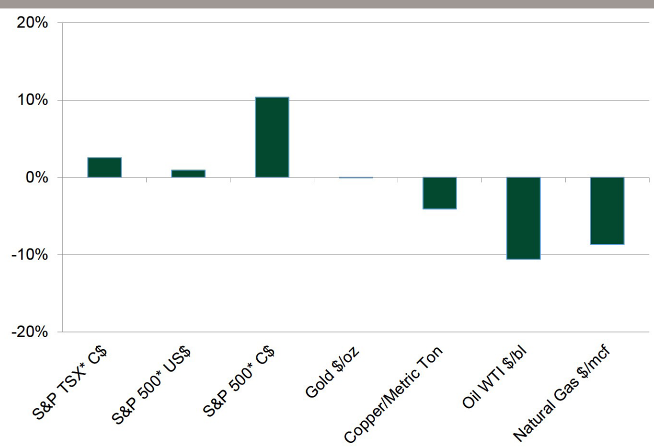
CUMBERLAND

# First Quarter Review
# North American Capital Appreciation Strategy
# March 2015

Macro events continued to dominate markets during the first quarter. The European Central Bank (ECB)'s decision to implement Quantitative Easing (QE) in January, put downward pressure on the Euro and the collapse in oil continued to hurt the Canadian dollar. While this was positive for the US dollar, it was not positive for US companies that generate earnings abroad, which currently make up about one third of the S&P500 revenues. Adding up the effects of a stronger US dollar and the impact it had on earnings revisions as well as the negative impact from lower energy prices, this managed to keep returns in North America at least in local currencies relatively flat. During the first quarter, the TSX returned 2.58% while the S&P500 returned 0.95% in US dollars.

Quarter Percentage Change to March 31, 2015




Source: Bloomberg *Total Returns

In Canada, probably the biggest surprise in the quarter was the move by the Bank of Canada (BoC) in January to lower its target overnight rate by one quarter of a percentage point. The Bank noted that the decision was in response to the recent sharp drop in oil prices, which will likely be negative for economic growth and underlying inflation in Canada. The Canadian dollar lost US $0.02 intraday and continued to decline through the balance of the first quarter. The expected widening divergence between the Canadian and US economies combined with the potential for rising interest rates later in 2015 in the U.S. resulted in the Canadian dollar declining US $0.07 during the first three months of 2015, closing at US$0.79. Adjusting for this swing in currency, the S&P500 returned 10.36% in Canadian dollars terms, a wide difference from the 0.95% in US dollar terms. That means that almost the entire return on the S&P500 measured in Canadian dollars during the first quarter resulted from currency moves rather from an increase in the actual value of the index.

Our sense is that this large drop in the Canadian dollar, which was at least partially triggered by the BoC's surprise decision to cut interest rates, was probably even more than the bank expected. It now appears the BOC is willing to see how the Canadian economy performs going into the second half of 2015 before doing anything further with interest rates. Signs of stronger Canadian manufacturing and increases in other non-energy exports, along with some stabilization in energy prices during the second half of the year would be encouraging. Meanwhile on the other side of the border, it appears the US Federal Reserve is pleased with the performance of the labour market in general (at least up until the latest March jobs data) with the latest reading on unemployment at 5.5%, three tenths below where it was last quarter. The weaker non-farm payrolls report for March will likely call into question the timing of the first Fed interest rate hike. However, wages did increase more than expected, which is also an important factor on the Fed's watch list. The latest reading on core inflation at 1.7%, remains below the Fed's target of 2%. However, the Fed believes that as the unemployment rate declines closer to 5%, wage inflation should push price inflation closer to the Fed's target of 2%. Meanwhile the transitory effects on inflation of low oil prices and declining import prices in light of the recent appreciation of the US dollar could impact the timing and path of the federal funds rate following the initial rate hike. Putting this all together, it seems that the Canadian dollar may have stabilized, at least for now.

