CUMBERLAND

Strategy Review
October 2012

After a weak second quarter that saw the S&P 500 ($U.S.) fall 2.8% and the TSX down 5.7%, both U.S. and Canadian equity markets rallied in the third quarter on stronger than expected second quarter earnings and the prospects that central bankers would provide more monetary stimuli to help bail out stagnating global economies. On July 26th ,the market seemed to get exactly what it wanted when the European Central Bank president, Mario Draghi, said he would do whatever was needed to keep the continent's monetary union in place to preserve the Euro. Then on September 13th, in a widely anticipated move, the Fed announced that it would purchase $40 billion a month in mortgage-backed securities. Unlike previous rounds of quantitative easing, Mr. Bernanke did not set a limit on how much the Fed would spend and instead tied the timeline of commitment to improving labour markets. The Fed also extended its commitment to keep interest rates "exceptionally low" to at least mid-2015 from late 2014. While the Fed response in general was widely anticipated, what was surprising was the open-ended nature of this third round of quantitative easing.

The sweeping measures taken by the Fed were enough to push the S&P 500 to its highest level in five years. In the third quarter, the S&P 500 ($U.S.) rose 6.4% (only 2.7% in C$ as a result of the stronger C$ during the quarter).The effect of further monetary stimulus also pushed oil prices back up through U.S.$100 per barrel for a brief period, gold to its highest level in almost a year and base metals, copper and nickel, to four month highs. This provided a welcome lift to the resource oriented TSX. In the third quarter, the TSX increased 7.0% on a total return basis.

During the third quarter, the strongest performing sectors in the S&P 500 ($U.S.) were Energy (10.1%), Consumer Discretionary (7.5%) and Information Technology (7.4%) while the defensive sectors including Utilities (-0.5%) and Consumer Staples (3.8%) lagged. The strongest performing sectors within the TSX were Materials (13.1%) and Energy (8.5%) as gold rose 11% in the quarter to U.S.$1773.90 per ounce and copper increased 8% to U.S.$3.73 per pound. While oil initially rallied through U.S.$100 per barrel, it ended the quarter at U.S.$92.19 per barrel for a gain of 9% on the quarter. The upward move in commodities appears to have occurred in anticipation of QE3 with little follow-on buying as most prices have either plateaued or retreated since the Fed announcement. Concern over the economic outlook in China and Europe is not helping as economists continue to cut their forecasts for Chinese and European growth. Short of an exogenous oil price shock from the Middle East it is hard to see the price of oil gain much more from here. With the advent of new technology, oil production in the U.S. is now back at levels similar to 1998. In 2005, petroleum imports accounted for 60% of U.S. consumption whereas in 2012 the number is expected to be 42%.

Asset Allocation for Capital Appreciation Portfolios (As at Sept 30, 2012)	
Equity	76%
Bonds	11%
Cash	13%

During the third quarter, the overall asset allocation was essentially unchanged in our core Capital Appreciation mandate. Within the equity allocation, our exposure to U.S. equities rose from 30% to 32%, while Canadian exposure declined slightly. The biggest sector increases were in Financials where we added to existing positions in JP Morgan Chase and Canadian Imperial Bank of Commerce, and Consumer Discretionary with the addition of Newell Rubbermaid Inc. Other new positions added in the quarter included Baytex Energy Corporation and Domtar Corporation. The biggest sector decreases were in Energy and Industrials with the sale of ShawCor Ltd. as well as Dun and Bradstreet. Both companies announced a strategic review process which included a potential sale of the company resulting in sizable gains in the share prices over a

relatively short time period. Taking a prudent approach, we decided to lock in these gains. A summary of all new positions added during the quarter including business fundamentals and valuation metrics is contained in Appendix 1 herein.

Regarding our income oriented investments, during the quarter bond yields continued on their 30 year plus decline, hitting an all time low in July of 1.57% on the ten year Canada bond. Investor concerns over the fate of the Euro zone have continued to drive yields lower. We believe that the greatest risk to bond portfolios is a sustained reversal of this trend and therefore have maintained a low duration in our bond holdings. During the third quarter, the overall return of the Cumberland Capital Appreciation mandate compared favourably on a risk adjusted basis to the 50%TSX/50% S&P500 benchmark in Canadian dollars with the overall return on the portfolio matching the combined indices despite the relatively conservative asset mix of the portfolio compared to the fully invested benchmark.

