any downside volatility.

R. Schulte-Hostedde
Portfolio Manager, Fixed Income

January 2015

Asset Allocation as at December 31, 2014

Asset Class	% of Portfolio
Cash and Cash Equivalents	8.6%
Government Bonds (incl. Floating Rate Notes)	17.3%
Corporate Bonds	52.7%
Preferred Shares	8.2%
Equities/Income Trusts	13.2%

Yield[4] Comparison as at December 31, 2014

FTSE TMX Canada Universe	2.2%
FTSE TMX Canada Government	2.0%
FTSE TMX Canada Corporate	2.7%
Cumberland Income Fund[5]	3.7%

1. FTSE TMX Canada Government Bond Index.
2. FTSE TMX Canada High Yield Index.
3. FTSE TMX Canada Corporate Bond Index.
4. 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.
5. 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.