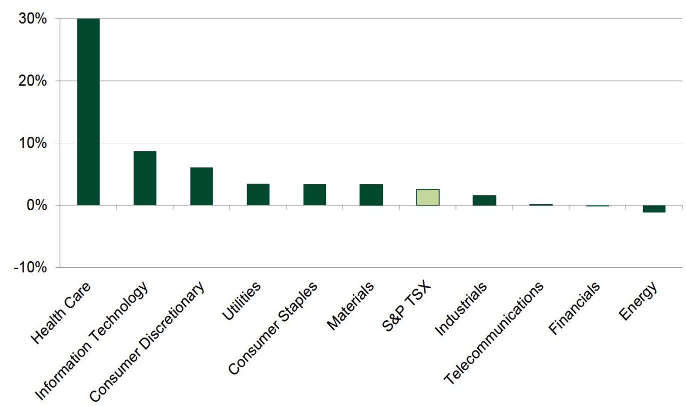
The wild card in that analysis is probably the price of oil. Oil fell 10.6% in the first quarter closing at $47.60 per barrel. While down, this is a far cry from the 49% drop in the second half of 2014. Last quarter, we said we would monitor indicators that might signal when a bottoming process in oil is taking place. One such indicator is the U.S. oil rig count. The U.S. rig count has now fallen 46% from its peak in October and 60% in Canada from last year's levels.

# North American Capital Appreciation Strategy
# March 2015

In the U.S., 90% of this drop was related to drilling for crude oil and 61% of the rigs stacked were the horizontal and directional rigs that caused the oil supply glut to begin with. We estimate the annualized opportunity cost in lost production from the decline in the rig count, at about 1.5 million barrels per day, has been removed from the market at current oil prices. Production continued to grow through the first quarter in the lower 48 states from 9.1mm bpd to 9.4mm bpd as the backlog inventory of wells drilled in 2014 were brought on production. However, data released the first week of April showed the first production decline in the lower 48. One data point is clearly not a trend but may be an indication of a supply inflection point. With lower pricing, global oil demand is also recovering faster than expected from the mid 2014 trough and is now approaching its historical range of annual demand growth of 1.0%-1.5%. We are also monitoring the level of inventories of crude in the U.S., which are at record highs on an absolute basis, however this fails to take into account the growth in storage capacity. A potential decline in production and seasonally higher refinery demand, which starts to pick-up around now, may help reverse the downward trend in oil prices. In the meantime, companies with downstream refining exposure such as Suncor and Cenovus, which were added in the first quarter, are benefitting from the higher refining margins in North America due to the large spread between the U.S. oil price and world oil prices, which provide a benchmark for downstream prices here in Canada and the U.S. Iran is also clearly a factor in the supply equation, however the likelihood of a quick emergence in Iranian production is low since before anything happens, this requires a detailed technical agreement on steps to reduce Iran's nuclear program which will take some time. It is likely that by then, the global supply/demand balance should be able to absorb further Iranian production.

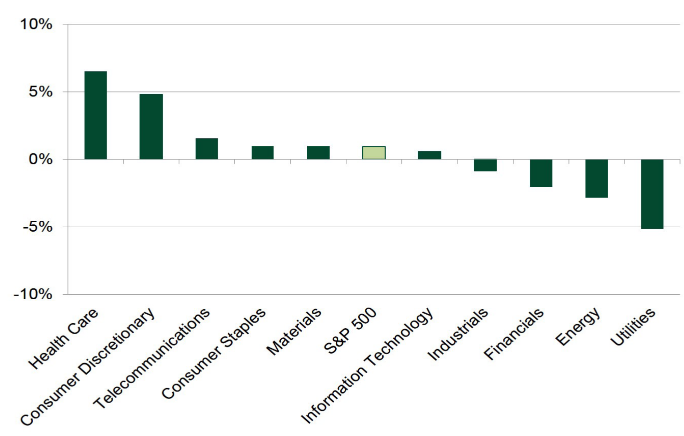
Taking into account how other global events might affect North American markets, the QE program announced by the ECB was generally received as being large and open-ended with many expecting it to continue beyond the target completion date of September 2016, "until there is a sustained adjustment in the path of inflation". The effect is to continue to drive long term yields even lower in the EU and has spilled over into both lower rates here in Canada and the U.S. given the relative attractiveness of our bond yields in North America. The improving liquidity situation in the EU, low oil prices and the lower Euro are having a positive impact on Euro zone manufacturing, which rose in March to a ten month high. Meanwhile, China continues to face a further slowdown in GDP growth which is forecast to be 7% in 2015 down from 7.4% in 2014. On a relative basis, this seems robust compared to other regions, however it represents a fifteen year low for the world's second biggest economy and will likely continue to keep downward pressure on both bulk and base metal commodities in the near term.

