CUMBERLAND

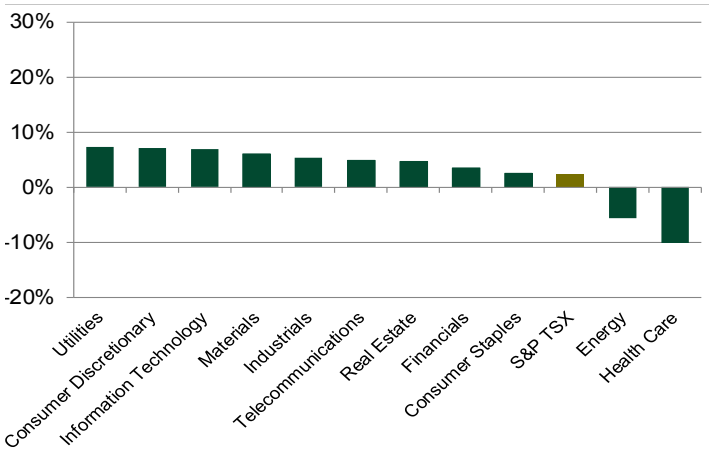
NORTH AMERICAN CAPITAL APPRECIATION STRATEGY FIRST QUARTER REVIEW

While I have been investing for over 30 years, which I guess still makes me a youngster compared to one other here at Cumberland, I must admit that coming to work has never been more interesting than it is now. While the S&P500 total return index' ("S&P500 Index") increase of 11.3% since the election certainly is interesting, in reality it is the US President that is keeping us, and the rest of the world, on our toes.. Even the TSX index has increased 7.3% on a total return basis over the same time period.

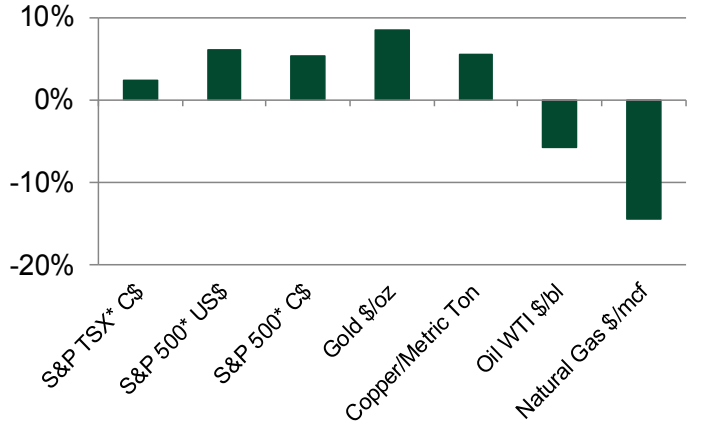
During the first quarter of 2017, the S&P500 Index was up 6.1% . Adjusting for currency, the S&P500 Index returned 5.3%, as the Canadian dollar appreciated by about a half of a cent, closing the quarter at US$0.75.

The positive return momentum continued on the back of Trump's pro-growth policy promises, including tax reform, regulation roll back, and increased fiscal stimulus.

