CUMBERLAND

Strategy Review
September 2011

Mission Impossible

The month of September was another month of elevated volatility for global financial markets as credit, currencies, stocks and commodities all reacted wildly to rampant speculation regarding the eventual course of action to be taken in Europe. The Canadian equity market took it on the chin, falling 9% last month as broad weakness in commodities dragged the index lower. Both oil and gold dropped over 11% during the month, driven by fears of a global economic slowdown and the closing of speculative long positions. Equity markets south of the border fared better as the safe haven status of the U.S. created global buying interest in their bonds, stocks and currency. The S&P 500 declined over 7% last month in U.S. dollars, but this was almost entirely offset by a 7% strengthening in the U.S. dollar relative to the Loonie. Not surprisingly, the euro also declined 7%, but remarkably, is actually higher year to date relative to the U.S. dollar by about 3%. Government bond yields in the U.S. and Canada plummeted to new lows, reflecting heightened fears over a new global banking crisis. The 10 year U.S. Treasury fell well below 2%, yielding just 1.8% at one point last month. Corporate bonds fared less well as spreads widened reflecting the dramatic move lower in government bond yields and heightened fears over credit risk from a potential double dip recession.

Fear seems to breed more fear. As panic set in over the lack of any credible plan to solve the European debt crisis, markets started to extrapolate to fears of a double dip recession in the U.S. and a "hard landing" in China. Actual economic data, while not spectacular, has actually come in better than expected in the U.S. and in our view is still not consistent with a recessionary outlook for the U.S. economy. Our view has been validated by earnings season so far this month, as companies have largely continued to beat both revenue and profit estimates by a healthy margin. China is a more difficult call, but while slowing, still managed to grow its economy at an annualized rate of just over 9% last quarter. So from where we sit, the major problem to worry about remains Europe.

The problem in Europe is, or rather was, actually pretty simple:

-A few countries found themselves owing far too much money either through mismanagement of their government (Greece and Portugal) or of their banks (Ireland).

-Banks across the entire euro zone own hundreds of billions of euros in bonds issued by these countries. They historically never built any reserves against potential losses on these

Cumberland Capital Appreciation Model Performance (net)[1] as of Sept 30, 2011

	1 Month	YTD	1 Year	2 Year	3 Year	5 Year	10 Year
Cumberland	-5.6%	-7.9%	-0.1%	5.3%	4.9%	2.0%	5.1%
SP500/TSX (50/50)	-4.8%	-8.0%	-0.3%	4.0%	1.9%	0.3%	3.4%

Asset Allocation

Equity	74.9%
Bonds	13.0%
Cash	12.1%

1. All returns are presented net of transaction costs and management fees. Performance for periods greater than 1 year is annualized. Cumberland model portfolio performance is utilized for monthly performance reporting; composite performance is available on a quarterly basis. Past returns do not guarantee future results.

bonds because weaker euro nations were seen as implicitly (though not explicitly) guaranteed by the stronger euro zone nations.

Here's where the trouble starts. Everyone in the EU was happy to have bond markets assume weaker states would be supported in times of trouble by stronger states, and in fact, all the politicians involved vigorously agreed this would of course be true. As is so often the case, what seems like a good idea is suddenly much less appealing when it comes time to actually take action. Nations on the hook to provide funding hummed and hawed, demanded drastic cuts in spending by the nations needing funding and then grudgingly offered something less than overwhelming financial support. This is how a bad problem becomes a crisis. While politicians waste time trying to nickel and dime their way out of a situation they find isn't popular at the polls, the market quickly crystallizes the important question:

> *If these guys are putting up such a fuss over these little bailouts, what are the chances they would rescue one of the bigger euro nations if they needed help?*

Markets quickly decided the answer was "not very good" and investors started dumping bonds of the weakest large euro nations, Spain and Italy. Now we have a situation. Adding Spain and Italy to the mix raises the stakes dramatically, and suddenly what started as an unpopular but easily fixed 30 billion euro problem two years ago is now a full blown trillion euro crisis. At this point there are really only three logical solutions to the crisis:

1. The rich euro nations explicitly guarantee the debts of the weaker euro states, effectively creating one collective debtor nation. This will be near impossible to do without consolidating fiscal policy across all seventeen nations and would likely result in the loss of AAA credit ratings for any who still have it, including Germany. This is not something that is likely to be solved by the end of the month, let alone by the end of next year, and in the end, may not be politically possible at all.

2. The European Central Bank (ECB) could continue to directly purchase sovereign debt of the weaker EU states, growing its balance sheet and effectively monetizing EU government debt. While less obviously painful (at least in the near term) than option #1, it still creates a collective obligation and has the added potential to create very large longer term costs for richer nations, including very high inflation and much higher interest rates.

3. Get someone else to backstop the weak euro states, namely the IMF (which means the U.S.) and/or the Chinese. If you think getting rich European countries to agree to a bailout was difficult, wait until you try to convince the American people they should be bailing out Europe.

Having decided they don't like either option #1 or option #2, the EU has embarked on what we would call "Mission Impossible", or what they are calling the European Financial Stability Facility (EFSF). Effectively they are hoping to come up with a way of convincing bond markets that weaker EU nation debt is fully guaranteed by the richer EU nations

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without the richer EU nations actually having to fully guarantee it. Good luck with that. In our view, this plan has far too many flaws, but to name just a few:

-Of the 440 billion euros in the EFSF, 160 billion is supposed to be contributed by the very countries they are trying to bail out (Greece, Portugal, Ireland, Italy and Spain). This leaves just 280 billion euros of "quality" backstop.

-Of the 280 billion euros in "quality" backstop, 130 billion has already been earmarked for Greece, Ireland and Portugal as funding for the bailouts announced earlier this year. This leaves roughly 140 billion euros to defend Spain and Italy who together have over 2 trillion euros of outstanding public debt. Even with 5:1 leverage this is not nearly enough to effectively backstop Spain and Italy for any meaningful period of time. Either contributions from richer EU nations (and maybe the IMF) need to get much, much larger or this plan will be dead on arrival.

We believe the EU will eventually end up shouldering the burden of rescuing the euro (either through option #1 or option #2) but it could very well take even more pain (as in further financial market stress) to get German agreement. In the meantime, government bonds offer negative real returns over the long term in our view while equities are delivering solid earnings, attractive dividend yields and long term capital appreciation. Within our clients' capital appreciation accounts we continue to hold a conservative but attractive allocation to equities of about 70% (excluding gold related equities). For clients with option eligible accounts, we have started to add modest amounts of portfolio protection as equity markets have rallied. Within income accounts, we remain focused on delivering income through yield with long term capital protection, a mandate which is not currently consistent with loading up on very low yielding government bonds. Markets are likely to remain volatile until a permanent solution to the EU crisis is determined. Until then, we continue to focus on long term capital preservation and growth.

John Wilson
Chief Investment Officer
October 21, 2011

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.