S&P TSX Sector Performance (C$)
1st Quarter 2015




Source: TD Securities

S&P 500 Total Returns (US$)
1st Quarter 2015




Source: TD Securities

# North American Capital Appreciation Strategy
# March 2015

During the quarter, the Health Care and Consumer Discretionary sectors continued to dominate the performance both north and south of the border. Health Care is expected to report the highest earnings growth in the first quarter of the ten sectors in the S&P500. The Health Care group also saw a significant amount of consolidation during the quarter including United Health's purchase of Catamaran Corporation at a 27% premium to the previous day's close. Catamaran was originally purchased at Cumberland in late 2013 and represented a total gain of about 51% in the portfolio. During the quarter we also added Perrigo Corp. to our Health Care holdings. Perrigo develops, manufactures and sells "over the counter" (OTC) health care products and generic pharmaceutical products. The private-label OTC category is growing, owing to an aging demographic that is price conscious, as well as the increased number of branded drugs going OTC in the next decade. Given these trends, we believe Perrigo is well placed for further growth and now represents a core position in our client portfolio.

The Consumer Discretionary sector, which performed relatively well in the first quarter, is also expected to show above average earnings growth despite this group not being particularly cheap anymore relative to other sectors based on forward price earnings. During the quarter within our consumer group we trimmed CBS and sold Target after a decent run up in the stock in a relatively short period of time. One new name added here was Time Inc. Time is the largest magazine publisher in the U.S. with 7 of the top 25 titles including Time, People and Sports Illustrated. Time is in the early stages of a substantial restructuring program designed to increase margins, improve free cash flow and accelerate the shift toward greater digital content offerings. The 3.4% dividend yield also supports a compelling valuation relative to its peers.

Turning to the sectors that lagged, Energy continued to underperform. There were a significant number of large equity financings both north and south of the border within the energy sector during the first quarter as companies were pressed to shore up their balance sheets. It is interesting to note that the demand for these deals was overwhelming in many circumstances, with many stocks trading higher post issue. We added to our Energy weight during the quarter including the purchase of Pembina Pipeline Corporation and Cenovus Energy. Cenovus is a large integrated oil company with assets in oil sands, refining and marketing and conventional assets. Cenovus' oil sands assets represent some of the lowest cost oil sands operating assets in Alberta. With the expansion of these assets being modular in nature, they offer a significant runway for future growth in a manner that does not require multi years of up front capital. Cenovus is also in a 50/50 partnership with Phillips 66 in two leading U.S. refineries. Refining and marketing provides access to global market prices for Cenovus' crude. Pembina transports 50% of all conventional crude oil and 30% of all natural gas liquids in Western Canada. A large portion of that is sent to Pembina's midstream division which performs natural gas liquids (NGL) fractionation and crude oil handling before the product is transported and sold to refineries. Pembina handles oil and gas molecules from the wellhead to the refinery door and as a result is able to earn multiple fees along the supply chain. Pembina's committed projects should see EBITDA growth from its current level of $1 billion to $1.7 billion by 2018. This is largely underpinned by long term take or pay agreements with producers of high credit and operational quality.

Financials also continued to underperform this quarter notwithstanding the fact that the outlook for earnings growth in the first quarter looks attractive, in fact second only to Health Care. The bear case for banks is that falling long term interest rates have the effect of depressing net interest margins or bank profitability. Also, the overhang of regulatory uncertainty and litigation resulting from the past financial crisis has continued to weigh on the group. Offsetting this, banks remain about the cheapest sector in the S&P500 and with a stronger U.S. economy and higher loan growth we expect earnings to accelerate. Banks should also benefit from a steeper yield curve in the event rates do begin to rise in the second half of 2015. During the quarter, we added Bank of America, one of the US nation's largest banks and most levered to rising rates. We believe continued improvement in asset quality and expense control, combined with rising rates later in 2015 should lead to outperformance for the bank and the sector.

