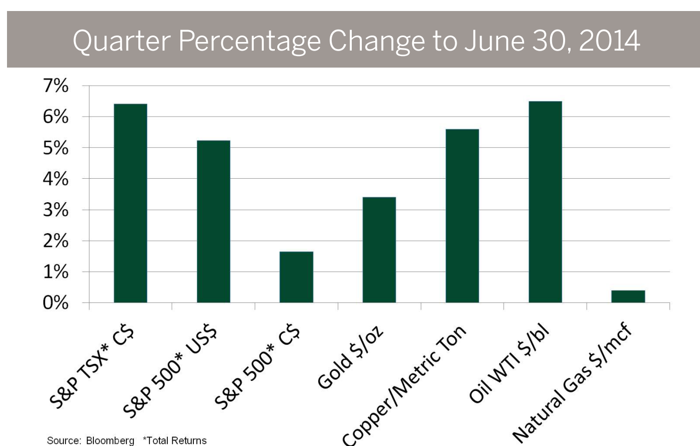
Second Quarter Review
North American Capital Appreciation Strategy
July 2014

The second quarter of 2014 saw a continuation of the positive performance trend exhibited in the first quarter in North America. Both indices, the TSX and the S&P500, hit new highs during the second quarter with the TSX slightly outperforming the S&P500 as it returned 6.4% while the S&P500 returned 5.2% in US$. Adjusting for currency, the S&P 500 returned 1.6% in C$ as the C$ strengthened by over 3 cents during the quarter reversing the downward trend it exhibited during the first quarter.



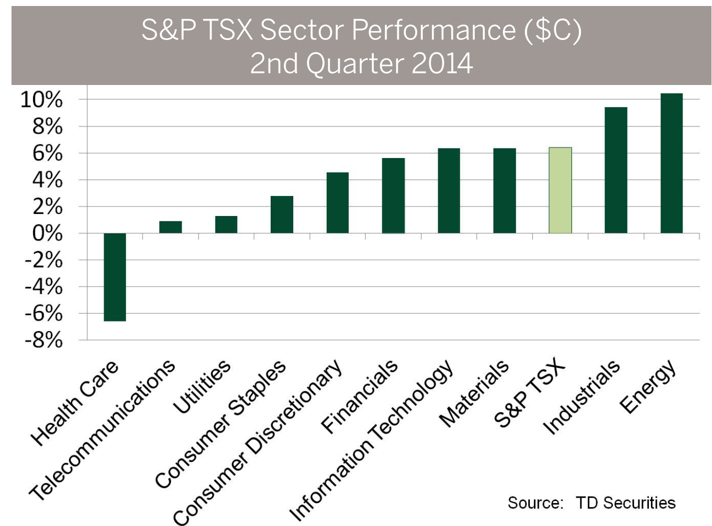
While it appears that it has been a clear goal for the Bank of Canada to talk our dollar lower, the latest inflation data in Canada may have caused them to think twice, with May inflation coming in at its two year high of 2.3%. Higher oil prices may have also helped to ignite our "petro-loonie" but it is hard to expect, with the muted wage growth data we are seeing and the dollar strengthening lately, that any change in monetary policy will be happening soon here in Canada. Global headlines that could have affected capital markets, but did not, include issues in the Ukraine, which now seems to have taken a back seat to the recent uprising in Iraq. The Islamic State of Iraq and Syria jihadist militant group (ISIS) continue to gain ground leading to a renewed centre of instability in the Middle East. While this initially caused oil to spike by $4.00-$5.00 per barrel, most of the large oil fields in Iraq are to the south out of combat range so they really are not in jeopardy, at least not yet. While the impact of this insurgency has not yet fully played out, it is worth noting that Iraq is the second largest oil exporter in OPEC after Saudi Arabia at about 2.3 million bpd. In the context of total global oil demand, which hit a new high in May at 92.2million bpd, it is somewhat material. Offsetting any potential disruption is Libyan production, which is set to resume soon to the tune of potentially 0.5 million bpd. Lately this has helped to relieve some of the upward pressure on oil prices. What we don't know is the long-term impact this conflict will have on oil prices as Northern Iraq was slated to be a significant oil producer over the next decade and this is now clearly at risk. Probably the strangest twist of events while all this was going on was the Obama administration paving the way for the first oil exports out of the United States in almost four decades. With renewed U.S. oil exports out of the U.S., there is really no reason why the difference between the U.S. oil price (WTI) and world oil price (Brent) should continue to exist regardless of what happens in Iraq. Currently WTI remains about $7.00 per barrel below the Brent world oil price. Our conclusion is that the price of oil is probably not going a lot lower any time soon but could go higher, and this remains an important part of our investment thesis. Having said all that, one thing that seems clear, these global events do not appear to be deterring investors so far.

