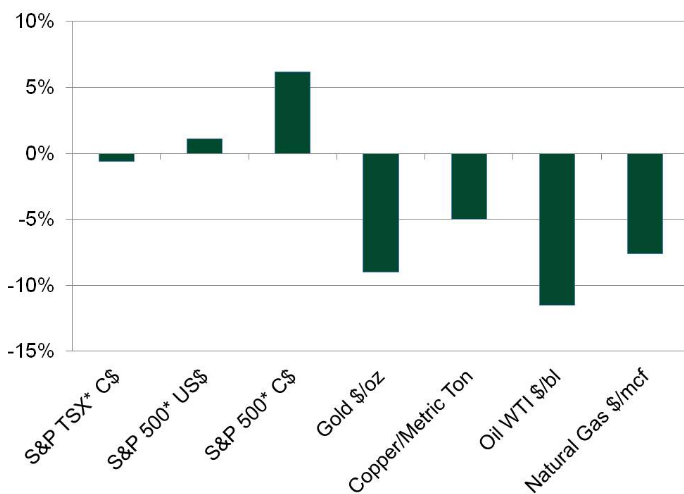
CUMBERLAND

Third Quarter Review
North American Capital Appreciation Strategy
October 2014

The TSX and the S&P500 started off with gains during the first two months of the third quarter but lost ground in September. The loss in September was enough to pull the TSX into negative territory for the quarter as it returned -0.6% for the third quarter while the S&P500 returned 1.1% in US$. Adjusting for currency moves, the S&P500 returned 6.2% in the third quarter as the C$ lost just over 4 cents, essentially reversing the gains it saw in the second quarter. The biggest drop in Canada occurred in the resource sectors driven by the decline in commodity pricing as West Texas Intermediate (WTI) oil fell 11.5% to US$91.16 per barrel and gold dropped 9.0% to US$1,208.15 per ounce. In the U.S., market trepidation early in the quarter centered around the second quarter earnings releases which in totality actually ended up coming in better than analysts' expectations as the blended earnings growth rate in Q2 rose to 7.7%. This drove a decent recovery in the S&P500 in August.

Quarter Percentage Change to September 30, 2014



Generally speaking, the overall economic news in the U.S. during the second quarter was quite good. The third reading on U.S. GDP for Q2 was revised up to 4.6% from 4.2% and 4.0% in the previous two months and reflects a strong rebound from the -2.1% weather-related decline in the first quarter. Putting these two quarters together suggests a growth rate of around 3% which may more accurately reflect the trend going forward. Stronger economic growth in combination with weaker US inflation data in August, as the Consumer Price Index (CPI) declined 1.7% year over year, and a data dependent Fed coming out in September and renewing its pledge to keep interest rates near zero for a "considerable time", all helped spur the S&P500 to an all time new high in mid September before the trend reversed in the second half of the month. As discussed in Gerry Connor's previous quarterly commentary, it seems that the Fed is hostage to the stock market. The last thing the Fed wants is the first rate hike to tank the market. So clearly, when it happens, the data to support it should be very clear. We are not there yet. After the end of the third quarter, the release of positive September jobs data confirmed a six year low in the unemployment rate at 5.9%. There were also positive revisions for the two previous months' data; however, average hourly earnings growth remained stagnant vindicating the Fed's current position.

Having said that, sometimes too much of a good thing is not so good when all of your counterparties are losing. That seems to be the case with the Euro zone and China as signs of weaker global economic growth have continued to put downward pressure on these markets and currencies, and even reversed gains in the S&P500 toward the end of the third quarter. Weaker than expected manufacturing in Europe is not helping and while China's manufacturing growth has stabilized, it is at an anemic level at best. In Europe, Mario Draghi, president of the European Central Bank (ECB) continues to drag his feet on further stimulus plans despite inflation hitting a five year low in September of 0.3% as compared to its target range of 2%. The ECB will start buying private sector bonds later this month in a program scheduled to last two years but it fell short of a full US style quantitative easing program, which could include sovereign debt purchases. Add in the continuing tensions between Russia and the Ukraine and it is hard to get too excited about the growth prospects in Europe. The combination of this global economic slowdown (excluding the U.S.) with the contraction in commodity

