CUMBERLAND

Strategy Review
October 2013

The S&P 500 continued its advance in the third quarter reaching record highs in early August. Strong manufacturing data and better than expected second quarter earnings reports helped propel the S&P 500 through the 1,700 level for the first time ever. The earnings growth rate for the index in the second quarter of +2.1% year over year was considerably better than forecasts and marked the third consecutive quarter of positive earnings growth. The market's focus then shifted to rising bond yields as better economic data spurred concerns that the U.S. Federal Reserve ("the Fed") would reduce ("taper") its $85-billion-per-month bond buying program in September, which would be sooner than market expectations, The bond buying program is aimed at keeping borrowing costs down and fueling the economy. News about chemical weapons attacks against civilians in Syria on August 21st added to the geopolitical nervousness in the markets as the likelihood of a retaliatory strike against Syrian President Bashar al-Assad's forces grew. Gold spiked up through $1,400 per ounce and oil rose over $110 per barrel, while the S&P 500 pulled back almost 5% from its early August highs.

Equity markets began to recover in September as it became more likely that a political resolution for Syria would be attained. The balance of market attention was back to whether or not the Fed would reduce its bond buying stimulus program. Its decision NOT to reduce bond purchases at this time caused a rally in equities and the S&P 500 once again hit new all time highs. The TSX also jumped to its highest level in over two years. At the top of the list of reasons for not reducing bond purchases was the recent rise in mortgage rates, which increased over 1% since May of this year. There is little doubt in our minds that the plunge in mortgage applications to the lowest level seen since November 2008 (likely a result of rising interest rates) the week before the Fed's decision, was an important piece of data. It seemed highly unlikely that the Fed would want to undo all that has been done to resurrect the U.S. housing market by allowing rates to rise further. Along with the decision to continue to stimulate the economy by not reducing bond purchases, the Fed reiterated that further bond purchases were not on a preset course but rather tied to improvements in economic data and would continue to be monitored over the coming months. All this would suggest to us a more gradual pace to rising rates going forward. The total return for the S&P 500 in the third quarter was +5.3% in US$ or +2.9% in C$ as a result of a stronger Canadian dollar in the quarter.

Given the market's expectation for the Fed to reduce bond purchases in September, bond yields continued to rise through the third quarter with the U.S. 10 year bond hitting a high of 3.0% in early September from a low of 1.6% in May. With the surprise announcement of NOT reducing bond purchases, the Fed has once again relied solely on "moral suasion" to get interest rates down. That is, it didn't actually have to take any actions in order to influence the market. It seems that the rise in interest rates was just too much and too soon as it ran the risk of slowing demand for homes and autos which have been the drivers fueling the growth in the U.S. economy. In addition, given the Fed's focus on employment and price stability, the latest economic data seemed to support this tactic with the unemployment rate remaining elevated and job growth, while improving, running below the pace seen in prior economic recoveries. Meanwhile the rate of inflation continues to track below the Fed's long run goal of 2.0%-2.5%. As a result, by the end of the third quarter the Fed helped drive the US 10 year bond yield down to 2.6% which was only marginally higher than where it ended in the second quarter.

The TSX returned 6.3% in the third quarter as the heavily weighted financials and oil and gas sectors both performed well and in line with the overall market performance. After the meltdown witnessed in gold and copper last quarter, it is not surprising to

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have seen some recovery in the metals during the third quarter. Gold rose 7.2% to US $1,328 per ounce and copper increased 8.8% to close at US $3.32 per pound. This leaves us wondering whether this is the beginning of a recovery or just a dead cat bounce for the metals. Inflation remains very low and directionally, we still believe interest rates will rise over time, which is not supportive of gold. Copper requires a recovery in emerging markets on which we are keeping a close watch. As for oil and gas, oil rose 6.0% in the quarter to US $102.33 per barrel and natural gas fell -0.3% to US $3.56 per mmcf. Most of Cumberland's resource exposure remains in oil and liquefied natural gas (LNG) related equities, where we have continued to build exposure and which were accretive to performance in the third quarter. We believe the build out of LNG to supply Asian markets over the next decade represents a major structural change to liquids rich gas production in Western Canada.