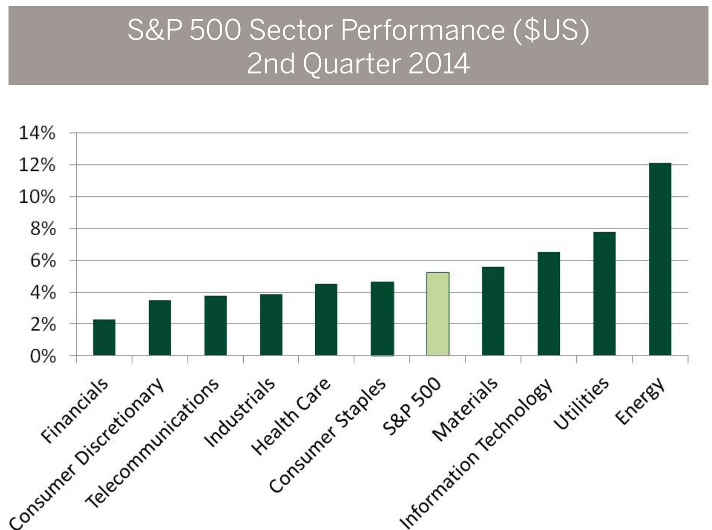
So what is getting investors so excited? Perhaps it is the economy. A lot has been said about the significant weather effects on first quarter U.S. GDP, however the final read in June came in at -2.9%, the worst reading since 2009. Looking forward, the consensus call for GDP in the second half of 2014 is much more upbeat at 3.1%, a pretty decent recovery. Given the prior two quarterly readings were 2.6% and 4.1%, the first quarter was likely an anomaly. Certainly the latest jobs data for June indicate a much more positive outlook with the unemployment rate falling to 6.1%, the lowest since September 2008. Importantly, the labor participation rate, or the number of people working or looking for a job, remained steady such that the decline in the jobless rate was not a function of the unemployed dropping out of the workforce. The stronger than expected U.S.

inflation data for May, up 2.1% year over year, also appears to confirm that economic growth is continuing since there is clearly more pricing power. So far this has not changed the U.S. Federal Reserve's stance on when interest rates will start to rise. They have suggested it will be "considerable time " after the end of the bond buying stimulus program, which now sits at $35billion starting in July.

Meanwhile in Europe, it is the opposite situation, as the focus remains on measures to stimulate growth and inflation, currently at 0.5%, which remains below the European Central Bank's (ECB) targeted range of close to 2%. At its June 5th meeting, the ECB cut its bank lending rate to record lows of 0.15% and initiated for the first time, negative rates for which it pays for bank deposits. The ECB also extended its long-term refinancing operation (LTRO) operation, which allows banks to pledge illiquid assets as collateral for cheap loans, in an effort to get banks to lend to businesses. And finally ECB President, Mario Draghi left the door open for U.S. style large scale asset purchases or quantitative easing if the inflation picture deteriorates further. This is all in an effort to breathe life into the Euro zone as easier access to capital and lower bank funding costs should in theory lead to more financial institutions lending money. The flipside is that banks are also under pressure to hold more regulatory capital. When you combine this with the deflationary risk, it is still not yet clear if the ECB has done enough. The relevance to us is that lower rates in the euro zone have helped to bring down rates here in North America at a time when many thought the opposite would be happening.

The accompanying charts show the sector returns for the TSX and the S&P500. Given the news out of Iraq, it is probably no big surprise how well energy performed during the second quarter both in Canada and in the U.S.. And given energy's large weighting in the TSX at 26.8% it significantly skewed the TSX's positive performance during the second quarter. However, as we have discussed above and in previous strategy reviews, we think there are a number of factors driving the energy outperformance suggesting it may continue. These include Iraq, the Obama administration change to allow oil exports from the U.S., which we just discussed, but also rising natural gas prices (which we reviewed last quarter), the infrastructure build out for liquefied natural gas (LNG) and advancements in new technologies such as hydraulic fracturing or fracking. Next to Financials, Energy remains our largest weighting in the portfolio.





