CUMBERLAND

North American Strategy
2013 Year End Review and Outlook
January 2014

The fourth quarter ended with a strong finish for the U.S. markets, which resulted in the best annual performance for the S&P500 index since 1997. In the quarter, the S&P500 returned 10.5% in US$ or 14.3% in C$, which helped drive the total return for 2013 to 32.4 % in US$ or 41.5% in C$. Clearly, the weaker Canadian dollar relative to the US dollar was a significant driver of the returns when viewed in Canadian dollars as the Canadian dollar declined approximately 7% during the year. As we discussed during our last client quarterly meeting and conference call in November, we began moving more assets into the U.S. in 2012 with the U.S. exposure in our North American Equity strategy increasing from approximately 25% to 43% by the end of the first quarter of 2013. We also removed our US dollar currency hedge in the fall of 2012, which had helped protect the portfolios from the prior decline in the US dollar relative to the Canadian dollar. Being unhedged during 2013 allowed our Canadian clients' portfolios to benefit from the relative strength of the US dollar.

Here in Canada, index returns were negative through the first half of 2013, but finished strong with the TSX posting a total return of 13.0% for the year and 7.3% in the fourth quarter. The improvement in the second half of the year reflected stronger earnings and higher valuations placed on those earnings, with Canadian valuations beginning to catch up with those in the U.S. In October, the Bank of Canada surprised the market with its decision to remove its interest rate tightening bias, citing weaker economic growth. This, combined with the Federal Reserve's move in the opposite direction in December, announcing its intention to reduce its monthly bond purchases by $10 billion to $75 billion per month starting in January, has put pressure on the Canadian dollar. In our view, a diverging stance on monetary policy between the two countries may be indicative of a lower Canadian dollar in 2014.

The fourth quarter was not short of political brinkmanship in Washington, which culminated in a sixteen day government shutdown in October as the Republicans attempted to use the budget debate and debt ceiling talks to delay the Affordable Care Act (Obamacare), which ultimately took effect October 1, 2013. In December, a bipartisan compromise on a two year budget deal was reached, which should stave off the threat of another government shutdown for the next couple of years. While the market reaction was positive, the market seemed to have become accustomed to dealing with these issues, and be willing to look through any short-term volatility.

What appeared to be a turning point, at least in our view, was the market's reaction to the strong November employment numbers and December's news of the Fed's reduction of its monthly bond purchases as noted above. This seemed to signal to the market that the economy was finally transitioning from being driven by central bank stimulus to being driven by fundamentals. Monetary tightening coincides with a stronger economy, which in turn typically supports higher earnings expectations by investors. Further economic data releases in the U.S. in December also supported a positive outlook, including the second reading of third quarter GDP, which came in at 3.6%, well ahead of analysts' expectations and almost a percentage point greater than the first reading in November.

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The combination of strong multiple expansion for 22.7%, dividends of 2.8% and to a lesser extent earnings growth of 6.9%, drove the +32.4% performance of the S&P500 in US dollars in 2013. Economically sensitive sectors were the strongest performers with Consumer Discretionary (+43.1% annual return) and Industrials (+40.7%) leading the way. With November monthly auto sales running at a seasonally adjusted annual rate of 16.3 million units, representing the strongest monthly sales since May of 2007, the strength seen in the Consumer Discretionary group was not surprising. Within Industrials, the Airlines and Railroads, which are typically closely tied to fluctuations in the economy, also stood out. The weakest performing sectors in 2013 were the interest rate sensitive Telecommunication Services (+11.5%) and Utilities (+13.2%) groups, as the U.S. 10 year bond yields bottomed in May at 1.6% and now hovers around 3.0%.

Similar to the S&P500, the top performing sectors in Canada in 2013 were Consumer Discretionary (+43.0%) and Industrials (+37.5%), while the worst performers were Materials (-29.1%) and Utilities (-4.1%). The move in the Materials sector was not a surprise given that gold suffered its first annual loss since 2000, declining 28.0% to US$1,205 per ounce due to an improving economy and because the Fed would be reducing its stimulus in early 2014. The decline in the price of gold heavily impacted gold mining companies with the TSX gold sector declining 44.0%. Even more interesting than the decline in the price of gold itself was the questioning of the survival of some miners. As a reminder, we exited the remainder of our gold positions in early 2013 and did not have any exposure throughout the rest of the year. Copper fell 7.2% to US$3.34 per pound but has remained range bound for most of 2013, while the TSX Metal and Mining sector was down almost 20%. Oil increased by US$6.38 per barrel to US$98.42 and natural gas, which has seen record inventory drawdowns due to cold weather, recently increased 26.2% to close at US$4.23 per mcf (1mcf = 1000 cubic feet). Notwithstanding the strong price performance for energy prices in 2013, the TSX Energy sub-index gained only 13.6% for 2013 as compared to the U.S. Energy sector, which was up 25.1% in US$. Energy remains our second largest sector weight after Financials and we expect stronger performance in 2014. With respect to Financials, the performance in Canada was 23.7% and 35.6% in the U.S.

