CUMBERLAND
Private Wealth

September 30, 2020

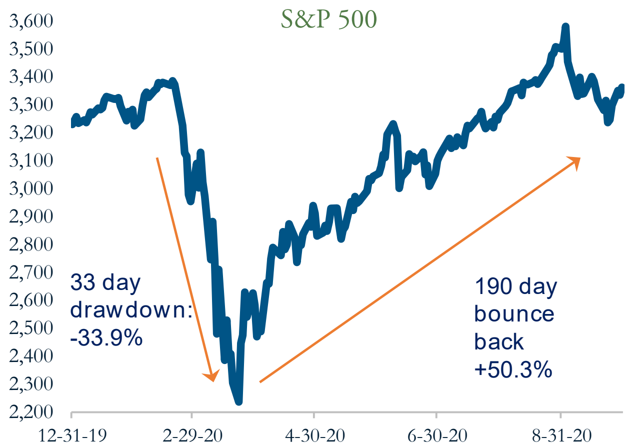
Third Quarter Review

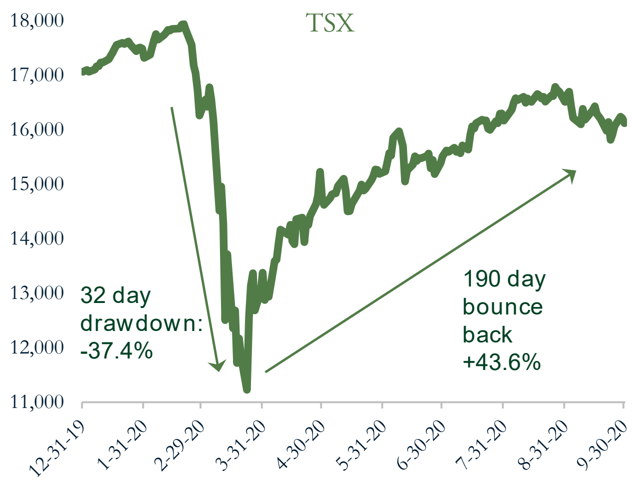
NORTH AMERICAN EQUITY STRATEGY

We recently held our client quarterly presentation (by webinar of course) and we covered many topics including our thoughts on the economic recovery, market outlook, valuation and how we are currently positioning the portfolio in anticipation of what's coming next. We had over 200 clients registered with many great questions, which made it quite interactive - something we all can appreciate in this crazy world we find ourselves living in. For those of you who missed it, there is a recording available but we will provide a bit of a recap here along with some of our latest thoughts.

After the severe drawdown in March of 33.9% for the S&P500 and 37.4% for the TSX, both markets have recovered 50.3% and 43.6%, respectively, through to September 30th as outlined in Exhibit 1.

Exhibit 1
2020 Market Drawdown and Recovery

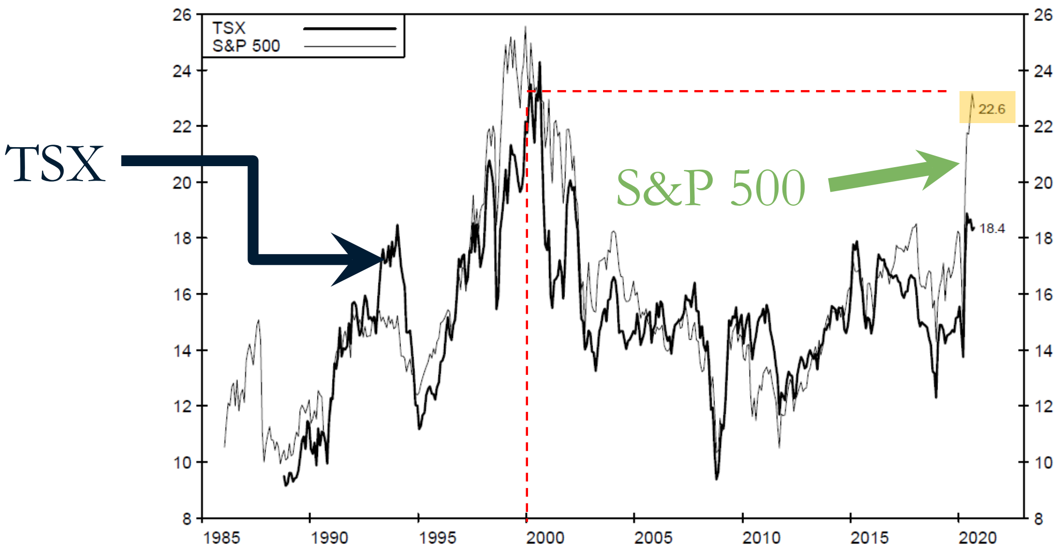




Source: Bloomberg, 12/31/19-09/30/20

The impact on valuations can be seen in this chart (Exhibit 2) with the S&P500 (the thin black line) approaching the year 2000 "Technology Bubble" type valuation levels.

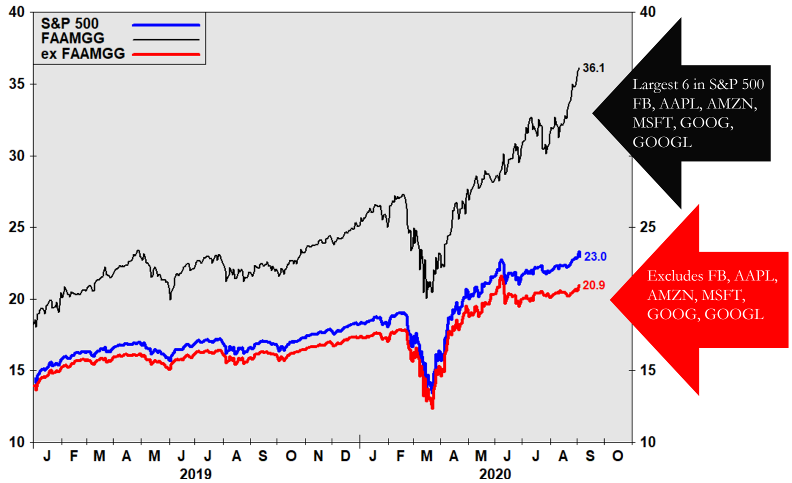
Exhibit 2:
Valuations: Forward Price/Earnings (12 months)



Source: TD Securities

The TSX is not as expensive relative to the S&P500 and could present an opportunity. However, given it has a larger cyclical (economically sensitive) component, we would likely need to see a continuation of the North American economic recovery and a shift more to companies that will benefit in that environment (ie: the value -oriented stocks) and away from the more growth-oriented technology names, which we are not ruling out as a possible scenario. Much of the increase in market valuation has been driven by technology or the FAAMGG stocks (Facebook, Amazon, Apple, Microsoft and the two classes of shares in Google), which is highlighted in the next chart (Exhibit 3) and is represented by the upper black line, which shows them trading around 36x earnings. The red line represents the S&P500 excluding the FAAMGG stocks, however even if you remove these stocks from the S&P500, the market is still trading north of 20x earnings versus historical averages closer to 16x.