S&P TSX (C$ Total Returns) 1st Quarter 2017

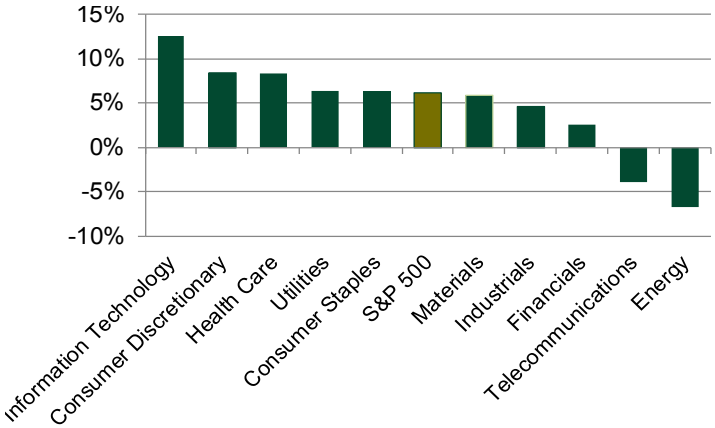


Percentage Change for Quarter to March 31, 2017



Source: Bloomberg Total Returns*

S&P TSX (US$ Total Returns) 1st Quarter 2017



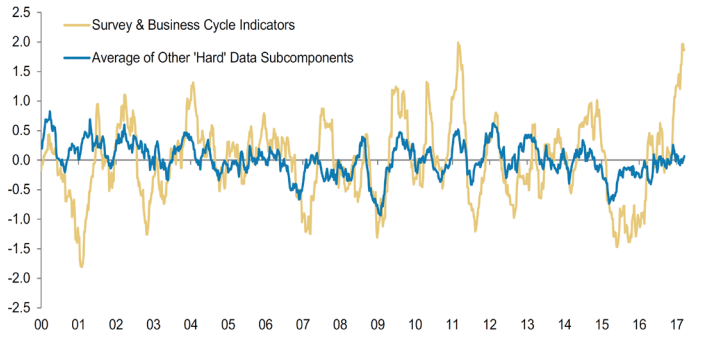
Source: Bloomberg Total Returns*

However, the failure of the Republican health care bill seems to be a clear indication that implementing Trump's legislative agenda may not be a slam dunk, but so far this setback has been a non-event for the market. On the other hand, this could accelerate tax reform, which we view as a positive for the US equity market. It is possible that the tax reform bill could be finalized by this summer, with the healthcare bill off the agenda. After the failure of Trump's American Healthcare bill (AHCA) to repeal and replace Obama's Affordable Care Act (ACA), Trump discussed how he thinks the ACA will eventually implode. The cynic in me thinks that any changes his administration may make to the ACA may in reality help clear the way for its eventual replacement by an amended form of AHCA.

Moving focus onto to tax reform at this time, could clearly keep this market buoyant from its expected benefits. Consider that the Q1 2017 estimated earnings growth rate for the S&P500 Index is currently predicted to be 9.1%. That marks the highest growth rate since Q4 2011. Remember, nothing has been factored into this growth rate for the benefits of tax reform. According to FactSet Research, estimates for 2017 and 2018 S&P500 Index earnings are $131.13 and $146.61, which represents 10.1% and 11.8% growth over 2016 and 2017 earnings, respectively. With the market now at 18.0x and 16.1x these estimates, the S&P500 Index is not cheap, but as we discussed in our December quarterly review, tax reform could further lift S&P500 Index earnings, materially changing valuation multiples in a positive manner. We also believe tax reform may broaden support in the Republican Party, therefore making it easier to pass legislation through the House and Senate. Our view is that until there is a better understanding of the design and potential impact of tax reform and how it will impact S&P500 Index earnings, the market is likely to move sideways. It's quite typical to see the stock market earnings forecasts looking the most optimistic coming into a new year and for it to move lower over time, but we are not seeing much change for this year or for 2018, so far. Tax reform would potentially impact 2018 earnings more fully than 2017 earnings, which may explain the lack of movement.

Perhaps the term "animal spirits", coined by the economist John Maynard Keynes, can best describe the market's focus on the soft economic data or sentiment data post-election versus, hard quantifiable economic data. In Exhibit 1 the soft economic data (yellow line), such as consumer confidence, which hit a 16-year high last week, may be influencing the higher valuations for the S&P500 Index. However, the question is, will the hard economic data (blue line) eventually catch-up to the soft economic data?