Asset Allocation for Capital Appreciation Portfolios As at December 31, 2013	
Equity	82%
Bonds	11%
Cash	7%

During the fourth quarter, our equity and fixed income exposures increased by 4% and 2%, respectively, as cash declined. Our weightings in Healthcare increased through the purchase of Sanofi and Catamaran. Sanofi is an overlooked global manufacturer of pharmaceuticals with a pipeline exposed to some of the largest market growth segments including diabetes, multiple sclerosis and cardiovascular disease. While Catamaran should be a net beneficiary of the Affordable Care Act (Obamacare), the considerable complexity surrounding industry changes has created a tremendous buying opportunity for the stock in our view. Overall, we believe Healthcare should continue to benefit from a strong demographic tailwind.

We also increased our weighting in Financials during the fourth quarter through the addition of Alaris Royalty, and increases in AIG and Bank of Nova Scotia. Combined, the three largest sector

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exposures at year end, namely Consumer Discretionary, Energy and Financials represent over 50% of the total. We expect 2014 earnings growth rates of 15.6%, 12.5% and 11.1% respectively, all of which exceed the overall expected growth rate for the S&P500 of 10.6%. Of the ten industry sectors within the S&P500, Financials and Energy are currently the cheapest as measured by price to earnings multiples using 2014 earnings. We believe owning the cheapest sectors with the highest earnings growth rates should be a win-win strategy entering 2014. In the case of Consumer Discretionary, notwithstanding its attractive earnings growth rate, it was harder to argue the sector was still cheap, so we began scaling our exposure back in the fourth quarter of 2013. A summary of new positions added during the quarter, including their business fundamentals and valuation metrics, is contained in Appendix 1 herein.

Overall, given the large move in the market in 2013, it may appear counter-intuitive to increase our equity exposure. However, the names we added late in 2013, follow a number of the sector themes we have discussed over the past year (demographics/aging population, increasing Liquefied Natural Gas (LNG) demand by Asian markets, rising interest rates) and have stock specific catalysts making them less dependent on upward moves in the overall market. Also, in general the names we added are much less volatile than those we trimmed back and the overall market. Similar to the fourth quarter of 2012, we also added portfolio insurance (for eligible accounts) during the fourth quarter of 2013 to protect our gains through March of 2014. This was accomplished by purchasing put options on the S&P500. The puts provide protection for about 15% of the equity portion of the portfolio (from the time of purchase). This, coupled with the cash and bond portions of the portfolio, would mean that approximately a third of the total value of the portfolio is protected on the downside, while still allowing for capital appreciation from market increases.

During the fourth quarter, the overall return of the North American Equity strategy lagged the 50%TSX/50% S&P500 benchmark in Canadian dollars reflecting a strong upward move in both markets, particularly the U.S., including currency, given the strong appreciation of the U.S. dollar and its impact on 50% of the benchmark. Our more conservative asset mix relative to the index, however, has helped achieve lower volatility yet higher returns than the benchmark in the longer term, which is our ultimate goal.

The bond market seemed to take in stride (this time) the Fed's decision to reduce its monthly bond buying starting in January 2014, likely because the Fed also pushed out expectations for when it will begin to raise interest rates, reminding the market that the current goal is to simply reduce stimulus and not to immediately tighten policy. While the U.S. 10 year bond yield remained range bound between 2.6% and 3.0% during the fourth quarter, we ended the year at the upper end of that band. With the era of strong central bank support now behind us, our view is that this will likely translate into continued or perhaps higher volatility in bond yields in 2014. Consequently, in our Income strategy we intend to keep our duration short, at around three years to dampen the sensitivity of bond prices to volatility in interest rates.

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Outlook

"A rising tide will lift all boats", seems to be an appropriate way to describe the markets in 2013, where the decision that affected an investor's performance the most was whether or not to be in the market. However, it is hard to argue that the market is cheap having witnessed the S&P500 forward price to earnings multiple (ie: using next year's earnings) rise from 12.7x last year at this time to 15.4x currently. While the easy money has been made, the good news is that we have now just approached the 25 year average forward P/E multiple, so the U.S. market is neither overvalued nor undervalued in our opinion.

In Canada, the forward price to earnings multiple is now below that of the U.S. at 14.7x and still below its 25 year average of 15.1x. What will really matter in 2014, particularly in the U.S. in our view, is being invested in the right companies and we feel we are well positioned in the sectors and stocks that should do even better than the consensus expectation for 2014 S&P500 earnings growth of 10.6%. We are, however, in somewhat unchartered territory with respect to monetary policy as the Fed begins to unwind its unprecedented stimulus program. Last fall we examined the performance of the S&P500, both preceding and post historical interest rate tightening cycles, going back to 1956 for the 12 month period before the first rate increase, and the following 24 month period. While we are not yet there, historical precedents would suggest equity outperformance extending into 2014 provided earnings hold up. Another factor we are keeping a close eye on is asset flows. For the first time since 2007, U.S. asset flows into equities were positive in 2013 while for the past six months they have turned negative for bonds. Even in Canada, where equity returns were lower than in the U.S, the latest data reported for November showed a significant swing to the positive for domestic equity flows. Perhaps this can be explained by lower valuations in Canada relative to the U.S. as mentioned above.