Outlook

As we head into earnings season, the consensus estimated earnings growth rate for the S&P500 for the third quarter is -2.7%, the first negative growth rate in 11 quarters. On June 30th, the expectation was for +1.9% growth rate in third quarter earnings. Many bellwether companies have provided negative guidance going into the third quarter. In fact, of the 103 companies that have issued guidance so far, 80 have been negative, which is the largest percentage negative since 2006. With respect to the impact of QE3, while another round of quantitative easing is understandable, there is already a lot of liquidity in the market, so it is questionable how much this might help the economy. Even with an upbeat September employment number the S&P500 was unable to hold on to its gains following the announcement. With the S&P500 trading at 12.8x forward earnings and the TSX at 13.8x it is hard to argue that the markets are expensive. Having said that, the year to date total return for the S&P500 ($U.S.) at the end of September was 16.4% (12.4% in C$) compared to the TSX total return of 5.4%.We continue to expect the market to grind higher here but once the U.S. election is over it will likely, once again, focus on issues surrounding the fiscal cliff as well as continued economic uncertainties in Europe and China. Our strategy has been to lock in gains where we have them and, for option eligible accounts, to reduce volatility by writing covered calls and purchasing puts on the S&P 500 for about one half of our U.S. exposure. While we will continue to pursue investing in companies with high free cash flow yields, superior returns on capital employed and trading at significant discounts to intrinsic value, this short term strategy allows us to participate in any further market appreciation but, including our cash and bond exposure, protect nearly 40% of the portfolio from a possible equity market pullback through the end of the year.

Peter Jackson
Chief Investment Officer
October 2012

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

Appendix 1: New Equity Investments-Cumberland North American Capital Appreciation Mandate Quarter Ended September 30, 2012

Canada

Baytex

Baytex is a perennial favourite oil producer at Cumberland. When the stock corrected from $58 per share to $40 per share with the pull-back in oil prices earlier this year we initiated a position in this company. Baytex has consistently grown its oil reserves and production at a five year compound annual growth rate of 13% and 9%, respectively. Management has laid out a plan to continue to organically grow its production 8%-9% per annum for the next five years. Baytex is one of the financially strongest oil producers and currently pays a dividend of 5%. It has a demonstrated track record of increasing its dividend at a compound annual growth rate of 7% per annum for the past three years. Baytex currently trades slightly above its net asset value of about $40 per share, which does not include 700mm barrels of contingent reserves that have an additional estimated value of about $4.9B or $40 per share.

United States

Newell Rubbermaid

Newell Rubbermaid's household-name brands include Rubbermaid, Levelor, Paper Mate, Sharpie, Waterman, Caphalon, Lennox, Irwin tools, and baby brands Graco and Aprica. Most brands are #1 or #2 in their segment, with two-thirds of sales coming from the US, and 50% of production outsourced. Management's strategy is to accelerate top line growth by devoting resources more thoughtfully to areas with the most growth potential, and streamlining the sales organization. The stock's current dividend yield is 2.2%, after a 25% increase in May 2012. Management plans to gradually raise the dividend payout ratio from the current 22% to 30-35%. Newell's high free cash flow yield gives it room to raise dividends and repurchase stock; $87mm was bought back over the past 6 quarters. With no major acquisition plans and reduced capital expenditure intensity, thanks to the outsourced model, this return of cash to shareholders is expected to continue. Management anticipates EPS growth to accelerate from 3-6% this year to 6-9% by 2014 based on smart allocation of resources towards driving demand in key areas, and better penetration of Emerging Markets. With only 5% overall share of its global addressable markets of $120 billion, Newell has a lot of runway to grow.

Domtar

Domtar is the second largest producer of writing papers (ie: paper for photocopiers or envelopes) in the world. While not a growth market, the North American writing paper market is an oligopoly with the top three producers controlling over 70% and jointly acting to preserve stability and profitability. With no need to build new plants, this business has minimal capital spending and throws off a remarkable level of free cash-flow. Domtar is in the fortunate position of having the choice of either spending this cash-flow to build out its presence in growing markets such as tissue and incontinence products or returning cash to shareholders through dividend and stock buybacks. With its high level of free cash-flow, the company could buy back all of its stock in under 7 years if it focused solely on that goal.