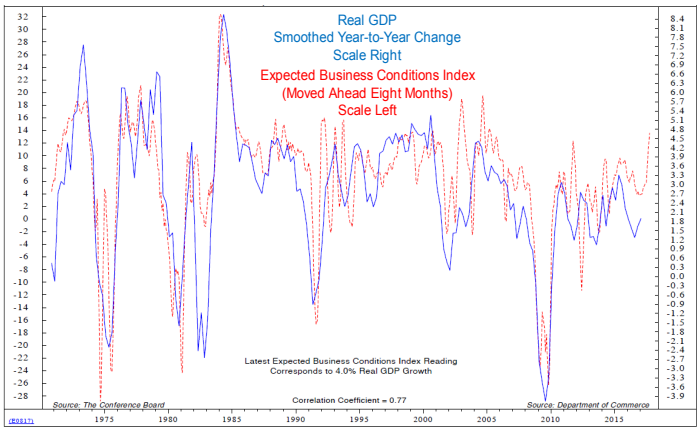
Exhibit 1: Record Gap Between the Strength of "Hard" and "Soft"' US Macro Data



Source: Bloomberg, Morgan Stanley Research

Exhibit 2, courtesy of Ned Davis, compares similar soft economic data, the Expected Business Conditions Index (in red) advanced eight months into the future, against real GDP in the US. According to Ned Davis, the high correlation of this data, at 77%, would suggest we should expect GDP growth of 4%! That's compared to the latest Q4 GDP growth of 2.1%. Most of the hard economic data, such as housing, industrial and labour market data, has been quite positive, but more or less in line with expectations, so it does beg the question: *are we in store for a catch-up?*

Exhibit 2: Real GDP vs Expected Business Conditions Index

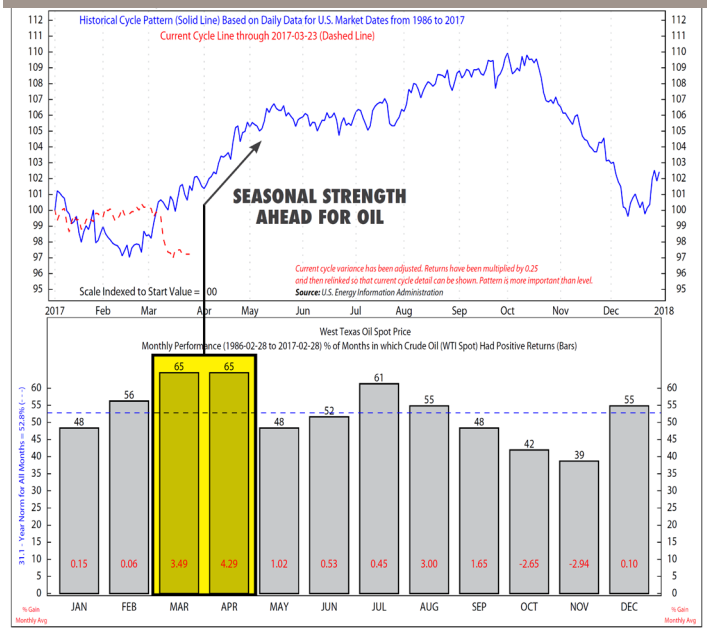


Source: Ned Davis Research, The Conference Board

As noted, the final reading for Q4 GDP was 2.1%, the unemployment rate in the US is running at 4.7% and core PCE inflation (the Fed's preferred measure of inflation) was 1.8% in February. This data supports that the US economy is performing reasonably well and the results are in line with the Federal Reserve's expectations for 2017, which is why nothing really changed in the outlook commentary from the Federal Reserve at its meeting in March. Expectations are still for three interest rate hikes in 2017 including the one announced in March. So, our view is the market is buying time to see how things play out with the hard economic data, but also to see if the Trump administration can deliver on its economic agenda in Washington. Given current stock multiple levels, it's probably fair to say that expectations for this scenario playing out are high.