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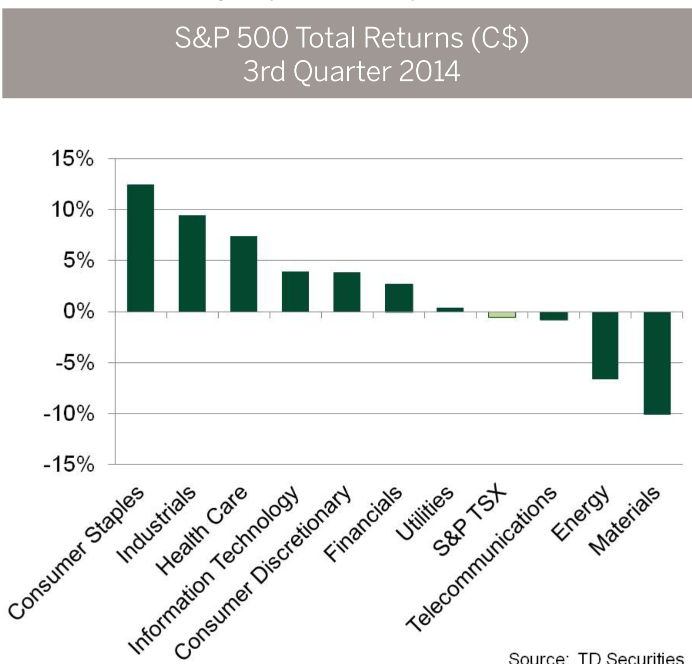
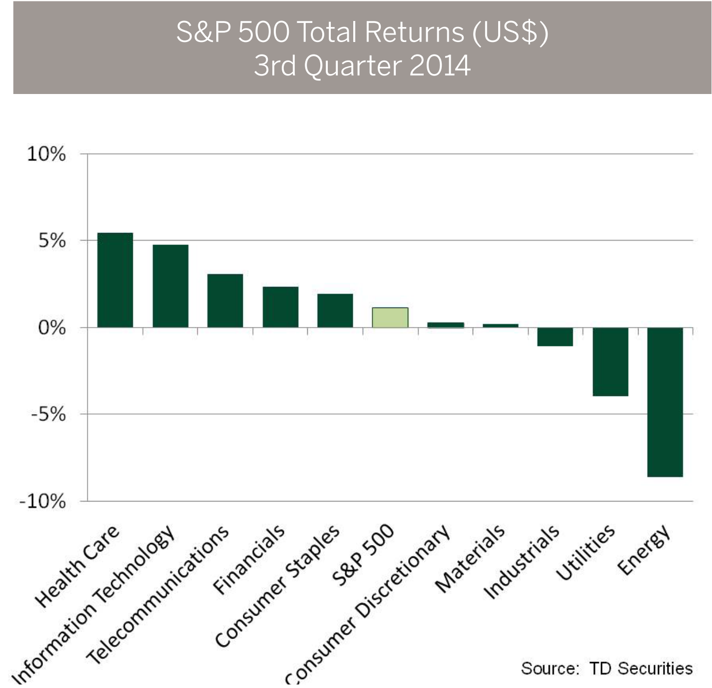
prices has continued to put upward pressure on the US dollar relative to the Euro and other currencies. Since June 30th, the Euro has lost 7.8% while the Japanese Yen has declined 7.6% relative to the US dollar. The Canadian dollar has not completely escaped unharmed but the decline hasn't been as severe given that our GDP growth is still reasonable at 2.5% after a pick-up in manufacturing output. The prospect of rising interest rates in the U.S. has also been supportive for the stronger US currency. The problem with a stronger US dollar however, is that it can lead to slower growth through weaker US trade performance and can potentially dampen inflation, which is pretty much the opposite of what the Federal Reserve is trying to accomplish. One concern for U.S.-based multinational companies in particular, is that the value of corporate profits earned abroad will potentially decline in dollar value terms. We reviewed Cumberland's exposure and while some of our companies like Apple and Citigroup have foreign exchange exposure, others such as Target, Verizon and Walgreens' are very low. Overall the portfolio is less exposed than the averages and the prospects and valuations for the companies that do have some exposure remain quite attractive. Still, stronger job growth in the U.S., lower gasoline prices which help the consumer and a stronger US currency lead us to favour more domestically exposed companies.





In terms of the sector performance for the TSX and the S&P500, the downdraft in oil and gold pulled the TSX into negative territory and reduced the performance for the S&P500. Since gold's August 2011 peak of US$1,888, it has declined about 36% and the main driver appears to be the appreciation of the US dollar. The extreme dollar optimism suggests contrarians like us might consider taking the other side of this bet. History shows however, that the US dollar actually performs best during a period of extreme optimism so with our current gold exposure below 2%, we prefer to wait until there is a definitive change in US dollar sentiment before making any bets on gold. Turning to oil, there are a number of factors that are affecting oil prices some of which are likely temporary and some that may be structural and only time will tell. On the temporary side, we are in the "shoulder" months for oil and gas during which the commodities typically underperform due to refinery maintenance turnarounds and gas storage levels approaching full for winter. Also technically, many producers look to forward sell a part of their future production looking out to next year to help solidify capital budgets. In 2014,

