CUMBERLAND

Strategy Review
January 2013

The S&P 500 in the fourth quarter was muted compared to the strong third quarter where it hit its highest level in five years. The total return for the S&P 500 in the fourth quarter was -0.38% in US$ or 0.76% in C$ as a result of a weaker Canadian dollar in the quarter. The TSX managed to fare a little better with a total return of 1.72% during the fourth quarter. While the S&P 500 began October trading near record highs, there were concerns about the impact Hurricane Sandy would have on earnings and it was reflected in downward pressure on stocks in late October. This was followed by a sharp selloff post the U.S. Presidential election in November as news about the fiscal cliff dominated the headlines. The market was concerned because if no budget deal was reached by year end, it would result in automatic spending cuts and higher taxes in 2013. Although political brinkmanship ended up pushing the U.S. economy over the cliff, at least for a few hours, the extraordinary New Year's Day compromise was a welcome relief for the markets going into 2013. Both political parties seemed to save face as the agreement raised taxes on the wealthiest 2% of Americans but permanently codified all tax brackets for everyone else. This one source of uncertainty held back consumers and businesses in 2012. The markets celebrated the economy avoiding a major dip in GDP by advancing the S&P 500 with its biggest one day advance in over a year during the first trading session of 2013. However, the issue is far from being fully resolved, as the deal focused only on the revenue side of the equation and has yet to address spending, the debt ceiling and the continuing resolution of the fiscal year 2013 budget. One economist referred to these issues as the three gorges that must be dealt with during the first quarter of 2013.

Despite the negative equity sentiment throughout the year, the S&P 500 was actually up 16.0% (in US$) in 2012 or 13.5% (in C$) as a result of a stronger Canadian dollar during the year. With a combination of earnings growth of 6%, multiple expansion of 7% and dividends of 3%, U.S. stocks had a pretty decent year. The strongest performing sectors in the U.S. were Financials (26.3%), Consumer Discretionary (21.9%) and Health Care (15.2%) while the weaker sectors were the commodity exposed groups namely, Energy (2.3%), Utilities (-2.9%) and Materials (12.2%). For the 12 months ending December 2012, the total return for the TSX was 7.2%. Similar to the U.S., the leadership in Canada was in Consumer Discretionary (22.1%), Health Care (24.7%) and Financials (17.6%) with Materials (-5.7%), Energy (-0.6%) and Utilities (4.0%) underperforming during 2012. This does not come as a big surprise given the weakness in oil prices, which fell $7.01 per barrel in 2012, closing at $91.82 per barrel. Gold and copper managed to close higher for the year, with gold gaining $111.65 per ounce closing at $1,675.35 per ounce and copper up $0.15 closing at $3.60 per pound. The more pressing issue within the Materials group and specifically the miners, has been the continuation of lower mine reserve grade and higher production and capital costs, which reduce the quality of the resource and the profitability.

Asset Allocation for Capital Appreciation Portfolios (As at Dec. 31, 2012)	
Equity	80%
Bonds	11%
Cash	9%

During the third quarter, our equity exposure increased 4% with the U.S. exposure rising 5% while the Canadian exposure decreased by 1%. Our net incremental commitment to equities was sourced from cash. The biggest sector increases were in Industrials through the addition of Cummins, while Suncor Energy and Agilent

Strategy Review
January 2013

Technologies increased the energy and health care sectors, respectively. Other new positions added during the quarter included Walmart Stores, Methanex Corporation and TD Ameritrade. The biggest sector decreases were in Technology and Materials. This included the sale of Western Union, Barrick and Agrium. A summary of all new positions added during the quarter including business fundamentals and valuation metrics is contained in Appendix 1 herein.