During the third quarter, the strongest performing sectors in the S&P 500 were Materials (+10.3%), Industrials (+8.9%) and Consumer Discretionary (+7.8%). The recovery in Materials followed the improvement in commodity prices in general, while Consumer Discretionary continued to outperform driven by better than expected second quarter earnings. We remain overweight in the consumer discretionary sector which continues to offer one of the strongest earnings profiles for 2013 and 2014. The worst performing sectors in the S&P 500 during the third quarter were Telecommunications Services (-4.4%), Utilities (+0.2%) and Consumer Staples (+0.8%). The leadership in the market has definitely shifted away from the defensive premium valued equities that dominated performance in the first quarter of 2013 towards the cyclically oriented sectors that should benefit from stronger economic growth.

In Canada, the top performing sectors were Healthcare (+10.9%), Consumer Discretionary (+8.3%) and Financials (+7.4%). Our exposure to Canadian banks continues to provide steady returns and should benefit as interest rates move higher. Similar to the U.S., the worst performing sectors on the TSX were Utilities (-3.1%) and Consumer Staples (+3.3%).

Asset Allocation for Capital Appreciation Portfolios As at September 30, 2013	
Equity	78%
Fixed Income	9%
Cash & Equivalents	13%

During the third quarter, our asset mix was relatively unchanged from that of the previous quarter. Our equity and fixed income exposure each rose 1% while cash & equivalents decreased 2%. The equity exposure, which reached 84% in the first quarter, has since declined after taking gains from a strong run in equities, particularly in the U.S. The exposure to U.S. equities declined 3% during the third quarter to 40% while the Canadian exposure increased 4% to 38%. The largest sector increases during the quarter were in Consumer Discretionary and Energy. Consumer Discretionary additions during the quarter included CST Brands, Brinker International and CBS Corporation. In addition to the strong earnings profile for the sector, in the case of CBS, we believe the balance of power has structurally shifted away from media content distribution in favour of media content providers of which CBS is a leading industry player. This shift in power has the potential to significantly improve revenues to CBS going forward. In Energy, we have continued to invest in companies that will benefit from the build out of Western Canadian liquefied natural gas (LNG). Our focus continues to be on the energy service providers where we believe the greatest operating leverage exists. Additions to Energy in the third quarter included Trinidad Drilling and ATCO Ltd. Financials continue to be our largest sector exposure and offer the greatest earnings growth while trading at the lowest sector valuations. Other positions purchased during the quarter included Labrador Iron Ore Royalty Corporation, Con-Way Inc. and Xerox Corporation. A summary of all new positions added during the quarter including business fundamentals and valuations metrics is contained in Appendix 1 herein.

During the third quarter, the overall return of the Cumberland Capital Appreciation mandate compared favourably on a risk adjusted basis to the benchmark in Canadian dollars, with an overall return exceeding the benchmark by a healthy margin despite a more conservative asset mix in the portfolio compared to the fully invested benchmark.

With the Fed's September decision to leave its bond purchase program unchanged, coupled with an economy that, albeit growing, does not appear to show signs of accelerating, we currently anticipate interest rates to take a "pause" from their recent increasing trend and be range-bound near current levels. As a result, within our income mandate we expect to opportunistically deploy some cash into corporate bonds and preferred shares. In addition, the newly appointed Fed Chairman, Janet Yellen, has a reputation for being in favor of very accommodative monetary policy and would therefore be less likely to support decisions that result in higher interest rates that could potentially slow economic growth. In our view, Yellen's appointment further increases the probability of interest rates remaining range-bound in the near term reinforcing our updated outlook for interest rates. However, our longer term central investment thesis remains unchanged: the current low interest rate environment is being manufactured by the Fed's policies and therefore risk is skewed to declining bond prices due to rising interest rates as the economy continues to improve. Consequently, we continue to focus on preserving capital by maintaining a bond portfolio with a low duration (low bond price sensitivity to interest rate movements) of 2.9 years and generating income primarily from securities issued by corporations with attractive credit characteristics.