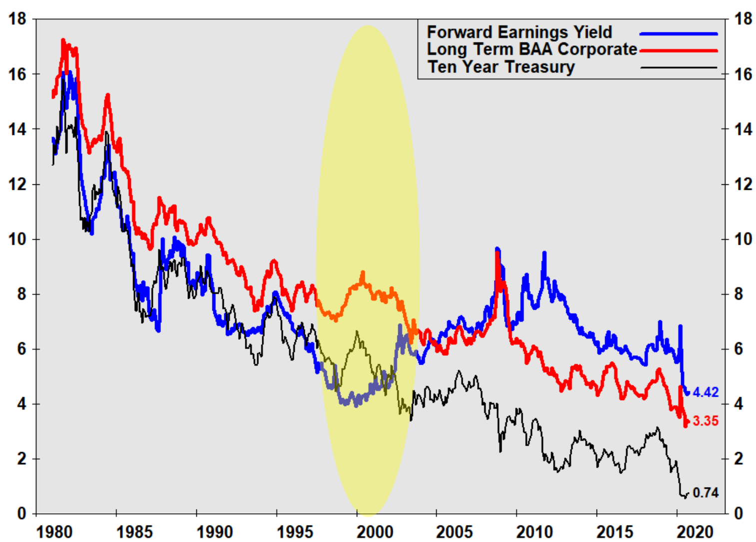
Exhibit 3:
Valuations: S&P 500 Forward P/E (12 months)



Source: TD Securities

Rather than just dismissing this market as overvalued, which is pretty much what most people over the age of 40 are inclined to do, including myself, we've attempted to try to understand what's driving what appears to be an excessive valuation. And to that end, we think a lot of the valuation increase or multiple expansion can be explained by the current level of interest rates. Exhibit 4 compares the forward earnings yield (which is just the inverse of the forward price / earnings ratio) for the S&P500 (shown in blue) to the yield on long term investment grade corporate bonds (shown in red) and the long term 10 year treasury yield (shown in black) going back to the 1980's.

Exhibit 4:
U.S. Yields on Risky Assets

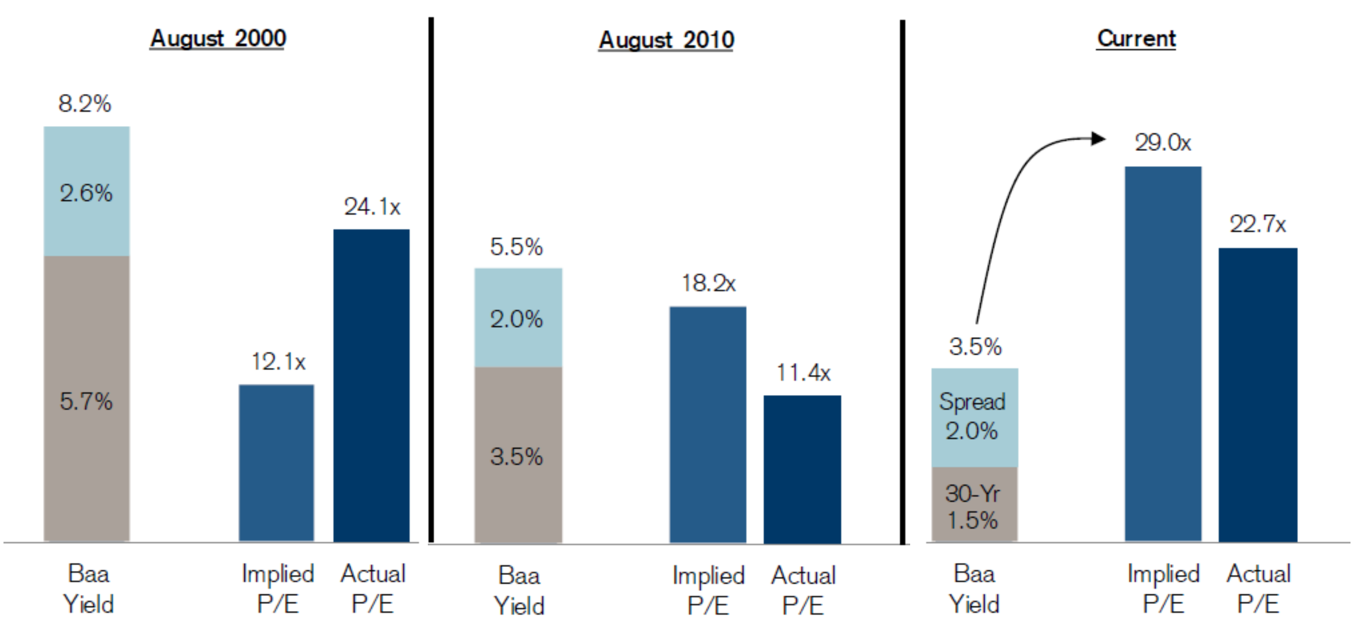


Source: TD Securities

What is obvious in this chart is that there is a high positive correlation between the level of interest rates as measured by the long term corporate bond yield and the earnings yield for the S&P500 (red and blue lines). Also, in the chart, if you look at the 2000 tech bubble (the yellow shaded area), risk free treasury yields were over 6% at that time and corporate bonds were yielding north of 8%. So, there were other attractive alternatives to owning stocks back then, which at that time had an earnings yield of only 4% (equal to the inverse of the P/E of 25x earnings at that time). Tech stocks were trading closer to 50x earnings (meaning they had an earnings yield of 2%). However, today the risk-free rate (yield on 10 year treasuries) is almost zero (0.66%) and investment grade corporate bond yields are close to 3%. So, interest rates are so low that bonds are no longer as attractive relative to equities driving investors into the stock market despite the low earnings yield (and therefore high P/E ratio) on stocks. They are generally still higher than what investors can get on bonds. In Exhibit 5, we have taken a closer look at different periods in history to try to further understand valuations today.