During the second quarter, we added a position in Finning International, which we consider a related derivative play on energy. Finning is the largest Caterpillar dealer in the world, with about 50% of its

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revenue coming from Western Canada. We expect Finning to be a major beneficiary of the build out of LNG and continued infrastructure development of the oil sands. The other large revenue source for Finning is South America (37%), which is highly correlated to mining and specifically the copper industry. In fact, Finning's share price correlates highly with oil (0.91 to 1) and copper (0.88 to 1) on which we are also quite constructive. In terms of copper exposure, another position we added during the second quarter was Capstone Mining. Capstone in an intermediate size copper producer with mining assets located in geopolitically friendly jurisdictions, in both North and South America. The company has a history of making well timed, prudent and value creating acquisitions that have positioned the company for robust organic growth. Currently, global copper inventories are at multi-year lows and given that copper has traded between $3.00 and $4.50 per pound since 2009, we believe there is good support for the metal currently at $3.25 per pound. Seasonality also favours copper going into the summer period; however, Capstone is very profitable at current copper prices so the investment thesis is not dependent on higher pricing (although clearly this wouldn't hurt). A summary of new positions added during the quarter including business fundamentals and valuation metrics is contained in Appendix 1.

Asset Allocation for Capital Appreciation Portfolios As at June 30, 2014	
Equities	81%
Fixed Income	11%
Cash	8%

During the quarter, our asset mix was relatively unchanged with our equity weight declining 1% in favour of a 1% higher cash weight. Since June 2013, we began shifting assets out of the U.S. market into Canada as we felt Canada offered better value based on the historical dividend yield spread between the two markets, among other factors. Currently, our Canadian equity exposure is 47% while our U.S. exposure is 34% (or 58% and 42% of equities, respectively). As discussed in our last review, where possible we hedged about 55% of your U.S. dollar exposure during the first quarter at around $0.90 U.S.. The hedge has increased in value with the recent strength of the Canadian dollar, and therefore has had a positive impact on your portfolio. During the second quarter, in option eligible accounts we rolled forward the S&P500 puts we had purchased in the first quarter, to protect portfolio gains through September 2014. At the time of purchase, the puts, combined with our cash and fixed income exposure, protect about 34% of the portfolio from a pullback in the equity markets while over 80% of the portfolio would participate in future upside.

The fixed income market seemed to snub the economy's progression during the second quarter. Despite five straight months of the U.S. creating over 200,000 jobs and a pick-up in inflation readings, bond yields barely budged and bond market volatility as measured by Merrill Lynch's MOVE Index also barely shifted. The absence of volatility has confounded market participants since a typical reaction to improving employment and higher inflation is an increase in bond yields. The economic data coming out of the U.S. is also forcing the bond market to contemplate how the U.S. Federal Reserve (the Fed) will react. Ever since the Fed hinted at tapering the bond buying program (May 2013), they have insisted that it did not imply an imminent increase in the policy interest rate. The Fed has constantly claimed that the U.S. still remains well below full-employment and inflation is well-below their target of 2%, justifying their ultra-low interest rate policy. However, during the second quarter as discussed above, inflation indicators began to heat up (in Canada too) and the unemployment rate reached the lowest level since the start of the credit crisis. Despite these data points, in June, Fed Chair Janet Yellen dismissed the higher inflation readings claiming the data was "noisy", but without explaining what she thought the "noise" actually was. Yellen also remains adamant there remains plenty of slack in the labour market. So the debate that is gaining momentum is on the timing of the Fed's first increase to the policy interest rate. At Cumberland, we expect continued improvement in the economic data will eventually not be able to be ignored by Yellen and others, and the policy interest rate will ultimately have to be increased from the 0%-0.25%

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range sooner than expected. As a result, we continue to view increasing interest rates (resulting in declining bond prices) as the primary risk to bond portfolios. We have therefore maintained the duration of our bond portfolio at just under three years compared to the 6 to 7 years of a typical bond benchmark index, since the prices of shorter duration bonds are less sensitive to changes in interest rates compared to longer duration bonds. Allocations to less interest sensitive asset classes such as high yield bonds, preferred shares, and dividend paying common equities also remain instrumental in generating additional income and moderating volatility.