With the S&P 500 up over 16% at its peak in September, our strategy going into year end was to protect your gains earned year-to-date while still being able to participate in any upside. Thus, we bought portfolio insurance (for eligible accounts) as part of our tactical decision to protect returns. We did this by purchasing puts on the S&P 500. The puts provided protection for about 15% of a Capital Appreciation portfolio, or roughly half of our U.S. exposure at the time we bought them. When you combine this with the cash and bond exposure, almost 40% of the portfolio was not exposed to a market pullback through the balance of 2012, yet over 75% was able to participate in any upside. One factor weighing on our decision-making process was the fact that the expected earnings growth rate for the third quarter for the S&P 500 had turned negative, and there is a high positive correlation between the direction of earnings and the S&P 500. Other factors considered included the fiscal cliff, debt ceiling discussions, Middle East tensions and technicals, suggesting an overbought market. During the fourth quarter, the overall return of the Cumberland Capital Appreciation mandate outperformed the 50%TSX/50% S&P500 benchmark in Canadian dollars. For the year, the overall return of the Cumberland Capital Appreciation mandate compared favourably on a risk-adjusted basis to this benchmark in Canadian dollars, with the overall return on the portfolio matching the benchmark despite the more conservative asset mix of the portfolio compared to the fully invested benchmark.

Our income strategy has remained largely unchanged during the fourth quarter. We continue to view the reversal of the 32 year decline in interest rates as the largest potential headwind to the fixed income portion of the portfolio. For that reason, we continue to keep the duration of the portfolio short, thereby dampening the magnitude of price movements as interest rates fluctuate. It now appears that 10 year Government of Canada bond yields bottomed last summer at 1.57% and have since trended higher to 1.90%. Contrast this with the performance of corporate bonds where spreads have continued to tighten, thereby increasing the total return of these bonds. Our bond allocation strategy has been skewed more towards corporate bonds and therefore the strategy has benefitted from this trend.

Outlook

While the fiscal cliff was averted, all else being equal, the compromise by Congress still results in the elimination of the payroll tax cut as well as higher taxes on dividends and capital gains that will likely create some fiscal drag on GDP in 2013. Add to this other outstanding issues yet to be resolved in Washington, including the budget sequestration at the end of February, the debt limit in early March and the expiration of the temporary budget on March 27. This suggests to us that investor sentiment will continue to be challenged in the near term. We have also witnessed a 6.2% decline in the S&P 500 fourth quarter 2012 earnings growth rate since September 30th, which suggests a cautious approach is still warranted. However, there are continuing signs that the U.S. economy is improving. The latest ISM manufacturing data was better than expected and suggests a pickup in activity. Also, the labour

Strategy Review
January 2013

market in the U.S. continues to improve with the unemployment rate matching the lowest levels since January 2009.

From a valuation perspective, it is hard to ignore equities as being the most attractive asset class. Forward price earnings (P/E) ratios for the S&P 500 and the TSX at 12.9 x and 13.3 x respectively, are still below the historical average P/Es of 14.2 x and 15.1 x. From an earnings yield and dividend yield perspective, equities are still significantly favoured over bonds and cash. Going forward, we will continue to maintain the same disciplined investment process to identify equities for inclusion into our clients' capital appreciation portfolios while maintaining a conservative tactical portfolio position. We expect volatility to continue in 2013 and this will present investing opportunities that we can continue to take advantage of.

Peter Jackson
Chief Investment Officer
January 2013

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.

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Appendix 1

New Equity Investments - Cumberland North American Capital Appreciation Mandates, for the Quarter ended December 31, 2012

Canada

Methanex

Methanex is the world's leader in the production of Methanol with about 15% global market share. The company has plants in Canada, Chile, Trinidad, New Zealand and Egypt. Methanol is a liquid fuel that is produced primarily from natural gas. About two thirds is used as a chemical feedstock in the production of a wide range of consumer and industrial products such as building materials, foams, resins, paints and recyclable plastic bottles. About one third is used in the energy applications such as direct blending into gasoline and biodiesel. Global demand growth for methanol is expected to increase from 50mm tonnes to approximately 75mm tonnes by 2016. This compares to global supply growth announced of about 10mm tonnes of which 2mm tonnes of the additional capacity is being built by Methanex in geographic regions with abundant cheap natural gas supply. Methanex has a history of strong profitability with an average return on equity from 2004 to 2011 of 20%. Methanex introduced a dividend in 2002 and has raised it nine times including a 9% increase last summer. It has also been a large buyer of its own stock, having bought back 40% over the past ten years.

