Market Commentary

PORTLAND INVESTMENT COUNSEL™

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News Highlights on Current Holdings

- **Prudential** (after completing 9 months of due diligence and competitive hiring from AIA) has just announced that it will buy AIG's Asian life business AIA from AIG in a deal worth $35.5bn. We believe this represents approximately 1.7x Economic Value (EV) and 18.7x 2007 Earnings per share and 25.4x AIA's 2009 New business profit. Whilst this realizes the group's ambitions by transforming the asset mix from c44% Asia to over 60% Asia it will be a large deal to fund and hence be significantly dilutionary to existing shareholders - we believe up to 15% - albeit on the conference call management indicated the deal to be earnings per share neutral by 2012. The positive angle is that the multiple being paid could be said to be significantly better than the average of Asian peers of 2.3x EV (however this is squewed by the Chinese names). Funding:
  - $20bn rights issue underwritten by Credit Suisse, JPMorgan and HSBC to be launched between May-June.
  - $5bn senior debt issue.
  - $10.5bn of securities to AIG composed of $5.5bn of "New Prudential" shares, $3bn of mandatory convertibles and $2bn preferred securities.
- Post the deal the stock will be dual listed in Hong Kong and London. The deal is we believe conservatively expected to create $340m of pre-tax synergies and complete in Q3. Prudential has a current EV around 540p.
- In our opinion, Prudential's acquisition of AIG's Asian life business is potentially a very good combination… given that the new group will, we believe, have between 20-50% market shares in its operating areas in Asia. Also the combination of AIA and Prudential's Asian operations would dominate the agency distribution channels – we believe door-to-door selling is the best way to tap the Asian "cash under the bed" savings – in the faster growing Asian regions where we believe through scale and reach the enlarged group would have a competitive advantage. They would also have a dominant position in the higher margin risk product areas in Asia. However, the standalone valuation of AIA is hard to determine and we believe the market will remain nervous pending clarity on value and on deal risks given the sheer size of the integration across countries (although clearly this creates cost synergies).
- **Bayer AG** announced their Q4 and full year 2009 results in Leverkusen, Germany, on Friday. While the operating results were broadly in-line with the expectations, the reported numbers were mildly below, impacted by larger than expected special charges related to restructuring and on-going litigation provisioning. Robust results in health care were offset by weaker than expected results in crop science and a slower recovery in materials science. The underlying operating margins were close to record highs for both healthcare and crop science. The outlook is cautiously optimistic with 5% sales growth targeted for the next 3 years and an average improvement in earnings per share of about 10% a year. We believe a stronger rebound is expected in the materials science area, the most badly hit in the current cycle, as well as significant positive developments are expected in pharma, especially around Xarelto, the potential blockbuster anti blood-clotting drug. The company's results were the third best in the firm's history in a very tough environment. Good cash flow management delivered a net cash flow of 5.4 billion euro, a record level. This allowed the company to reduce its net debt position by 4.5 billion euro, to 9.7 billion euro and maintain its annual cash dividend at a 1.4 euro/share level. Market focus is likely to be on 2010 guidance which we believe is deliberately conservative, especially re crop science, from a new management team, whereas we remain strong advocates of this company.
- **Nestle**, the largest food producer in the world, announced a 4.1% organic growth outpacing its European rivals, Unilever and Danone. Notably, its top line growth was driven by both pricing and volumes in a historically tough trading environment. At the same time the company guided for a step-up in the organic growth for 2010 as well as an increase in the earnings before interest and tax (EBIT) margin, consistent with the now famous 'Nestle model' of continuous improvement.
- Following the successful divestiture of the last Alcon stake and robust internal cash flow generation, the company is able to increase its annual dividend by 13%, to 1.60 Swiss francs/share, as well as to continue its share buy-back program by acquiring 10 billion Swiss francs worth of its own shares in 2010.
- **Schindler**, the leading elevator and escalator (E&E) company reported a net profit increase of 3% over the previous year, driven by the improved profitability in its E&E business, which delivered an EBIT margin of 11.6%, up from 10.2% the year prior. Of note, despite a 9.1% decrease in orders received compared to 2008, the order intake has improved towards the end of the year reaching a growth rate of 7% year on year for the last quarter. The book to bill ratio for the fourth quarter sat at 1.02. Cash generation was solid throughout the period, the company closing the year with

almost 2 billion Swiss francs of net cash. The company is maintaining its 2 Swiss francs/share dividend.