In addition, if we compare relative dividend yield (annual dividend divided by price) of the S&P500 to the TSX we find that the current spread is 1.03% (TSX 2.95% versus S&P500 1.92%) as compared to the historical spread of just 0.52%. Assuming some level of reversion to the mean over time, this implies relative upside of over 20% for the TSX versus the S&P500. This also dovetails with our shift back into Canadian equities, which have risen from 32% to 38% of the portfolio over the past six months. In conclusion, unlike last year where the decision was whether to be in the market, 2014 will likely be a stock pickers market and we feel we will be able to add significant value in that environment.

Peter Jackson
Chief Investment Officer
January 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.

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Appendix 1
New Equity Investments-Cumberland North American Capital Appreciation Mandates
Quarter Ended December 31, 2013

Canada

Alaris Royalty Corp

Alaris Royalty Corp. invests in private companies in exchange for an ongoing royalty stream for the primary objective of generating cash flows to fund a stable dividend to its shareholders (currently 4.8% dividend yield). Alaris currently has committed capital to 13 private companies in a diversified set of industries. Each royalty stream that Alaris receives has an annual reset feature based on a revenue-driven metric. The annual reset amount usually is equal to a percentage change in gross revenue or same-store sales. In addition to the reset feature, the majority of the royalty streams have an agreed upon "collar" that limits the annual change to, on average, to +/- 5%, thereby keeping the cash flows stable from year to year. Alaris expects to deploy more than $150 million in new investments this upcoming year which should allow management to continue their track record of stable and consistent dividend growth for 2014 and beyond.

Catamaran Corporation

Catamaran Corporation is a pharmacy benefits manager (PBM), which while incorporated and listed in Canada, operates primarily in the United States. PBM's utilize large-scale aggregated buying power and cutting –edge technology to manage and control prescription drug costs for companies and health plans (like Blue Cross). Catamaran has been not only one of Canada's fastest growing technology-based companies but also one of the fastest in all of North America in the last decade. Not only has it consistently gained share by using its technology expertise and the flexibility of its smaller size versus the two industry giants (Express Scripts and CVS Caremark) to better meet customer requirements but it has also grown by a long series of strategic acquisitions. In a world starved for growth, we feel that at 19X 2014 earnings for a company that should have double-digit growth for years, the company is undervalued. The onset of Obamacare in the US has caused confusion around its effects on the company keeping its valuation low; yet our due diligence has found the legislation to be a net benefit to Catamaran.

United States

Sanofi SA (ADR)

Sanofi is a major global manufacturer of pharmaceuticals and consumer health care products, headquartered in Paris, France. Its five divisions are Pharmaceuticals, Vaccines, Generics, Animal Health, and Consumer Health. Among global pharmas, it has one of the largest exposure to emerging markets and derives its sales from the US, Europe, and rest of the world / emerging markets in roughly equal proportion. The stock was pressured in the first half of 2013 by short-term problems including inventory overstocking in Brazil, competitive pressures in Animal Health; and the slowdown in emerging markets. We believe management has competently addressed these setbacks, and over a multi-quarter timeframe, Sanofi should continue to leverage its industry-leading footprint in the fastest-growing regions. After enduring a major patent cliff over the past few years, the business is now focused on five areas less vulnerable to patent expiry: animal health,

vaccines, consumer health (over-the-counter products such as Allegra for allergies), diabetes care, biological therapies for rare diseases ("orphan drugs"), and emerging markets. Given the drug pipeline with 15 launches planned between now and 2016, and margin optimization opportunities, we expect Sanofi to achieve high single digit operating income growth over a multi-year timeframe.

KBR Inc.

KBR Inc. is a global engineering, construction, and services company supporting the energy, hydrocarbons, power, industrial, civil infrastructure, minerals, government services, and commercial markets. The business has been transitioning over the past few years away from defense/government and towards oil & gas and chemicals processing/downstream. The biggest sub-segment of KBR's hydrocarbons business is Gas Monetization, which constructs liquefied natural gas (LNG) and gas-to-liquids (GTL) facilities that allow for the commercial development and transportation of natural gas resources. The stock underperformed the overall market in 2013 because a meaningful number of project awards and final investment decisions were pushed out to 2014, resulting in a declining backlog. While visibility on exact timing is limited, we anticipate the pace of LNG and chemical facilities/processing construction will ramp up over the next few years. As the builder of one-third of the existing global LNG infrastructure, KBR has a sustainable competitive advantage in bidding on E&C contracts for these facilities. KBR also benefits from opportunities created by the US chemicals "renaissance" spurred by cheap natural gas. With a better pace of project wins serving as a catalyst, KBR's cash return to shareholders and return-on-assets profile should be rewarded with a multiple more in-line with its peer group.