On the far left is August 2000, the same period we just discussed (the tech bubble). In August 2000, investment grade corporate bond yields were yielding 8.2% as compared to the S&P500 trading at 24.1x earnings or the inverse earnings yield of 4.2%. However, if you assume equities should yield at least as much as corporate bonds, that is 8.2%, the inverse of that, the implied P/E ratio that one should expect for the stock market would be no higher than 12.1x. We believe at that time investors looked at the actual market valuations, which were significantly higher than that and opted out of stocks for other assets such as corporate bonds yielding 8.2% or even risk free bonds (10 year treasuries) yielding 6%, which effectively drove the end of the tech bubble. A similar analysis is shown in the middle clip of Exhibit 5 ten years later.

Exhibit 5:
Bond Yields vs. S&P Price/Earnings



Source: Credit Suisse

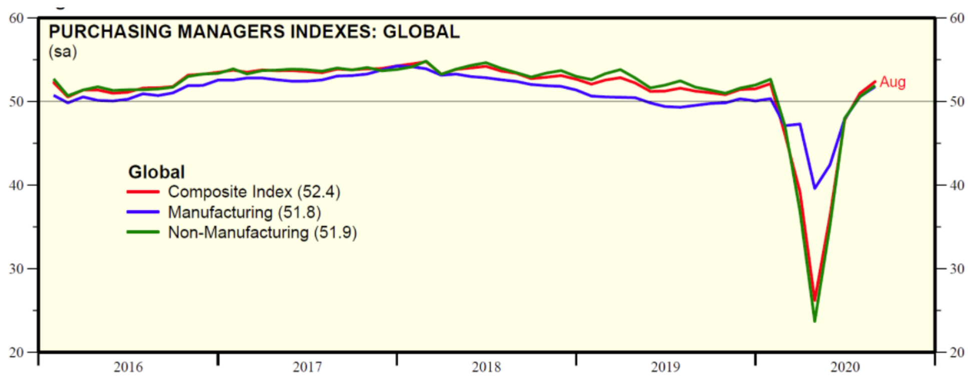
In August 2010, which was the beginning of the past 10 year bull market for stocks, corporate bond yields of 5.5% suggested the implied equivalent P/E for the market might be closer to 18.2x as compared to the very depressed Great Financial Crisis Price/Earnings valuation of only 11.4x at that time. This is very simplistic way of looking at valuations as it may not adequately measure equity risk premiums, the underlying earnings growth assumptions for the market or what the U.S Federal Reserve (FED) action was at the time, however; applying the same valuation analysis another 10 years later at today's record low bond yields implies a comparable market P/E of 29x, which is much higher than the current 23x forward P/E. So, if the FED keeps its foot on the gas pedal keeping interest rates low, combined with the possibility of a vaccine and a recovering economy, these types of valuations may persist!

So, let's consider each of these possibilities:

On March 23rd, the FED adopted QE4, an open-ended commitment of bond and mortgage-backed security purchases. Together, between the FED and some large commercial banks, this has resulted in an unprecedented $2.5 trillion in security purchases since that time, and is one of the primary reasons interest rates have remained so low. Much of these purchases were to fund the Treasury payments to individuals and households under the CARES Act (Coronavirus Aid, Relief, and Economic Security Act) as well as grants, loans and tax relief to distressed businesses. On September 16th, the FED released its latest summary of economic projections following its Federal Open Market Committee (FOMC) meeting. Of the 17 FOMC participants, not one expects any change in FED interest rate policy, which essentially keeps rates at zero, in 2020 and 2021 and only 1 of the 17 participants expects an increase in 2022.

In terms of the economic recovery taking hold, Exhibit 6 measures the global composite (Purchasing Managers Index) PMI index (shown in red). This combines the global manufacturing (M-PMI) and non-manufacturing indices (NM-PMI). Anything above 50 indicates the global economy is expanding. As indicated in the chart, it has rebounded from a record low of 26.2 during April to 52.4 during August, which is the best reading since March 2019. And looking at the chart, it certainly does look V-shaped! Closer to home, the US advanced Markit PMI for September, released last week at 53.5 showed factory activity grew at a robust pace in September. US Markit Services grew at a slower pace of 54.6, however; the overall pace of activity remains fairly strong and firmly in expansion territory (above 50).

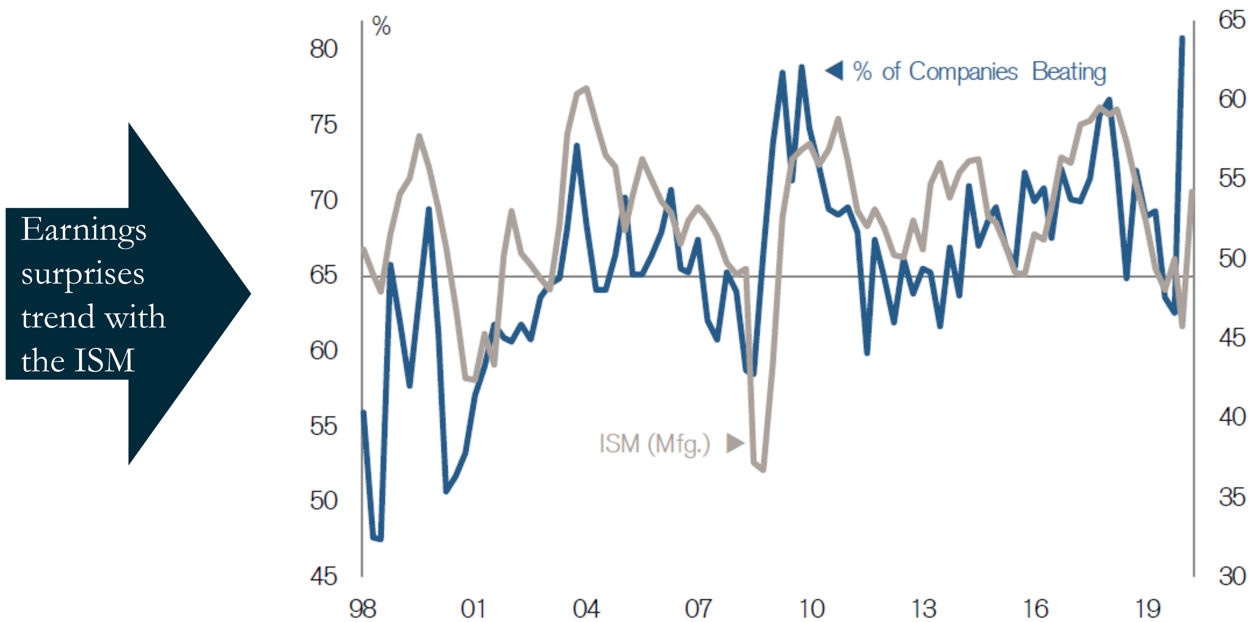
Exhibit 6:
Global Purchasing Managers Index