# North American Capital Appreciation Strategy
# March 2015

During the quarter, we also added a new position in Arris Group. Arris provides media entertainment and data communication solutions in the U.S. and internationally. A complete 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 March 31, 2015 | |
|---|---|
| Equities | 79% |
| Fixed Income | 10% |
| Cash | 11% |

During the first quarter, our asset mix shifted 5% in favour of cash from equities. Our Canadian exposure has declined from 43% to 34% while our U.S. exposure increased from 41% to 45%. Much of the decline in Canadian equity exposure occurred very late in the first quarter with the sale of Catamaran. In Canada, our exposure to materials also declined. Our energy exposure increased in Canada through the names previously discussed, however our weight in this group remains lower than 50/50 TSX/S&P500 benchmark weight. We continue to hold a small exposure to gold through our holding in Goldcorp. This is a contrarian call given the US dollar strength, however gold has managed to stabilize in the $1,200 range since last fall and Goldcorp is free cash flow positive at that level. In the U.S., as previously discussed, we added a number of new stocks to the portfolio. Our largest weight continues to be in Financials and our weighting increased through the purchase of Bank of America. The balance of the growth in U.S. exposure was capital and currency appreciation. Foreign exchange had a positive impact this quarter as we removed the currency hedge in our Canadian dollar reported portfolios in January at slightly under US $0.83.

Bond yields in Canada and the U.S. declined during the quarter, having now declined for the last five quarters. The yield on the Government of Canada 10 Year bond started the year at the highest yield for the quarter at 1.79% and declined to 1.36% by March 31st, 2015. In the US, the yield on the 10 Year Treasury declined from 2.17% to 1.92%. These material declines in yields (and therefore increases in bond prices) were mainly driven, yet again, by extremely accommodative changes in monetary policy. Firstly, on January 21st came the Bank of Canada's (BoC) surprise 0.25% cut to Canada's overnight target rate. Then on January 22, citing unacceptably low inflation expectations, ECB President Mario Draghi announced the much anticipated launch of a European sovereign bond buying program. As already discussed, although the launch of a program was anticipated, it was the monthly quantity (€60 billion) and duration (to be carried out "until at least September 2016") that surprised the bond market. The ECB's program has had a profound impact on bond yields in Europe. For example, the yield on a German 10 Year bond is now below 0.20%, and bonds with maturities of 7 years or less are now priced to have a negative yield, meaning an investor has to pay the German government to own a German government bond. Although the ECB's policy has understandably had a direct impact on bond yields in Europe, it also has an indirect impact on other countries' sovereign bond yields. For example, with yields so low in Europe, Canada's 10 Year bond yield of around 1.5% looks outright cheap on a relative basis (e.g. compared to Germany's 0.19%) to global bond investors. The relative "cheapness" allows investors to continue to buy Government of Canada bonds thereby keeping bond yields at low absolute levels and bond prices elevated. The ECB's actions coupled with the decline in oil prices and the BoC's rate cut has resulted in continued flows into the fixed income asset class. The availability of low yields and the asset class flows were not overlooked by corporate issuers during the quarter. In Canada, companies issued C$30 billion of bonds during the quarter, the highest level of quarterly issuance ever. Such volume usually causes credit spreads (the extra yield demanded by investors for taking company risk versus government risk) to widen, thereby cheapening the price of the bond and making it more attractive. However, this quarter bond investors absorbed the issuance with little impact to corporate spreads resulting in corporate bond yields remaining low and therefore generally expensive, in our view. At Cumberland, we continue to view interest rates as artificially low due to extreme central bank monetary policies. Central banks have signaled they are determined to raise inflation expectations and will likely continue to shock markets until inflation begins to increase. Such outcome could cause bond prices to fall and bond yields to rise. We therefore continue to view it prudent to keep the duration short (low sensitivity to changes in

# North American Capital Appreciation Strategy
# March 2015

interest rates) and generate income by investing in select corporate bonds, preferred shares and dividend-paying common shares.