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45% of production was hedged or sold forward, yet only about 16% is currently hedged for 2015 creating a current hedging backlog, which again is more technical than structural. As for the structural, oil production has risen from 4.2 million barrels per day (bpd) at the start of 2009 to 9.2 million bpd in mid September 2014. The growth, as we have talked about in the past, relates to the success of horizontal drilling, multi-stage fracture technology and development of resource plays in North America. Over this same time period, the US oil rig count has increased from 200 rigs to about 1,600 rigs (opposite to what the gas rig count has done, which is one reason why we are more bullish on gas) with plans by the seven largest drilling contractors in North America to build an additional 150 rigs over the next 18 months. So speculation that oil production will continue to grow in the U.S. has also weighed on the current and future price of crude. We have brought our exposure down in the past three months and we will continue to monitor these trends.

On the positive side, sector outperformance of Healthcare continues to benefit from the secular trends of aging demographics, increased usage as a result of the government healthcare expansion (Affordable Care Act) as well as higher utilization as unemployment declines. Over the past 12 months, we have built up our Healthcare exposure and will continue to do so.

During the third quarter we added three new names to the portfolio including Walgreens, Quebecor Inc and Agrium Inc. Walgreens plays into the secular theme on Healthcare although it is technically classified as a Consumer Staple. In the case of Quebecor, while the vast majority of the growth and value today lies in its Quebec telecommunications operation, we believe there is potential of Quebecor being the fourth national wireless carrier in Canada. While there have been previous attempts and failures already, it could transpire under the right set of circumstances. This is not part of our primary investment thesis, yet should this happen, our upside percentage to target potentially doubles. In the case of Agrium, we believe the negativity surrounding the fertilizer industry wholesale pricing is close to a bottom. Meanwhile Agrium's retail business provides stability and growth over the next two years as we wait for the wholesale business to improve. 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 September 30 2014	
Equities	79%
Fixed Income	10%
Cash	11%

During the quarter our asset mix remained fairly conservative with equities and fixed income declining 2% and 1%, respectively, in favour of cash. Cash was sourced from the Canadian side of the equity portfolio which dropped 2% to 45% while the US equity exposure remained unchanged at 34%. During the quarter, we reduced the US dollar hedge exposure back to 50% at around $0.92 US. With our higher cash levels, we have not rolled forward the put options at this time.

In terms of our fixed income strategy, the fixed income market continues to be preoccupied with anticipating the Fed's first interest rate increase since 2006 and the impact that a rate tightening cycle would have on the economy. The bond market's verdict so far is that there is a 50/50 chance that the Fed will announce the first fed funds rate hike in over 8 years next summer, and the higher interest rate environment could be a headwind to the economy's future growth rate. It is worth noting however, that the market's view differs from the Fed's own view. In September, the Fed released the 2015 interest rate forecasts of their individual committee members. Whereas 16 out of the 17 members had forecast the federal funds rate to end 2014 at the current level of 0.00-0.25%, only 2 members expect the interest rate to end 2015 unchanged. In addition, 11 of the 17 members forecast a fed funds rate greater than 1.0% by the end of next year. The divergence of expectations between the Fed and the fixed income market is somewhat troubling and will likely be the source of continued volatility. The

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expectation of a possible rate hike has had contrasting impacts on short-term versus long-term bond yields. For example, the yield on a 2 Year U.S. Treasury bond increased during the quarter from 0.46% to 0.57% since the Fed funds rate has a greater impact on short-term bonds. Conversely, the 10 Year US Treasury bond yield declined from 2.53% to 2.49% during the quarter and went as low as 2.34% in August. Longer-term bonds (such as the 10 Year Treasury) are less impacted by changes to the Fed funds rate and are more influenced by other economic variables such as expected inflation rates and GDP growth rates. One explanation for the rise in short-term yields and the simultaneous decline in longer-term yields is that the rise in the Fed funds rate will increase financing costs for consumers and businesses thereby slowing the expected GDP growth rate in future years. Although we acknowledge this is a possible outcome, we also must acknowledge that the unemployment situation continues to materially improve and commercial & industrial loan balances, consumer confidence indicators, and small business optimism all continue to increase, signaling underlying strength in the economy. At Cumberland, we do not believe the bond market is properly reflecting the probability of stronger-than-expected economic growth, and consequently we see risk in long-term bond yields heading higher (and therefore bond prices heading lower). We have therefore maintained the duration of the bond portfolio at 2.9 years compared to the 6 to 7 years of a typical bond benchmark index since the prices of shorter duration bonds are less sensitive to changes in interest rates as compared to longer duration bonds.