Source: Yardeni Research

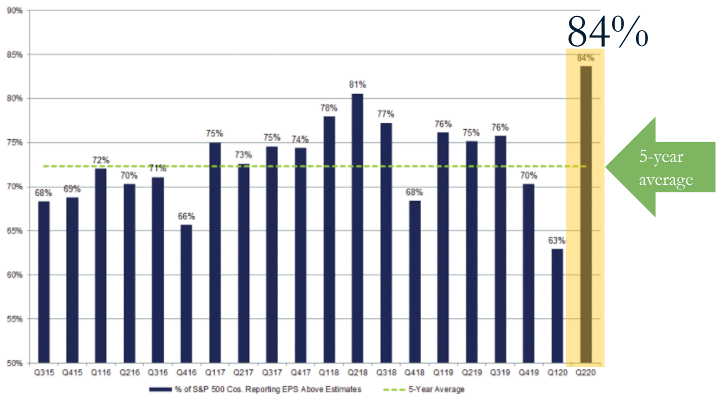
Exhibit 7 compares US ISM (Institute of Supply Management) Manufacturing PMI (the grey line) to the percentage of US companies beating on earnings (the blue line). As indicated in the chart, there is a strong positive correlation between earnings beats and recovering ISM manufacturing data. For the second quarter of 2020, the number of companies in the S&P500 beating estimates actually soared to 84% (Exhibit 8), the highest on record since they began tracking the data in 2008. Not only was it the highest number of companies beating on earnings but the size of the actual earnings beat versus consensus was also the highest on record at 23.1% compared to the trailing 5 year average of 4.7% (Exhibit 9).

Exhibit 7:
US ISM Manufacturing vs. Beating Earnings



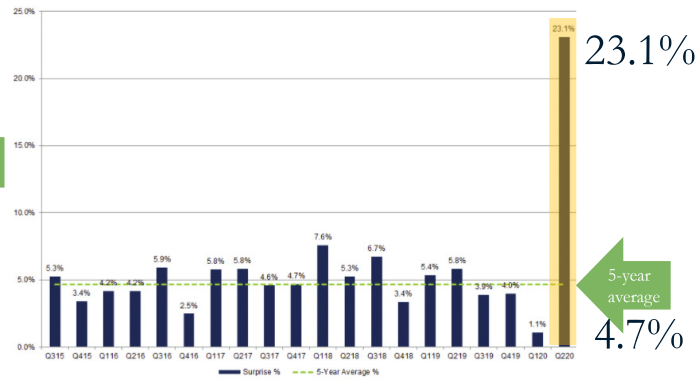
Source: Credit Suisse

Exhibit 8:
S&P 500 Positive EPS Surprise (% of companies)



Source: Factset

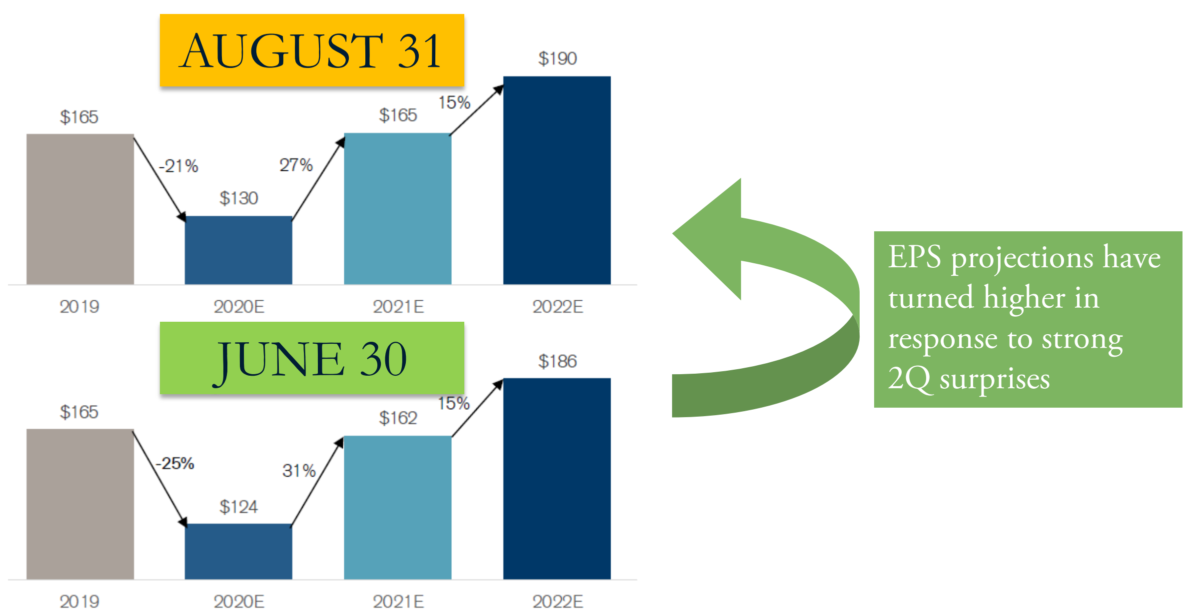
Exhibit 9:
S&P 500 Size of Earnings Surprise



Source: Factset

Exhibit 10 looks at the consensus earnings estimates for the S&P500 for 2020, 2021 and 2022. It compares estimates at June 30th, and at August 31st. As indicated in the chart, forward earnings estimates are materially increasing. This, combined with Jerome Powell's statement in July that the Fed is "not even thinking about, thinking about, thinking about raising rates" could provide the bridge for the market multiple to catch up to the future earnings.