## OUTLOOK

At the start of the year, earnings for 2015 were expected to increase 8.3% based on expected earnings of about $127 for the S&P500. Today according to Factset, consensus earnings for 2015 for the S&P500 are estimated to increase 2.5%. Most of the concerns about lower earnings relate to the strong US dollar as about one third of S&P500 revenues in aggregate come from non-US sources. Other factors contributing to lower earnings include slowing global growth and lower earnings from energy producers and related industries. Given the S&P500 began the year at 2,058.9 and closed the March quarter at 2,067.9, not much has changed in the numerator for the price/earnings (P/E) equation. Based on forward earnings estimates for the next twelve months, what we have referred to in our previous quarterly reviews, the market is currently trading at 16.7x. This compares to the forward P/E three months ago of 16.3x and three months prior to that of 15.2x. Recall the long term average P/E is 15.4x.It is hard to argue that the market is super cheap here but the outlook for earnings in 2016 is better. The consensus is for earnings to recover in 2016 to about $135.5, which could support a higher valuation than today. What is supporting equity valuations currently is the very low level of bond yields. Based on our equity risk premium model, it would suggest a normalized level for the S&P500 of about 13% higher. While the current earnings projections are somewhat disappointing (although not that unexpected), the valuation today is still reasonable in the context of the extremely low level of interest rates. We believe that in order for the Federal Reserve to have a shot at raising rates later in 2015, it will likely require a continuation of the economic recovery leading to stronger employment and higher inflation. This should support some level of earnings recovery later in 2015, otherwise rates are likely to remain low and the market range bound. In that context, we are finding some cheap companies to buy, the forward P/E on your portfolio is only 15.3x with better earnings growth characteristics than the market. We will be opportunistic in putting cash to work with the view that if we do not see the right opportunity, we are content holding some cash and waiting for one.

**Peter Jackson**
**Chief Investment Officer**
**April 5, 2015**

# Appendix 1
# New Equity Investments:
# Cumberland North American Capital Appreciation Mandate
# Quarter ended March 31, 2015

<u>**United States**</u>

### Perrigo Corp.

Perrigo (PRGO) develops and sells OTC healthcare products, generic prescription pharmaceuticals (mostly topicals for dermatological applications) and active pharmaceutical ingredients. The company is the largest global manufacturer of store brand OTC healthcare products (~75% US market share) and store brand nutrition products (~25% US share). Within OTC, the major product categories sold include analgesics, gastrointestinal, cough/cold/allergy/sinus, smoking cessation, pet care, feminine hygiene, diabetes care and dermatological care. Perrigo inverted to Ireland through the 2013 acquisition of Elan and in the process gained an attractive tax structure.

Perrigo operates in an industry with attractive long-term characteristics. Consumers are increasingly switching over to private label options which are priced at a discount to the branded products while offering the same level of quality. The private-label OTC category is growing, owing to an aging demographic which is price conscious and the increased number of branded drugs going OTC over the next decade. Given these trends, we believe Perrigo is well placed for further growth and owing to its advantageous tax rate, the company can reap greater cost savings from acquisitions. The current management team is highly regarded and has a strong track record of growing revenues and margins.

### Time Inc.

Time Inc. (TIME) is the largest magazine publisher in the U.S. with 7 of the top 25 titles including People, Sports Illustrated, Time and Southern Living. TIME was spun out of parent company Time Warner in 2014 and is in the early innings of a substantial restructuring and asset disposition program, which is designed to increase margins, improve cash flow and accelerate the shift towards digital content offerings. Although the legacy print magazine business is likely to modestly decline, Time Inc. is well positioned to continue to take market share and consolidate the industry, resulting in stable and high cash generation that can be re-invested into online products and support a significant +3% dividend yield. Over the medium-term, TIME's highly regarded editorial content and its digital platforms are expected to grow at a rapid pace. Currently with 6 billion page views per quarter, 131MM unique visitors per month and only having taken recent control of their websites, Time Inc. has a solid footing from which to build and grow a successful digital and video offering, resulting in steady growth and improved returns on invested capital. We view TIME's current valuation discount to lower quality and less well established peers as a compelling opportunity to invest behind the structural demand trend for digital content consumption.