Outlook

Who wants to sell when everything just keeps going higher? Well with perfect hindsight, no one does. The problem is looking forward we don't have that luxury. We do have a lot of factual data however and perhaps a review of that will explain why we are positioned the way we are, which is generally cautious. The forward P/E on the S&P500 is currently 15.8x versus the 25 year average of 15.4x. For perspective, the forward P/E was 15.4x at both March 31st and December 31st so it is somewhat higher now than it was earlier this year with the S&P500 at all time highs. While this level does not suggest the market is particularly overvalued and looking out to 2015 calendar year earnings, the S&P500 is actually trading at 14.9x. The main concern is that the forward P/E is based on a projected forward 12 month earnings growth rate of 11.7%. And given that earnings are only expected to be up 3.7% in the second quarter over the first quarter, the consensus forecast assumes some stellar growth in the second half of 2014 and into 2015. Pretax profit margins are close to 45 year highs and that was driven partially by cycle low labour costs as a percent of GDP over the same time period. With the labour market now improving and back at the best level in almost six years with signs of inflationary pressures mounting both in Canada and in the U.S., it is probably as good as it gets in terms of pretax operating margins for the economy as a whole. Meanwhile volatility as measured by the VIX is approaching the lows of 2006 as complacency continues to be the word of the day. If we compare the equity risk premium (trailing earnings yield to the U.S. ten year bond yield) to the historical ten year average equity risk premium, it implies we are around fair value on the S&P500. So once again, it tells us that the market is not cheap but not expensive either. The last time we saw the market around fair value using the average ten year equity risk premium was in January but U.S. 10 year yields were 2.99% not 2.61% as they are today.

From a funds flow perspective, flows into domestic equities in the U.S. have turned negative the past two months after being positive in 2013 and through the first quarter of 2014. Flows into U.S. bonds have turned positive in the first and second quarters of 2014 after being negative through the second half of 2013. In Canada, flows into equity and balanced funds all remain positive so far in 2014, while flows into bond funds turned positive during the second quarter of 2014 after being negative in the first quarter and through 2013.

So if we add all these data points up, I would summarize by saying it's not over yet, it's just getting a little riskier. Canada still looks relatively cheap compared to the U.S. on a dividend yield basis with the current spread at 0.88% as compared to the ten year historical average of 0.56%. To get back to the historical average ten year spread, the TSX would have to rise about 13% relative to the S&P 500 which supports our call of shifting more assets to Canada from the U.S. For now, we remain comfortable having some reserves on the sidelines, some put protection and will choose our spots (stock and sector selection) carefully.

Peter Jackson
Chief Investment Officer
July 8, 2014

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.

Appendix 1
New Equity Investments
North American Capital Appreciation Strategy
Quarter Ending June 30, 2014

Finning

Finning is the world's largest Caterpillar dealer, and is the authorized dealer in Western Canada, the UK, and the South American countries of Argentina, Bolivia, Chile and Uruguay. Besides equipment sales, the company provides service, parts, equipment rental and used equipment sales. Our interest in Finning is two-pronged. Our primary interest is as an operational turnaround where new management, with a return on invested capital focus, has been implementing operational changes that are predominantly within their control. The company has given financial goals for the improvements which, if achieved, would be quite material for the overall company results. Our secondary interest in Finning is that it fits in very nicely with our theme of a large multi-year capital spending boom in Western Canada focused on the oil sands and the facilities build-out for LNG shipping to Asia from BC. A final added embedded warrant is their leverage to a renaissance of presently weak mining spending.

Capstone

Capstone mining is engaged in the exploration, acquisition and development of copper in the U.S, Mexico, Canada and Chile. Capstone's flagship asset is the Pinto Valley open-pit copper mine in Arizona, which it bought in October 2013 for $650 million. Since purchasing Pinto Valley, Capstone has more than doubled the mine life from 5 to 12 years and consequently added over $117 million in economic value. In addition, the company continues to lower costs and increase production at the mine as they increase throughput and instill best practices. Currently, the company is working with KORES (Korean National Resource Corp) to advance the extremely low-cost, large-scale Santo Domingo copper-iron ore development project in Chile. Capstone has a strong operational record of mine development, low net debt level of $172 million (versus book value of $1.3 billion) and an industry-leading growth profile in low risk jurisdictions. Therefore, the company stands to benefit immensely from the upcoming rebound in copper prices, which we believe is imminent as negative supply shocks persist during a period of stable and robust demand.