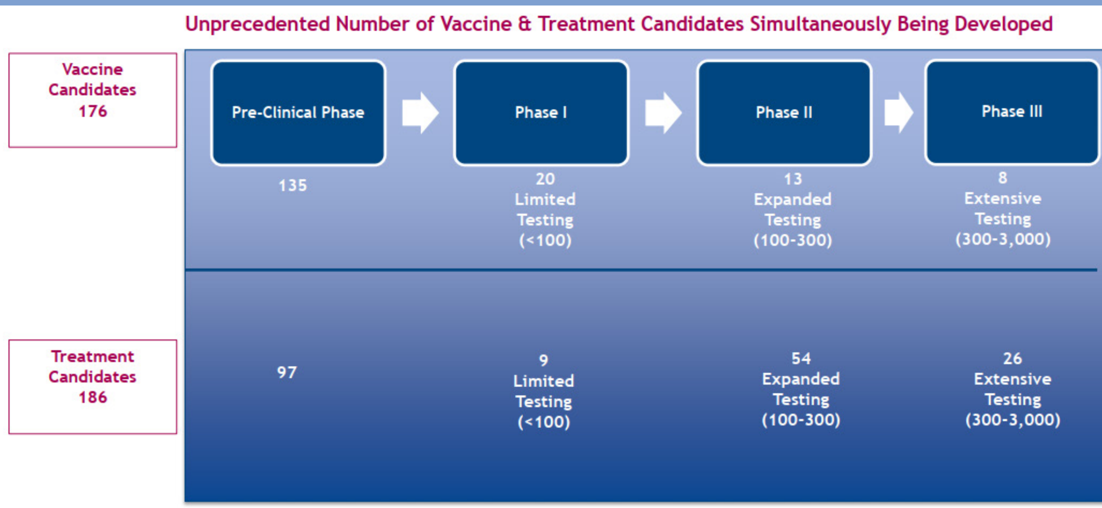
Exhibit 10
S&P 500 Consensus EPS: Current vs June 30



Source: Credit Suisse

Regarding a possible vaccine or treatment for COVID -19, Exhibit 11 shows the latest count of vaccine and treatment candidates. As indicated in the chart, there are a number of Phase 3 clinical trials under way, with some data indicating whether the vaccine is effective rolling out as early as October 2020. While no one can say for sure when and how this will play out progress on a vaccine will likely have a much bigger overall effect on the economy than anything else, including the upcoming election.

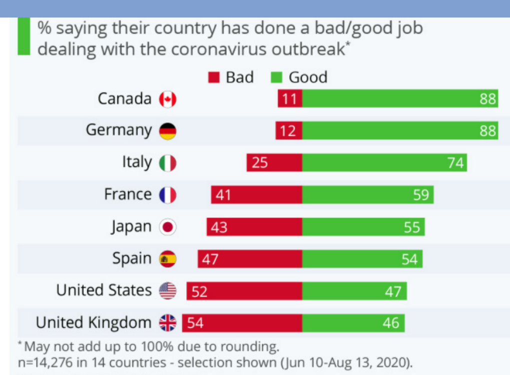
Exhibit 11:
COVID-19 Vaccine & Treatments



Source: Sun Trust

And if there is anything good to say about the situation here in Canada, as indicated in Exhibit 12, it might be that most Canadians feel our Government has done a pretty good job in handling the outbreak at least compared to other countries.

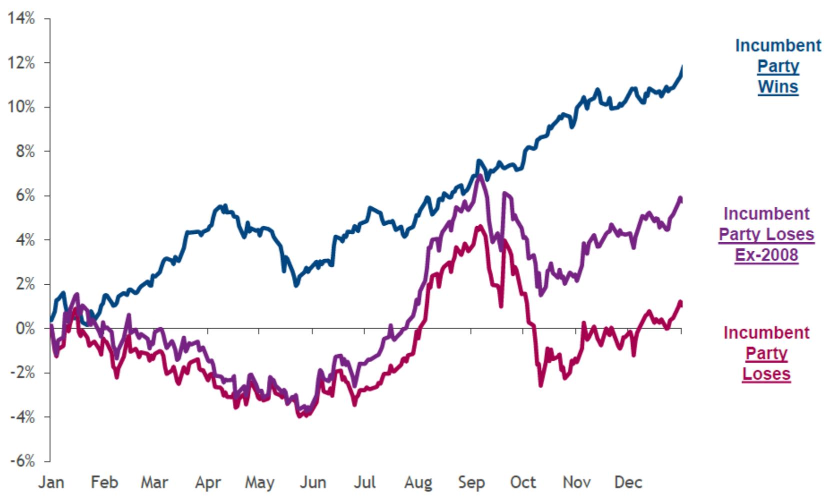
Exhibit 12:
Where Government COVID-19 Responses Get Public Approval



Source: https://www.statista.com/chart/22756/public-opinion-on-government-coronavirus-response

The other known unknown is that this is an election year. Exhibit 13 looks at the historical average path for the S&P500 going back to 1928 for the 12 months following a US election. As indicated in the chart, the stock market tends to do best when the incumbent party wins (which is the blue line). This may reflect the fact that the status quo is maintained and there are no surprises. However, even when the incumbent party loses (red line), the returns have historically been modestly positive after the first year of the election. Excluding the Great Financial Crisis of 2008, returns have been even higher at mid-single to double digits depending on who wins (purple and blue lines).

Exhibit 13:
Typical Market Path: All Election Years, Incumbent Party Wins/Losses (1928-2016)



Source: Sun Trust

Another concern should the Democrats win is Biden's pledge to raise corporate taxes from 21% to 28% or about half of Trump's tax cut in 2018.