### Arris Group Inc.

Arris Group (ARRS) is a global communications technology company specializing in the design and engineering of broadband local access networks. The company's products include optical transmission, cable telephony, internet access and video broadband technology for cable system operators. ARRS has been one of the main beneficiaries in the growth of video traffic over the internet and its equipment enables broadband providers to satisfy increasing bandwidth requirements from consumers. The company's set-top-boxes (STB) and modems also enable cable operators and pay TV providers to provide enhanced features that facilitate the structural shift towards unified home entertainment. Current uncertainty around Net Neutrality and Title 2 regulation for cable and wireless operators, along with the pending merger of Comcast and Time Warner Cable, has led to lumpiness in Ariss Group's quarterly results and has resulted in a depressed valuation. We believe this uncertainty creates opportunity. ARRS continues to report strong Y/Y growth even in this environment and is currently yielding 12.5% in free cash flow. With a significant runway of growth ahead of them in international markets the stock is an attractive buy.

### Bank of America Corporation

Bank of America (BAC) is one of the largest consumer focused banks with over 80% of revenues within United States. The bank operates 5 segments in consumer & business banking and has the largest deposit base and branch network in United States. Over the last year BAC's

# Appendix 1
# New Equity Investments:
# Cumberland North American Capital Appreciation Mandate
# Quarter ended March 31, 2015

stock had been under pressure as it reeled from crisis era litigation expenses and the bank faced increased capital requirements from Basel 3 and SIFI regulations. In August 2014 the bank announced a $16.7B settlement with DOJ which put the mortgage lending litigation issue behind them. The regulatory requirements are also well understood by the street now and over the last year BAC has taken significant steps to reduce costs and re-focus the business to improve ROE. BAC's profitability was also pressured over the last year driven by a lower interest rate environment resulting in NIM compression. BAC's large consumer deposit base is a source of low cost funding and BAC should be a major beneficiary when interest rates rise. We see BAC as a story in transition as declining crisis-related expenses and reduction in core expenses give way to meet/exceed Basel 3 capital/liquidity targets. An improving US economy, the specter of higher interest rates and greater control over operating leverage should also result in healthy EPS growth. BAC's normalized earnings should also benefit from the large cost-cutting program under way, reductions in large legacy asset servicing costs and declining litigation expenses.

<u>Canada</u>

**Pembina Pipeline Corporation**

Pembina pipelines (PPL) is one of North America's largest integrated midstream energy companies with a diverse portfolio of assets located throughout the Western Canadian Sedimentary Basin. Pembina Pipeline Corporation transports 50% of all conventional crude oil and 30% of all natural gas liquids in Western Canada. A large portion of that is sent to Pembina's midstream division which performs natural gas liquids (NGL) fractionation and crude oil handling before the product is transported and sold to refineries. Pembina handles oil and gas molecules from the wellhead to the refinery door and as a result is able to earn multiple fees along the supply chain. Pembina's $6 billion in committed projects should see EBITDA growth from its current level of about $1billion to $1.7billion by 2018. This is largely underpinned by long term take or pay agreements with producers of high credit and operational quality.

**Cenovus Energy Inc.**

Cenovus Energy Inc. (CVE), an integrated oil company, develops, produces and markets crude oil, natural gas liquids (NGL's) and natural gas in Canada with refinery operations in the United States. Cenovus' oil sands assets represent some of the lowest cost oil sands operating assets in Alberta. With the expansion of these assets being modular in nature they offer a significant runway for future growth in a manner that does not require multi years of up front capital. Cenovus is also 50/50 partnership with Phillips 66 in two leading U.S. refineries. Refining and Marketing provides access to global market prices for Cenovus' crude. The stock has lagged due to a large equity recapitalization that took place during the first quarter. We believe this combined with improving refining margins in their downstream operation should help mitigate further downside until oil prices begin to recover.