For now, the world feels like a better place. Geopolitical risks are reduced. Oil prices are lower but not too low. Bond yields are down and the Fed is in no rush to reduce monetary stimulus. The uncertainty surrounding the U.S. budget issues and debt ceiling could create some volatility; however, we think these issues will get worked out and any near term negative stock market momentum will be short-lived. The global economy is growing again. The September Global Purchasing Managers Index (PMI) increased to a 27-month high with gains in both developed and emerging markets. This should help drive upward revisions to economic forecasts in the coming weeks and months. In terms of liquidity, as Cumberland's Chairman Gerry Connor likes to point out, liquidity always trumps the economy when it comes to driving the direction of markets. Year to date, total estimated flows into equity long term mutual funds are positive for the first time in seven years, while money has flowed out of bond funds. BMO Capital Markets estimates the S&P 500 market return is 5 times higher on average when money is flowing into stocks compared to when it is not.

So what about valuation? While estimated earnings growth has slowed in the third quarter for the S&P 500, negative earnings pre-announcements this quarter have so far been the second lowest in two and a half years. Analyst estimates for the fourth quarter are now predicting double digit earnings growth in five of the ten S&P 500 sectors. And with leadership shifting from more defensive sectors to more economically sensitive cyclical areas driving the market, this is more typical of a market experiencing an earnings recovery. It also suggests the market breadth (the number of companies advancing relative to the number declining) is

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improving, which is positive as the market technicians would note. However, so far the 12 month forward market multiple on earnings in the S&P 500 has risen 15.2% year to date (from 12.5x to 14.4x) which accounts for 77% of the total return for the nine months ending September 30th. So that's the bad news since stock price improvements are being driven less by increases in underlying company earnings. The good news is that there appear to be decent prospects for higher earnings growth going forward, as discussed above, and the historical average price to earnings (P/E) ratio currently at 14.4x is still below the 25 year average of 15.4x. The 25 year range has been 10x to 25x. This suggests to us that there is still room for the S&P 500 to go higher from here. Another way to look at it is the inverse of the P/E multiple or the earnings yield (E/P which is currently 6.9%) and compare this to the U.S. 10 year bond yield, currently 2.6%. Long term, these yields have more or less tracked one another 1:1, but even if we look at the average difference for the past ten years this risk premium (the difference between the earnings yield and the 10 year bond yield) has averaged 2.6% versus the current level of 4.3%. If in fact these yields begin to converge by either the earnings yields declining and/or bond yields increasing, either would be positive for stocks assuming real GDP growth and negative for bonds. Given that the Fed is in no rush to drive up long term interest rates any time soon, there is also time for earnings to improve, justifying higher stock prices. Finally, as greater confidence builds, the risk premium demanded by investors to own risky assets should fall as a result of the world feeling like a better place to invest.

Peter Jackson
Chief Investment Officer
October 2013

Appendix 1
New Equity Investments-Cumberland North American Capital Appreciation Mandates
Quarter Ended September 30, 2013

Canada

ATCO LTD

ATCO is a surprisingly under-followed, relatively low risk investment opportunity that has had a 17 year compound annual earnings growth rate of 12% and has visible growth for at least the next few years. The company essentially has two divisions with 2/3 of earnings coming from providing utility, natural gas and electric power distribution mostly in Alberta and 1/3 from providing remote accommodation for companies primarily in the resource business. Alberta neglected and under-invested in expanding its power distribution infrastructure for most of the last decade and is presently involved in a major upgrade which will see ATCO spending about $10 billion over 5 years dramatically increasing its rate base upon which it earns a regulated return. While the oil sands around Fort McMurray have provided much of the growth for the remote accommodation business in the last 5 years and will continue to do so for the next few years, the real upside for this business is in providing camps for workers involved in the extraction, pipeline and port facility construction associated with the large scale liquefied natural gas (LNG) projects proposed for northwest Alberta and BC.

Trinidad Drilling

Trinidad is a leading provider of oil and gas drilling services primarily in Canada, the United States and Saudi Arabia. They have a technically advanced modern fleet which is capable of drilling deep wells commanding higher day rates and margins, yet the stock currently trades below industry peers in terms of valuation. Trinidad will benefit from the likely LNG build out in Canada as well as growth in non-North American markets through a recent joint venture with Halliburton Company, one of the world's largest oilfield services companies. Trinidad adds to a basket of stocks that we have accumulated in 2013 to position for what we believe represents a major structural change in the Canadian oil and gas industry.