In Canada, the TSX total return for the quarter was 2.4%. While the heavily weighted Financials outperformed, Oil and Gas did not, as mounting US oil inventories and rising production in the lower 48 US states put downward pressure on the price of crude oil. Oil closed 2016 at $53.73 per barrel and drifted down to almost $47 per barrel by mid-march before rallying at quarter end to close at $50.60 per barrel. With the oil rig count doubling from its bottom of 316 rigs since May 2016, lower 48 oil production rose 425,000 barrels per day (bpd)in the first quarter of 2017 to 8.6 million bpd after declining 432,000 bpd in all of 2016. While this is perhaps a reason to be more cautious, we actually think the price of crude oil could move higher over the next quarter. The latest inventory reports for refined crude (i.e. gasoline) are starting to look more balanced and as US refineries come out of scheduled maintenance downtime and the summer driving season swings into full gear, demand for gasoline should pick up. Also, OPEC producers ramped up exports ahead of the cut on January 1st 2017, causing some of the downward price per barrel pressure. That crude has now worked its way through the US inventory data. Meanwhile, as a result of the increased rig count, oil well service costs jumped 9% in February, as the cost of materials and labour rose. We got a taste of the impact recently when Halliburton, North America's largest Fracking company issued a Q1 profit warning due to higher costs. So, this should raise the breakeven well completion costs, which may either lower oil production growth in the future or possibly be a catalyst to drive oil prices higher. Exhibit 3 shows the seasonal strength for crude, which is currently at it strongest and is another reason we are reasonably positive in the short term for oil prices.

Exhibit 3: West Texas Oil Spot Price



Source: Ned Davis Research

Meanwhile, the Canadian economy is showing signs of improvement. The latest labour force survey showed the unemployment rate dropped to 6.6%, the lowest in over two years on the back of higher than expected full time jobs. Also, January GDP is up 2.3% year over year, and came in well above expectations on widespread growth across both the goods and service sectors. Obviously, some of this relates to the improvement in oil prices year over year, which as noted should continue in the near term.

Asset Allocation for our North American Capital Appreciation Strategy
As at March 31, 2017

Equities	83%
Fixed Income	3%
Cash	14%

Our asset mix continues to reflect a more cautious equity market outlook given the recent strength in stocks both in Canada and the US in the past two quarters. With our equity weight at 83%, we continue to hold a fair amount in cash and fixed income reserves in the event of a pullback.

In Exhibit 4, we examine all corrections in the S&P500 Index going back to 1927. As indicated in the table at 96 days without a pullback as of March 31st, the S&P500 Index now well exceeds the average (63 days) and median term (43 days) days between 5% corrections. So, a pullback would not surprise us, hence one of the reasons for holding some cash reserves at this time. Having said that, the global macro environment remains equity friendly. Most of the central banks are still focused on lower interest rates, global economic growth is picking up and corporate earnings are improving, which all helps valuation expectations.

Exhibit 4: S&P500: 1927 to Present...
Summary of Corrections 5% or greater

Number of 5%+ Corrections	216	
AVG Time Between 5%+ Corrections	63 Trading Sessions	2.9 Months
Median Time Between 5%+ Corrections	43 Trading Sessions	2.0 Months
Number of Sessions We've Gone Since the Last +5% Correction	**96 Trading Sessions**	**4.2 Months**
Median Magnitude of 5%+ Corrections	-8.2%	
Median Duration of 5%+ Corrections	22 Trading Sessions	

Source: Cornerstone Macro LLC

Exhibit 5 is the Global Purchasing Managers Index (PMI) heat map, which indicates that since last summer, economic conditions continue to improve across the globe. This might present an opportunity to add to our international exposure in the event of a market pullback for portfolios following our North American plus International strategy.

Exhibit 5: Global Purchasing Managers Index' Heatmap

	Feb-17	Jan-17	Nov-16	Aug-16	Feb-16
Global	52.9	52.7	52.0	50.7	50.0
U.S.	57.7	56.0	53.5	49.4	49.7
Canada	54.7	53.5	51.5	51.1	49.4
Japan	53.3	52.7	51.3	49.5	50.1
U.K.	54.6	55.7	53.5	53.4	50.9
Euro Area	55.4	55.2	53.7	51.7	51.2
France	52.2	53.6	51.7	48.3	50.2
Germany	56.8	56.4	54.3	53.6	50.5
Italy	55.0	53.0	52.2	49.8	52.2
Spain	54.8	55.6	54.5	51.0	54.1