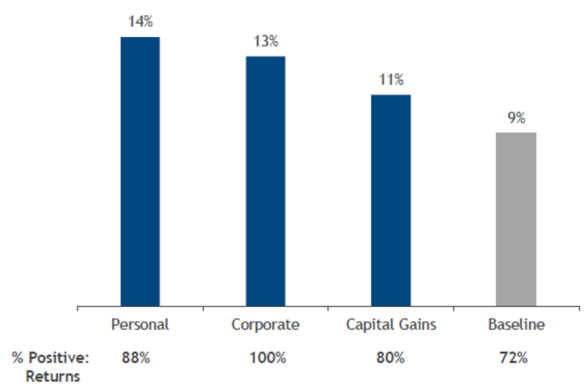
This represents a loss of about $9 of earnings potentially. However, recall in 2018 when Trump introduced the tax cut, the stock market was down over 6% that year as the FED was raising rates. The point being that other factors could come into play other than just changes in the tax rate. Exhibit 14 looks at the impact of historical tax increases in the US whether it be personal, corporate or Capital Gains against the performance of the S&P500. This appears somewhat counterintuitive but stock market returns have been consistently positive.
This does not mean tax increases are good for the economy, but it does infer that other factor besides tax increases influence markets.

Exhibit 14:
Stronger Performance In Years of Tax Increases?

Years in Which Taxes Were Increased

Year	Personal	Corporate	Capital Gains
1950	X	X	
1951	X	X	
1952	X	X	
1968	X	X	X
1969	X		X
1970			X
1971			X
1972			X
1976			X
1987			X
1991	X		X
1993	X	X	X
2013	X		X
Total	8	5	10

S&P 500 Average Returns During Years
With Tax Increases
1950 - Current



Source: Sun Trust

During the Third quarter of 2020, the S&P500 total return index was 8.9% in US dollars. Adjusting for currency, the S&P500 returned 6.6% in Canadian dollars, as the Canadian dollar appreciated about 1.5 cents closing the quarter at US $0.7509. The TSX total return in the second quarter was 4.7%

During the quarter, our overall equity exposure decreased by 2% to 93% from 95% at June 30th. Our US equity exposure decreased from 55% to 50% while our Canadian equity weight increased from 40% to 43%. Cash increased from 5% to 7%. It is important to note that many of our clients follow our North American plus International strategy for the equity component of their portfolio, meaning that the actual weights of US and Canada within their equity holdings will be less than this given the allocation to international positions outside of Canada and the US.

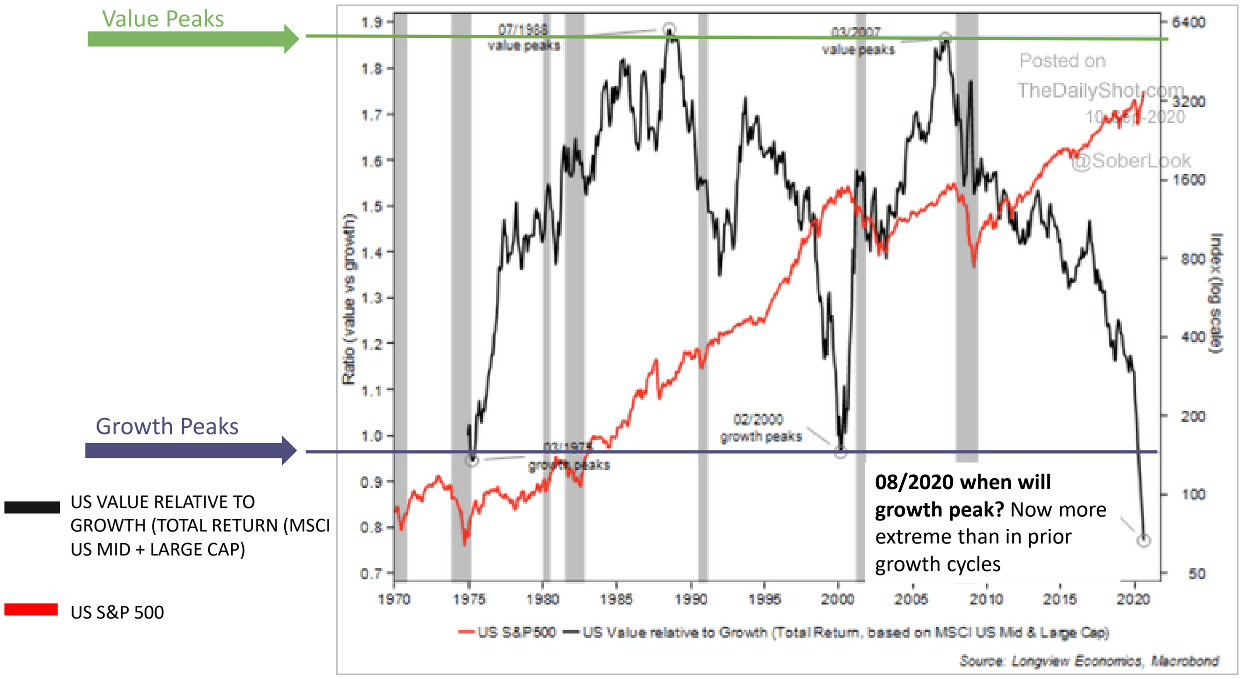
Asset Allocation for our North American Capital Appreciation Strategy As at September 30, 2020

Equities	93%
Fixed Income	0%
Cash	7%

As we discussed at our recent client quarterly presentation, we have taken somewhat of a barbell strategy with our large sector exposures split between what we consider offence and defense companies or growth versus value. In the current environment, it is important to position the portfolio to benefit from the economic recovery while not fully depending on it, so our current split between offence or growth stocks, which are typically more dependent on trends independent of an improving economy is about 38% (down from 41% at June 30th) versus defense or value stocks, which are more dependent on an economic recovery is about 49% (down from 51% at June 30th). Staples, which we don't classify as either growth or value, make up the balance of our equity exposure. Our growth style stocks are represented by reasonably priced positions with strong secular tailwinds that are in place regardless of the economic environment. For example, trends such as the transition to cloud computing, digital payments and ageing demographics many of which have only strengthened during the pandemic outbreak. These are represented by Information Technology, Communication Services and Healthcare sectors. Our value style investments are the more economically sensitive cyclical sectors in Financials, Consumer Discretionary, Industrials, Energy and Materials.