Labrador Iron Ore Royalty Corporation

Labrador Iron Ore Royalty Corporation ("LIROC") is a Canadian corporation which owns mining leases and mining licenses of an iron ore mine near Labrador City, Newfoundland and Labrador. LIROC has granted Iron Ore Company of Canada ("IOC") exclusive rights to mine the iron ore in exchange for a 7% royalty and 10% commission on all iron ore products produced, sold and shipped by IOC. In addition, LIROC owns a 15% equity stake in IOC which provides dividends to LIROC. The IOC is nearing the finish line of a recent expansion at the Labrador City mine which should improve both the royalty revenue and the dividend received from the IOC. In turn, we expect LIROC to be able to increase its dividend, which currently yields almost 5%.

United States

Con-Way Inc

Con-Way is a US based provider of Less than Truckload (LTL) transportation services to a broad range of industries. We invested in this turnaround story because we are confident that CNW can double its operating margins in the next few years by re-pricing or eliminating many of its unprofitable routes. At an industry average operating margin of 10%, Con-Way's EPS could essentially double. Despite this earnings power, CNW is trading at just 5.0X 2014 EBITDA while its competitors trade between 6.5X and 8.5X.

Brinker International

Brinker is a casual dining operator which owns the Chili's and Maggiano's banners. While the industry has matured we think Brinker is best positioned to take market share as it has spent the last five years reimaging its stores, investing in proprietary kitchen equipment, and improving the value proposition of its menu items. As a result, guest satisfaction scores have increased for the last eight quarters, a figure we believe will eventually lead to increased traffic and higher comparable sales.

CBS Corporation

We think CBS will be one of the largest beneficiaries of the increasing value of content over the coming years as so called over the top or subscription video on demand (SVOD) providers such as Netflix, Apple, Amazon and Hulu continue to disrupt the cable operators. CBS has a dominant market share in television ratings yet receives only a fraction of the industry advertising dollars. We think CBS's recent victory over Time Warner in the dispute regarding retransmission fee, or the fees which cable operators must pay to broadcasters for re-airing content, shows that the balance of power is quickly shifting towards broadcasters such as CBS. Therefore, we expect that retransmission revenues in the coming years will meaningfully surpass current market expectations.

CST Brands

CST Brands is the second-largest independent retailer of motor fuels and convenience merchandise in North America. It owns and operates 1,032 US locations, mostly in Texas, and 840 Canadian locations under the brand names Corner Store and Depanneur du Coin brands. Previously a subsidiary of refiner Valero, CST Brands was spun off on May 1, 2013. The management team is comprised of experienced leaders who have been operating the business within Valero, who now have an opportunity to optimize the operations. For example, while CST has its own private-label food brands including sandwiches and packaged goods, coffee, and energy drinks, contribution of food to non-fuel merchandise sales is 9% for CST versus 20% or better for peers. Management is planning to open 23 New to Industry (NTI) locations in 2013. The new stores will be 4,500-5,500 sq ft (versus 2,000 sq ft on average for existing stores), with 40% of the floor space devoted to the food offering, driving same store sales growth and margin expansion. CST pays a 1% dividend yield; most of its free cash flow will be used to build new locations and strategically acquire convenience-store chains of 50 stores or fewer.

Xerox Corporation

Xerox is predominantly known as a global leader in printing and copying equipment technology. In recent years, Xerox has reinvented itself from a technology player in the challenged printer industry to a leader in the fast-growing, high margin outsourced services business. Through its acquisition of Affiliated Computer Services (ACS) in 2009, Xerox has gained a strong foothold in Business Process Outsourcing (BPO) and IT outsourcing. Within services, the company has a high and rising exposure to growth areas such as Healthcare, Transportation and HR services. In fact, Xerox is well positioned to benefit from "Obama Care" as the company provides Medicaid administrative solutions along with software for healthcare payer claims processing, billing and reconciliation. The company's services business is currently running at $12 billion in annual revenues, making it the No. 3 provider of BPO service behind ADP and First Data. This growth in services is also helping Xerox improve its margin profile as operating margins in services are higher than operating margins in the legacy printing business. The company continues to build on this transformation and we think it is attractively valued, with a free cash flow yield of over 14%, as the market is giving it little credit for its makeover as a services company.