Expanding ≥ 52 | 52 > Neutral ≥ 50 | Contracting < 50

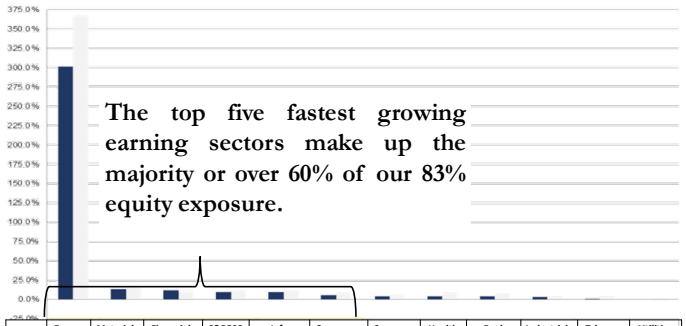
Source: Markit, ISM, Haver and RBC Capital Markets

As of March 31st, our country exposure in the North America strategy continues to favour US equity at 46% over Canadian equity at 37%. Financials (20.9%) continue to be the largest sector exposure in the portfolio, although with the strength in this group since the US election, the valuation has become extended, particularly in the US. We cut our weight in JP Morgan and Wells Fargo over the last quarter based on the strength of their returns which would likely be more vulnerable in a market pullback given their more stretched valuations. We have maintained our Energy weighting at about 13% for reasons noted above. Two new names added were Enbridge and LyonellBasell Industries, which is technically classified as a materials company, but is energy-related. Both companies should benefit from a more energy friendly U.S. government, as well as a more favourable regulatory environment and lower taxes. We have already seen Trump pass an executive order for the approval of the Keystone XL and the Dakota access pipelines and Enbridge is a partner in the latter.

Our largest sector weighting increase for the quarter was in Information Technology, which went from 8.8% to 13%, with the addition of Alphabet Inc. (GOOG) and CGI Group (CGI).

Exhibit 6 shows a breakdown of the S&P500 Index earnings growth by sector for 2017. As indicated in the chart, the top five fastest growing earning sectors make up the majority (or over 60%) of the 83% equity exposure we have with Consumer Discretionary rounding out the fifth position. A complete summary of new positions added during the quarter, including business fundamentals and valuation metrics, is contained in Appendix 1.

Exhibit 6: S&P500 Earnings Growth CY 2017



	Energy	Materials	Financials	S&P500	Info Technology	Consumer Disc.	Consumer Staples	Health Care	Real Estate	Industrials	Telecom Services	Utilities
Today	301.1%	13.3%	11.9%	9.8%	9.6%	5.6%	4.2%	4.2%	4.1%	3.3%	0.5%	-0.7%
31-Dec	368.0%	16.7%	10.4%	11.5%	11.3%	8.3%	5.6%	7.8%	7.6%	3.4%	3.7%	0.6%
CPWM	12.9%	5.9%	20.9%		13.0%	8.6%	3.8%	9.3%	1.0%	7.9%	0%	0%

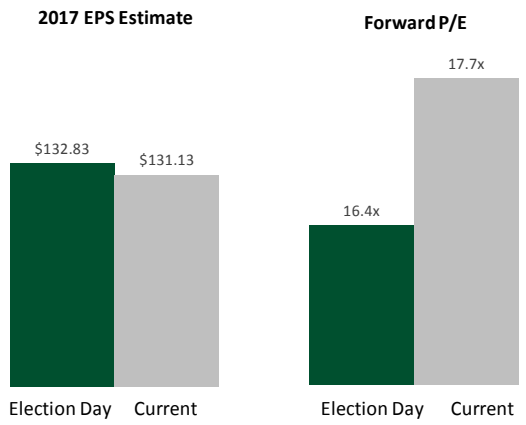
Source: FactSet, Earnings Insight

Outlook

On the left side of Exhibit 7, we compare 2017 earnings per share estimates on the US Election Day to today's 2017 earnings estimate. Similarly, on the right, we compare the US Election Day forward price/earnings, multiple and today's price/earnings multiple. Last quarter, we tried to quantify the impact on the S&P500 Index earnings from tax reform suggesting a 10% across the board tax reduction could add as much as $18 to current to 2017 and 2018 earnings estimates of $132 and $146, respectively. With 2017 and 2018 S&P500 Index earnings estimates largely unchanged today at $131 and $147, it appears