OUTLOOK

Currently the S&P500 is trading around the same level as it was three months ago so not much has really changed. Taking into account the growth in the forward earnings on the S&P500, the forward price earnings multiple is a little lower at 15.2x which is now slightly below the long term average of 15.4x. Given the US 10 year bond yield is down slightly over the same time period, the two when combined have improved the equity risk premium slightly suggesting some marginal improvement to valuation from where we were three months ago. Clearly though, earnings will be the critical swing factor going forward. While third quarter earnings growth estimates have declined over the past three months from 8.9% on June 30th to 4.7%, this still represents a fairly robust year over year growth rate. However the 12 month forward earnings estimate remains lofty with 12 month forward estimates up 11.7% over the 12 month trailing. Last quarter we talked about pre-tax profit margins being close to 45 year highs resulting from cycle low labour costs which appeared to have bottomed. The appreciating US dollar headwind and slowing global growth will probably not have a big impact on third quarter profits but we expect that it may be talked about in future earnings guidance. Despite our near term reservations, we remain optimistic that economic conditions will continue to improve going forward. Interest rate increases will eventually come but only when economic conditions improve first, suggesting there is still a long way to go in this bull market. Under these conditions of higher rates, a further risk to valuations is likely in the case of higher yielding securities lacking commensurate underlying dividend growth to offset the prospect of high interest rates in the future. Our focus will continue to be on investing in companies that trade at a discount to our intrinsic value, generate high returns on invested capital and offer strong free cash flow per share growth to support future dividend growth.

Peter Jackson
Chief Investment Officer
October 6, 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.

Appendix 1
New equity investments:
Cumberland North American Capital Appreciation Mandate
Quarter ending September 30, 2014

Canada

Agrium

Agrium operates two divisions: wholesale and retail. The company's wholesale division produces and markets the three major crop nutrients (colloquially, fertilizers): nitrogen, phosphate and potash. Agrium's retail division runs a network of nearly 1,500 retail farm stores in Canada, the U.S and Australia that sells crop nutrients, crop protection products (herbicides, pesticides), seeds (corn, soybean etc.) and agricultural merchandise and services to farmers. The company is in the final stages of a $7 billion capital expenditure program that grew its fertilizer capacity and expanded its retail footprint during a four year period when farmer wealth expanded significantly. Over the next several years, as fertilizer and crop prices recover from ten year lows that were caused by yield-induced supply gluts, Agrium should reap the benefits of their capital expenditure program and drive strong cash flow growth which should in turn drive their dividend higher.

Quebecor

While Quebecor's roots in print media and TV broadcasting still remain as a small part of the company, the vast majority (over 90%) of the value of Quebecor lies in its telecommunications division (Videotron) which provides cable, internet, wireline telephone service and recently, wireless telephone service in the province of Quebec. The company's industry leading customer service and operating metrics combine with a discount valuation to offer a margin of safety that supports their growth opportunities in wireless. The companies four year old wireless venture recently launched a new LTE network and the iPhone for the first time, which should help Quebecor achieve their goal of 25% penetration (6% currently) and in turn drive margins and cash flow higher. While not included in our valuation, Quebecor has a significant opportunity to expand nationally given that: (1) the Canadian Radio-television and Telecommunications Commission (CRTC) seems poised to tighten rules in favor of a renewed fourth wireless carrier and (2) the company recently purchased one of four blocks of spectrum in Ontario, Alberta and B.C at $0.83/MHz (less than half the price paid by incumbents).

United States

Walgreens

Walgreens (WAG) is currently undergoing a merger with Alliance Boots (AB) to create one of the largest drug retail and health care distribution companies in the world with over 11K stores, 180K points of distribution and 100MM retail loyalty card members. The newly formed company will still be primarily US driven (65% of sales) with developed Europe, namely the UK, largely accounting for the remainder. AB also has a fledgling but rapidly growing international division with exposure to Thailand, China, the Middle East and Latin America.

Recently, Walgreen's stock has sold off almost 20% as a result of disappointment surrounding revised earnings targets and a lack of tax inversion. Although the core drug retail business is clearly facing some headwinds, the combined WAG-AB is well positioned to benefit from multiple structural tailwinds while generating substantial amounts of annual free cash flow (>$5B). More specifically, ageing demographics, the increased use of generic drugs and the expansion of health care coverage in the US should all combine to help Walgreens grow earnings. Additionally, the infusion of new management should drive further operational improvements and cost savings and help the company better leverage its best-in-class real estate and brand.