Exhibit 15 compares the ratio of value versus growth stocks (the black line) to the performance of the S&P500 (the red line) over time.

Exhibit 15:
Growth vs. Value



Source: Longview Economics, Macrobond, Daily Shot

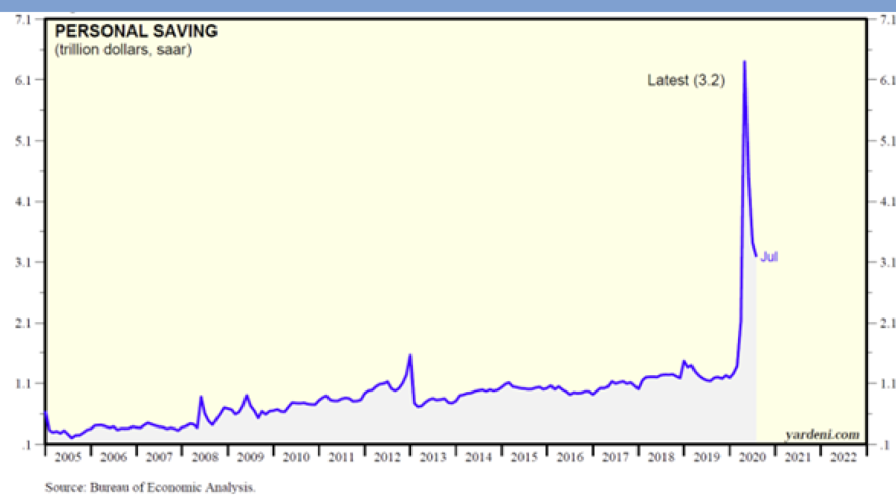
As indicated in the chart, while the S&P00 has consistently increased over time there are periods when value outperforms growth and vice versa although as indicated on the bottom right hand side of the chart, the peak in growth outperformance appears to be at a new extreme suggesting a possible reversal of the trend in the future. Our "bar bell strategy" allows us to be somewhat agnostic at the moment to one or the other style, however; the portfolio is tipped more toward the value end of the spectrum at 49% value versus 38% growth. Either way, we feel well positioned for any cyclical shift, but we should also continue to benefit from the strong secular tailwinds mentioned above.

During the quarter we added one new name, Thomson Reuters (TRI) to the portfolio. Thomson Reuters provides news services as well as legal, tax and accounting information services to professionals globally. We believe TRI offers an attractive risk reward payoff as it continues its evolution as a business software provider, which could help command a higher valuation. We also believe under its new management there exists opportunity to expand margins while compounding its top line growth. A complete review of the business and fundamental outlook for each of the companies that were purchased during the quarter can be found in Appendix 1.

Outlook

As discussed, there are a number of known unknowns that have recently caused a surge in the level of market volatility in September. These include the second wave of COVID-19, uncertainty around the election and the prospect (or lack off) in the US for more fiscal stimulus measures as the current relief packages wind down, elevated market performance over the past few months and what appears to be an excessive valuation of the S&P500 at least when compared to historical valuation levels. However, in the context of unprecedented low levels of interest rates, we attempted to demonstrate how the current valuation levels may be justified or at least explainable. Regarding the economic recovery and its impact on future earnings, it appears supported by the strong bounce back since May in retail sales, durable goods orders, payroll employment and new and existing home sales not to mention the global PMI's we discussed. It appears to point to a V-shaped economic recovery that has supported a second quarter earnings recovery leading to materially higher estimates and estimate revisions for 2020, 2021 and 2022. While unemployment still has a way to go to get back to pre-COVID levels, Exhibit 16 shows that consumers still have a lot of cash on the sidelines as the July personal savings level of US $3.2 trillion, while down from the record high in April of US $6.4 trillion, is still above the US $1.1 trillion level at the start of the year.

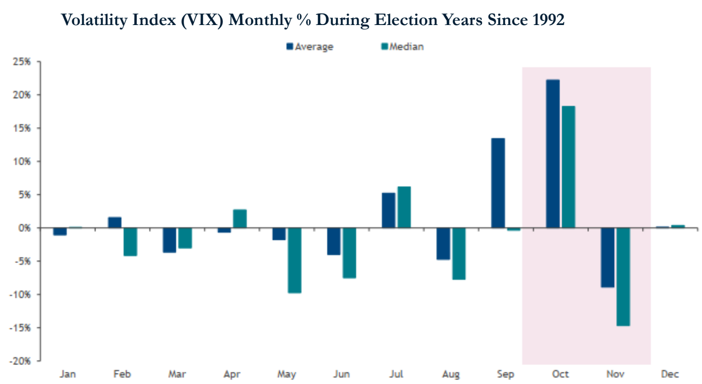
Exhibit 16:
Personal Saving



Source: Yardeni, Bureau of Economics

Exhibit 17 measures the historic volatility in the periods leading up to an election going back to the early 1990's. As indicated in the chart, volatility historically increases in the September to November time frame as we have witnessed recently. In anticipation of this, we did increase our cash level a little at the beginning of September in the North American Capital Appreciation / equity strategy. However, as we showed in Exhibit 13, post-election one year returns for the S&P500 have historically been positive in the mid-single to low double digits regardless of who wins. And while volatility has risen recently, Exhibit 18 shows that S&P500 returns tend to be elevated following periods of higher volatility. During the current period of volatility, we will be looking for opportunities to put some of the cash raised back into the market.

Exhibit 17:
Historical Volatility (VIX) Around Election Time



Source: Sun Trust

Exhibit 18:
Performance by VIX Level

%	S&P 500	
When VIX>15	**Return**	**Annualized**
Subsequent 2 months	1.4	8.9
Subsequent 3 months	1.9	7.9
When VIX>20		
Subsequent 2 months	1.8	11.5
Subsequent 3 months	2.2	9.1
When VIX >30		
Subsequent 2 months	4.3	29.0
Subsequent 3 months	5.7	24.8

Sept 30/20
VIX 26.4

Note: 1996 to Present
Source: Standard & Poor's, Russell, CBOE, Haver Analytics, Credit Suisse

Our final chart in Exhibit 19 shows some of the important characteristics of our portfolio versus the benchmark. It examines our portfolio relative to the S&P500/TSX benchmark by valuation, profitability, and risk. In the blue clip at the top, we look at our valuation as measured by the Forward Price/Earnings multiple and Enterprise Value/EBITDA multiple, followed by Profitability in the middle purple clip as measured by the Return on Equity (ROE) and the Return on Invested Capital (ROIC).