analysts have been waiting to see how things unfold for the economy and under the Trump administration before updating their estimates. So, the net effect is that Forward Estimates for the market have not kept up with the commensurate move in the market such that the forward P/E multiple has expanded from 16.4x to 17.7x. As a result of this valuation lift, it does suggest some increased risk, which is one reason why we are maintaining a higher cash weighting so far in 2017.

Exhibit 7: 2017 EPS Estimate vs Forward P/Es



Source: S&P, Thomas Financial, FactSet, and RBC Capital Markets

Exhibit 8 reviews the risk, profitability and valuation characteristics of the Cumberland North American Capital appreciation strategy. As indicated, our portfolio today is less volatile than the market as measured by its relative beta and standard deviation. Looking at the North American equity portfolio in aggregate, we have brought down the equity weight since last October from about 90% to its current level of about 83% and added more defensive names to the portfolio such as Enbridge and Intact respectively, which have lowered the overall volatility profile of the portfolio.

Exhibit 8: Cumberland North American Capital Appreciation Strategy

	Portfolio	50/50 S&P500/TSX
RISK		
Standard Deviation	8.11%	9.06%
Beta (Portfolio)	0.85	-
PERFORMANCE		
ROIC (5yr average)	11.7%	9.3%
ROE (Latest FY)	21.4%	19.9%
Debt/EBITDA	3.0x	4.1x
VALUATION		
P/E (Fwd 12m)	15.8x	17.0x
EV/EBITDA (Fwd)	10.1x	11.4x

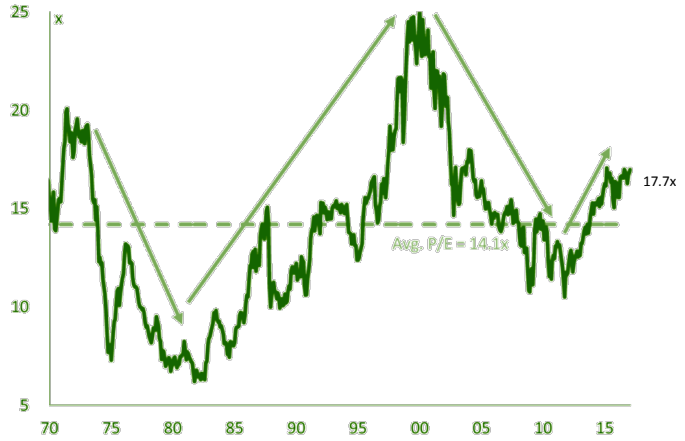
Source: Bloomberg

Other portfolio characteristics we have focus on, which are evident in Exhibit 8, relate to the high quality and low valuation characteristics of the Cumberland portfolio. In aggregate, we believe owning companies with above average Return on Invested Capital and Return on Equity that have less leverage and are cheaper than the market, should provide greater downside protection in volatile markets. These companies should grow earnings faster and outperform the market, and we believe they will not be as impacted over the long term by any short-term disruption to the market.

Exhibit 9 looks at the Forward Price-Earnings multiple for the past 50 years. The forward Multiple has ranged from 6x to 25x averaging about 14.1x over the period, which implies at 17.7x todays multiple we are trading above that average. However, as indicated in the chart, while multiples do mean revert over time, they tend to do so over long periods of time, reversing directions at extremes usually caused by rapidly rising rates or a

recession. It does not appear we are yet at one of those extremes. So, while the market may look somewhat stretched, in the short term it could stay expensive and even get more expensive for some time. Our tactical strategy is to hold extra cash reserves while managing our volatility through investing in high quality companies trading at below average valuations.

