CUMBERLAND

Cumberland Income Fund

3rd Quarter 2013 Review and Outlook

The Cumberland Income Fund gained +1.1% during the third quarter of 2013 compared to the gain of +0.1% posted by the DEX Universe Bond Index during the same period. The Fund has gained +2.8% year to date and +4.0% year over year, while the DEX has declined -1.6% year to date and -1.3% year over year. The bond market's heightened volatility that began last quarter spilled over into Q3 in earnest as interest rates continued on an upward trajectory. The Fund was able to dampen much of the volatility by continuing to keep duration (bond price sensitivity to interest rate movements) low, maintaining the weighting in floating rate notes (FRNs) relatively high (23% of the Fund), and ensuring that the portfolio remained diversified by holding securities that offer attractive risk / reward characteristics, in our view.

In Canada, much of the new issuance of bonds ground to a halt during July and August as the seasonal lull was exacerbated by rising interest rates and the first real outflow out of bond funds since the end of 2010. In September however, corporations had some funding catch up to do such that new bond issuance picked right back up and the quarter ended with a very solid C$28 billion in new corporate issuance. Year to date, corporations have issued over C$80 billion in new bonds, a level that is already ahead of the entire annual amount experienced in every preceding year except 2012. And since the bond issuance pipeline for October is looking robust, we will likely see record issuance again in 2013.

Much of the volatility in interest rates and bond prices can trace its source back to periodic comments made by Federal Reserve Chairman Ben Bernanke over the past several months. During speeches, press conferences, and testimonies to Congress, Bernanke has made conflicting comments about the expected evolution of the Fed's asset purchase program (Quantitative Easing or QE). On one hand, Bernanke has alluded that the economy is not currently strong enough to warrant reducing the rate of bond buying, while on the other hand he announced that the asset purchase program could start to be reduced later this year and be wound down by the middle of 2014 - conditional on the economy growing in-line with the Fed's forecasts. As the quarter unfolded, U.S. economic data seemed satisfactory and did not show signs of an economy beginning to weaken. The bond market, therefore, continued to price in a greater and greater probability that the Fed would follow through with their hints of beginning to taper bond purchases later this year. Ever since May 22, 2013, when Ben Bernanke made the first mention of possibly reducing the Fed's rate of bond purchases, bond yields (interest rates) have moved higher and bond prices have moved lower. To recap, using the U.S. 10-Year Treasury bond yield as an example, the 2013 low in interest rates came on May 2nd when the 10-Year Treasury traded at a yield of 1.6%. By July 1st the yield was at 2.5%, and by the early morning of September 6th the 10-Year Treasury yield had increased by a hefty 85% from the low, peaking at 3.0%, which translated into a price decline of -11%. Based on all the commentary from Bernanke the bond market had all but priced in the expected reduction in QE of roughly $10 billion from the current monthly pace of $85 billion. The "taper" announcement was expected to be included in the scheduled September 18th Federal Reserve Open Market (FOMC) committee statement. The market anxiously awaited the announcement of the beginning of the end of the historic Quantitative Easing program. When the statement was finally disseminated investors could almost hear a collective "*Huh?*". The Fed had announced they were leaving the asset purchase program unchanged at $85 billion per month. During the press conference that immediately followed, Bernanke cited the increase in interest rates since May (the very increase *he* engineered by talking about reducing their asset purchases!), the increase in oil prices, and a prescient comment about the political uncertainty of resolving the U.S. debt ceiling debate as reasons to leave QE unchanged. Yields quickly reversed and the 10-Year Treasury bond yield dropped back down to 2.6%, only 0.1% higher from where the yield began the quarter. We now start the fourth quarter with the Fed's reputation in question since they failed to follow through on the taper they had so carefully telegraphed over the past four months.

Throughout 2012 and 2013 we at Cumberland have viewed the risk of bond yields rising (and bond prices falling) as a much more probable outcome than what seemed to be priced into the market. Our basic thesis has been that central banks around the world with their accommodative monetary policy have been keeping

interest rates at artificially low levels via their massive bond buying programs. And as the global economy steadily, albeit slowly, improved interest rate risk became greater and greater, in our view. So throughout the summer, as Bernanke repeatedly mentioned the possibility of scaling back the rate of the Fed's bond buying program, the rise in yields and decline in bond prices was the most likely outcome. The timing and magnitude of the rise in interest rates is not something we could have predicted with any precision, and we did not have any insight into Bernanke's intention to begin publicly discussing the taper, but the Fund's asset mix strategy has been to hoard cash and allocate capital to very liquid floating-rate-notes with coupons that re-set quarterly and are benchmarked off of short-term interest rates due to our view of interest rate risk mentioned above. Holding these short-term securities allowed the Fund to dampen much of the volatility experienced by the general bond market over the quarter.

We now expect interest rates to stabilize over the near to medium term at these higher levels. In our view, the Fed's decision not to taper implies the Fed was uncomfortable with how high the bond market had taken up yields/interest rates in such a short period. To borrow a phrase from Bernanke this summer: we expect the Fed to "push back against" any further material increase in interest rates. In addition, as we go to print, Janet Yellen, the Fed's Vice-Chairman, has just been nominated by President Obama to succeed Bernanke as Fed Chairman. Janet Yellen has been supportive of Bernanke's accommodative monetary policies and she is viewed to be very sympathetic to the high level of U.S. unemployment. It is therefore less likely that she will make monetary policy decisions that result in higher interest rates and further reinforces our view that interest rates should remain range bound at current levels.

With our expectation that interest rates will remain stable in the short to medium terms, our strategy is to continue with what the Fund had started during the middle of the third quarter: Deploy cash into this higher interest rate environment. During the third quarter, we accumulated an equity position in Northland Power, an independent power producer, at an average dividend yield of 6.6%. We also deployed cash into preferred shares issued by both Enbridge Inc. (an oil pipeline operator) and Emera Inc. (a Nova Scotia based electric utility company). Cumberland also added to its existing common equity position in Davis + Henderson (a company that offers supporting services to the banking industry) and initiated a position in a convertible bond issued by the company during the quarter. In the bond allocation, we added to both our Corus Entertainment and Ford positions. It is noteworthy that Ford was upgraded from a high yield rating (BB+) to an investment grade rating (BBB-) by the rating agency Standard & Poors.

In conclusion, we want to underscore that despite our near-term expectations for stable interest rates, our longer term central investment thesis remains unchanged: the current low interest rate environment is being manufactured by the Fed's policies. As the economy slowly improves and the U.S. deficit continues to shrink, the Federal Reserve will inevitably have to end the QE program. Our view, therefore, is that risk is still skewed to declining government bond prices due to rising interest rates. Consequently, we continue to focus on preserving capital by maintaining a bond portfolio with a low duration (low bond price sensitivity to interest rate movements) of 2.9 years and generating income primarily from securities issued by corporations with attractive credit characteristics. Finally, although rising interest rates are generally a headwind for fixed income investments their basic investment characteristics within a diversified investment portfolio remain unchanged: They offer diversification, lower volatility if managed prudently, and provide a source of income generation.

R. Schulte-Hostedde
October 2013

Asset Allocation as at September 30, 2013

Asset Class	**% of Portfolio**
Cash and Cash Equivalents	9.7%
Government Bonds (incl. Floating Rate Notes)	27.9%
Corporate Bonds	44.0%
Preferred Shares	9.0%
Equities/Income Trusts	9.4%

Yield Comparison[1] as at September 30, 2013

DEX Universe	2.7%
DEX Government	2.5%
DEX Corporate	3.2%
Cumberland Income Fund[2]	3.6%

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 management fees