Suncor

Suncor is an integrated oil company with upstream operations producing approximately 560K barrels of oil equivalent per day. Its production profile is approximately 90% oil and 10% natural gas. Suncor has four refinery operations, refining 455k barrels of oil per day. Its refineries are located in Edmonton, Colorado, Sarnia and Montreal. Suncor downstream operations currently benefit significantly from the large spread between North American oil prices (WTI) and global oil prices, which its refined products are priced at. In its upstream operation, Suncor estimates that it will grow its production by approximately 8% per year to the end of the decade. The key factor that makes Suncor more attractive today is that it can now self fund its growth as opposed to raising external capital. Since the acquisition of PetroCanada in 2009, it has used excess free cash flow to pay down net debt from $13.4 billion to $5.0 billion today. With the balance sheet in excellent shape and cash flow in excess of both maintaining and growth capital requirements, Suncor has significant excess cash flow for share buybacks and greater dividends. In September it began a $1 billion share buyback program, after completing a $1.5 billion buyback in the previous 12 months. Suncor currently pays only a modest dividend of $0.52 per share but has stated that they are targeting a 25% payout ratio. Assuming $3.00 to $3.50 of earnings, a 25% payout implies a $0.75 to $0.87 dividend in 2013 and would take it to a 2.3%-2.7% yield at current prices.

United States

Walmart Stores

Walmart Stores (Walmart) operates retail stores in various formats globally, under a pricing philosophy of Everyday Low Prices (EDLP). The Company operates in three business segments: Walmart U.S., Walmart International, and Sam's Club. Between January 2000 and June 2012, Walmart's shares returned exactly zero percent for investors, excluding dividends. During this period, its EPS rose at a CAGR of 15% while its price earnings multiple contracted from over 50X in 2000 to just 14X today. We believe this secular multiple contraction over the last 12 years was mostly a reflection of Walmart's declining productivity, which is most commonly measured by the company's return on invested capital. Walmart management has outlined a detailed strategy for improving productivity, including using

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technology to improve inventory turns and leveraging existing infrastructure, and has set forth specific targets. We believe Walmart will be rewarded with multiple expansion as the market realizes the company is improving its return on invested capital, and represents an exceptional risk/reward trade-off.

Cummins

Cummins is the largest global independent designer, manufacturer, and distributor of diesel engines for trucks, and supplies related technologies including emission solutions, fuel systems, filtration, and turbochargers. Cummins has thousands of customers, and provides OEM truck makers such as Paccar, Volvo Trucks, and Navistar with truck engines through longstanding supply agreements. In the U.S., where Cummins commands 40% market share in heavy-duty truck engines, fleet managers have added new trucks at below the long-term replacement rate for the past 7 years, suggesting pent-up demand. Cummins has longstanding presence in China, Brazil, and India, where tightening emissions standards should drive higher content per engine. Finally, Cummins has a successful natural gas truck engine product line that is well positioned to benefit if natural gas gains acceptance as a transportation fuel. The company has raised its dividend in each of the past 6 consecutive years and increased it 25% in Q2 2012.

Agilent

Agilent is the world's pre-eminent manufacturer of testing equipment, and operates in three segments: Electronic Measurement, Life Sciences, and Chemical Analysis. In its competitive market segments, Agilent's brand stands for all-around engineering excellence and outstanding customer service. R&D runs at 10% of revenue, more than its peers, and 7,000 researchers sustain a robust pipeline of technological innovation, with dozens of new product introductions per year. 75% of Agilent's revenue comes from outside the U.S., with 30% from Emerging Markets. Agilent has made two transformative acquisitions in the past three years, both of which furthered the corporate strategy of reducing business cyclicality. Management efficiency programs have reduced fixed costs by $525mm since 2008. In addition to returning $8.6 billion of cash to shareholders via stock buybacks over the past 7 years, Agilent recently initiated a dividend, providing a modest 1% yield. We expect healthy cash generation should provide for future dividend increases.

TD Ameritrade

TD Ameritrade (45% owned by TD Bank) along with Charles Schwab dominate the online brokerage business in the U.S. and around the world, as well as providing an online platform for a growing number of independent retail advisors. Much of TD Ameritrade's earnings come from the spread earned in brokerage accounts by investing this money in 2 to 3 year bonds. While TD Ameritrade has grown total client assets at a healthy double digit annual rate over the last few years, this has been effectively negated by the effects of lower interest rates on overall earnings. The day interest rates reverse their fall and return to more normalized levels TD Ameritrade could easily double overall earnings and we bought the stock for this eventuality.