Exhibit 9: S&P500 NTM P/E



Source: S&P, Thomson Financial, Fact Set and RBC Capital Markets

Peter Jackson
Chief Investment Officer
April 2, 2017

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

United States

Alphabet Inc. (GOOG)

Alphabet Inc., founded in 1998 is the parent of Google, and YouTube, provides online advertising services in the United States, the United Kingdom, and rest of the world. The company offers performance and brand advertising services. We purchased GOOG shares this quarter given our long-term positive outlook on the shares, based on significant secular growth toward online advertising and away from traditional sources of media input, strong market share in its core search business and other internet advertising segments. Alphabet maintains a significant competitive moat structure which is achieved through its scale, innovation, and over $42 billion in Capital Expenditures, and $33 billion in Research & Development over the last five years.

Our investment thesis is based on seeing GOOG as growth at a reasonable price, with upside driven by 1) stable margins in the near-term, 2) top line growth above expectations driven by new ad products including a 4th mobile ad unit, the rollout of Promoted Places on Google Maps, and 3) multiple re-rating driven by greater transparency and the growth of Cloud over time. Alphabet is well exposed to long-term thematic trends in artificial intelligence/machine learning, ride sharing, autonomous driving and big data.

In terms of valuation, our analysis made a distinct case for owning GOOG shares over other growth Information Technology names such as Facebook, Amazon and Neflix for instance. GOOG shares trade at a discount to growth names AMZN, FB, NFLX on a Price-to-earnings and Price-to-free-cash-flow basis. Excluding the cash on its balance sheet, GOOG shares trade about in line with the benchmark S&P500.

LyondellBasell Industries (LYB)

LyondellBasell is a global commodity chemical company, converting oil and gas feedstock into downstream chemicals and plastics. Lyondell has proven itself to be a disciplined operator with impressive rates of return on invested capital over the previous 10 years. We think that Lyondell is a good investment because (1) we expect continued high demand for their plastics products as emerging markets reduce plastic recycling operations due to harmful environmental consequences; (2) Lyondell's low cost North American gas feedstock give it an advantage relative to other chemical and plastics producers in other regions; and (3) ever more stringent transport fuel standards should provide strong demand for Lyondell's fuel additives business. Lyondell's valuation is very attractive, trading at over a 20% discount to our intrinsic fair value estimate, less than 10x 2017 Earnings Per Share and offers a 3.8% dividened yield.

Canada

CGI Group Inc (GIB.A)

CGI Group is Canada's largest provider of IT services, mainly outsourcing, consulting and systems integration and has grown to be a top ten player in the industry world-wide through a series of very successful acquisitions over the last 15 years. CGI's stock has appreciated by an average of 19% a year over the last 30 years putting it in pretty rarified territory. The industry naturally grows a bit faster than nominal GDP and requires little investment in capital equipment or working capital allowing for a high return on investment. CGI has recently been successful in winning quite a bit of business helping banks and other financial service companies undergo

digital transformations by tying legacy computer systems to slick digital customer interfaces as they work to stay relevant in a world where consumers become increasingly comfortable with banking over the internet. CGI doesn't pay a dividend as it wants the financial flexibility to make transformative acquisitions when they become available and in the intervening periods they use their free cash flow to buy back stock which can be scaled back during acquisitions. Despite its superior track record the stock trades at a decent discount to its better known comparable companies. We have acquired an excellent franchise at a decent price with CGI with the wild card that they could do a large and accretive acquisition over the next few years (debt/EBITDA is below 1X now).

Enbridge Inc (ENB)

With the merger with Spectra Energy, Enbridge is now North America's largest energy infrastructure company with significant exposure in all of North America's key oil and gas regions. Oil and gas producers almost exclusively rely on companies like Enbridge to get their product to market. And generally, once a pipeline is established, it attracts very little competition. As a result, Enbridge has been able to secure stable rates of return even through industry downturns. With long visibility into its growth opportunities, Enbridge has provided guidance for cash flow and dividend growth above 10% per year out to 2024. We think Enbridge's management is being conservative and that investors are not yet appreciating Enbridge's investment opportunities.