Exhibit 19:
North American Portfolio Comparison to Benchmark

	Portfolio	50/50 S&P500/TSX Benchmark
Valuation		
Forward P/E (12m)	19.9x	19.1x
Forward EV/EBITDA	16.4x	14.1x
Profitability		
ROE (5 yr average)	24.6%	20.8%
ROIC (5 yr average)	12.5%	9.3%
Risk		
Standard Deviation (5 yr)	10.8%	11.5%
Beta (5 yr)	0.92	1.00
Debt/EBITDA	3.7x	4.6x
ESG Score	73.1	52.5

Source: Bloomberg, Morningstar, NA Portfolio, 30Sept2020

Finally risk is shown in the dark green clip as measured by the standard deviation (a measure of volatility), beta (volatility relative to market), leverage (debt) ratio and our Environment Social Governance or ESG score as measured by Sustainalytics. As indicated in the chart, the portfolio continues to trade about in line to slightly above the market multiples, yet is consistently more profitable as measured by the ROE, ROIC, and this is accomplished with less leverage and lower overall risk or volatility.

Peter Jackson
Chief Investment Officer
September 30, 2020

APPENDIX 1

NEW EQUITY INVESTMENTS:

NORTH AMERICAN EQUITY MANDATE

CANADA

Thomson Reuters

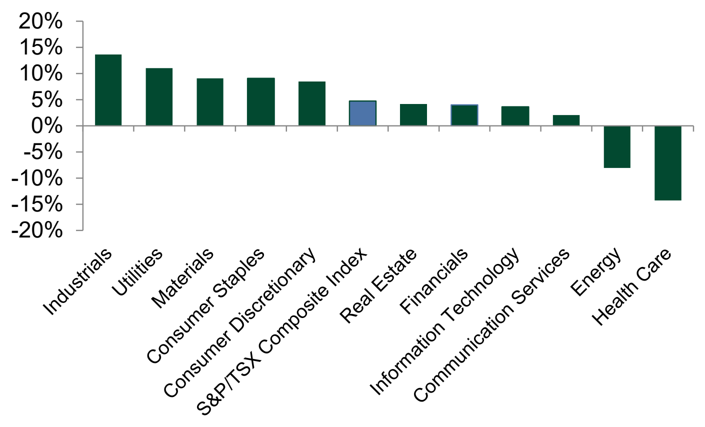
Thomson Reuters is a Canadian company that provides leading legal and accounting software and content. Their products are deeply embedded into their customer's day to day business resulting in a 90% renewal rate. It has an attractive business model with 80% recurring revenue and 90% of its revenues coming from electronic delivery, including cloud-based offerings. We believe that over the medium term, they will be able to grow their revenue mid-single digits, leading to free cash flow growth in the high single digits. And the upcoming sale of their financial division, Refinitive, to the London Stock Exchange (LSE), for about $9 billion in LSE stock (about 15% of the LSE) will represent a good store of value that Thomson Reuters can draw down on over time to fund future growth opportunities.

We already owned Thomson Reuters in our Canadian model but added it to the North American portfolio in August after having increased conviction in their earnings stability and ability to grow their business through tough economic environments. In their last quarter, despite the Corona virus related slowdown, they were able to produce 2% organic revenue growth in their 3 main segments and then reaffirmed their firm wide guidance for revenue growth of 1 - 3% for the year at a time when most other companies were pulling their guidance for the year.

APPENDIX 2

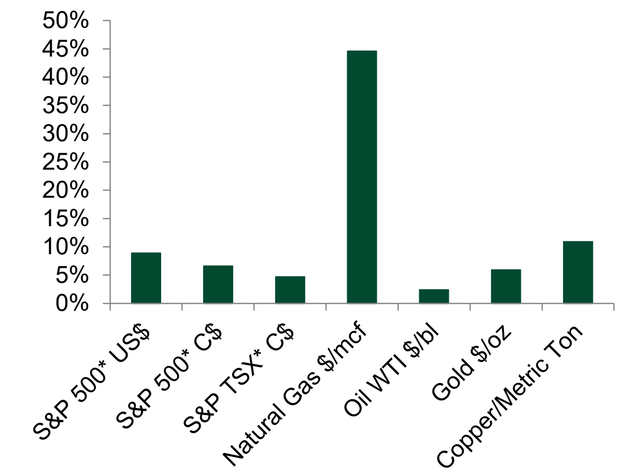
PERFORMANCE CHARTS

S&P TSX (C$ Total Returns)
Quarter Ending September 30, 2020



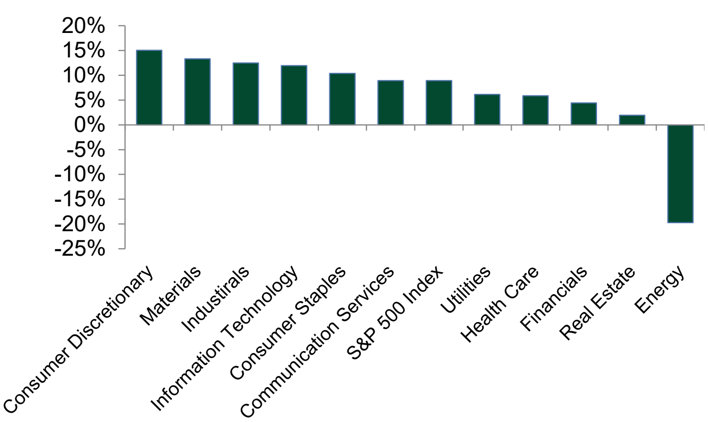
Source: TD Securities

Quarter % Change
Quarter Ending September 30, 2020



Source:Bloomberg *Total Returns

S&P 500 (US$ Total Returns)
Quarter Ending September 30, 2020



Source: TD Securities