- **Novartis** won't pursue large, Alcon-style takeovers, Dow Jones reports. "We see significant growth over the next ten-years," CEO Joe Jimenez said during the company's annual general meeting in Basel. "Alcon gives us the growth platform as the takeover is consistent with demographic trends." Because people are getting older around the world " the need for eye care treatment will rise," Jimenez said. Given the growth prospects for Alcon and the need to integrate the company into Novartis over the next few years, Jimenez said Novartis is likely to pursue smaller, bolt-on acquisitions in areas such as vaccines rather than seek a bigger deal.
- **Iberdrola**… Spain's largest power group Iberdrola met forecasts with a 6.3 percent rise in 2009 core profit, thanks to consolidation of its US operations and a better performance by its renewable unit in the fourth quarter.
- **Lloyds Banking Group,** Britain's largest retail bank, shrank its losses in 2009, despite a 24 billion pound $37 billion) hit from loans that soured, mostly assets inherited from last year's takeover of rival HBOS.
- Lloyds reported a statutory pre-tax profit of £1.0bn and pro-forma loss of £6.3bn (after fair value unwind of £6.1bn). Income was £24.6bn benefiting from 2H09 gain of c£0.8bn. Impairment charges were £24.0bn, or £5.4bn in 4Q and Non Performing Loans are up c£10bn Half on Half. Guidance is for a similar sequential c20% HoH reduction into 2010. The group margin came in at 1.77%, implying a sharp recovery in 4Q09, which looks to have been driven entirely by Retail. The 2009 numbers look fairly disappointing as management resolve to clean up the acquired HBOS book. Impairment charges are guided at c£14bn broadly in line with consensus. The net interest margin is guided to c2% in 2010 and rising thereafter, leading to high-single digit income growth within two years. Overall, Lloyds still has to prove it has a handle on credit quality, but the projected margin improvement should be enough to provide comfort.
- Core Tier 1 ratio is 8.1%. Cost synergies from the integration of HBOS have been lifted to £2bn by end 2011 from £1.5bn. Annualized run rate savings were £766m by year end. We believe the final results highlight that impairments are past the worst, the net interest margin is recovering and cost synergies from the HBOS integration are ahead of schedule. Having escaped the Asset Protection Scheme, the group looks adequately capitalized but remains a very modest holding in our funds, albeit presenting opportunities to write both put and call options.
- Standard Chartered launched custody & clearing services for Middle Eastern clients - Standard Chartered launched custody and clearing services for clients investing in Bahrain and Oman, bringing the number of Middle Eastern markets where the firm provides securities services to five. Giles Elliott, global product head of securities services, said 'ongoing demand for regional and international investment services in the Middle East is the reason for the firm's decision to expand.'

Economic Activity, Consumer and Business Conditions

- US Consumer Confidence sharply missed expectations in February, down 18.5% m/m to 46.0 from 56.5 in January (revised up from 55.9) and versus expectations for 55.0. The decrease in the February reading was driven by both decreases in consumer sentiment surrounding the present situation (down 23.2% m/m and the lowest reading in over 40 years), and in sentiment surrounding the future conditions (down 17.4% m/m). The spread between the two narrowed, but remains in negative territory, which it had initially touched in September 2008, a pattern consistent with past "official" recessions. This is hardly a surprise given that:
    - The average duration of unemployment is currently sitting at 30.2 weeks, the highest since at least 1950 and 50% higher than the previous highest level in 1983;
    - The initial unemployment claims number worsened by adding 54,000 claims over the last two weeks to reach 496,000, while the four week average reached 474,000.
    - The personal income number, released Monday morning, disappointed, indicating an increase of only 0.1% month on month, versus the 0.4% expected.
- Of note, these results should be interpreted in the context of the severe winter weather that hit much of the US. Past evidence suggests that winter storms have a significant negative impact. As such, we would look to March data to confirm this negative trend before drawing any firm conclusions.
- On a mildly positive note, the second estimate of the Q4 GDP growth led to an upward revision to 5.9% from the previous 5.7% estimate. All inflation indicators, including the headline and core consumer price index (CPI) and the core personal

consumption expenditure (PCE), show balanced risk between inflation and deflation. The core PCE index, the Fed's favourite inflation gage, is sitting at 1.5%, unchanged from the previous month reading.

- The set of data released in Canada over the same time period was significantly more up-beat: retail sales in December exceeded expectations, the average weekly earnings improved by 2.8% year on year and the revised Q4 GDP growth weighted in at a robust 5% annual rate. In an environment of relative inflation acceleration, with the headline CPI at 1.9% and core CPI at 2.0% year on year, markets' expectations for a BoC tightening are stronger. However, the central bank has expressed several times its concern with the impact of a strong dollar on the very weak manufacturing sector.
- 'Volcker Rule' stalls in US Senate – Per the WSJ, key US senators are expected to scrap President Barack Obama's proposal to prohibit commercial banks from certain risky trading activities, people familiar with the matter said, a setback for the administration's bid to limit the size and scope of the largest US banks. The proposal – named the "Volcker rule" after former Federal Reserve Chairman Paul Volcker – would have essentially prevented any commercial bank with federally insured deposits from owning a division that makes speculative bets with its own capital. But after resistance from lawmakers from both parties, Senate Banking Committee Chairman Christopher Dodd (D., Conn.) and other legislators are expected to introduce a plan next week that would give regulators more discretion to limit and potentially ban risky trading at banks, especially if it poses a risk to the broader economy. The measure would stop short of banning such trading outright.

Financial Conditions

- The 10yr treasury yield was relatively stable at 3.69%, while 2s/10s remained steep at 285bps. In our view Chairman Bernanke's testimony last week was largely as expected. He described the economy in cautiously optimistic terms, reiterated his previous statements on the Fed's exit strategy, and continued to say the federal funds rate would likely be low for an extended period. He did note that the Fed was developing the capacity to carry out reverse repurchase agreements with the GSEs. Overall, the testimony does not change our views that the first rate hike will probably occur in 4th quarter 2010 or later.
- Separately, new home sales tumbled 11.2% m/m to 309,000 in January, significantly below consensus of 353,000. This left new home sales at a record low for the series which goes back to 1963. The weakness was driven by a 35% plunge in sales in the Northeast, which more than offset a gain of 23% in the region the prior month. For the first time since April 2007, inventory of new homes for sale increased, albeit only by a slight 0.4%.
- Policymakers continue to accommodate a recovery in bank profits. The U.S. 2 year/10 year treasury spread is 2.82% and the U.K.'s 2 year/10 year treasury spread is 3.07% - enabling financial services companies' assets booked at these levels, to be very profitable, so enabling them to accelerate the absorption of anticipated consumer credit losses.
- Our concerns are mostly focused around the later cycle issues facing financial services companies – particularly commercial real estate and unsecured consumer loans/credit card loans. However, commercial real estate exposure is more acutely held by US regional banks – rather than larger more diversified global financial services companies. The number of small U.S. banks failing continues to grow (22 to-date in 2010 and 140 in 2009) but their franchises are being acquired/absorbed as convergence of the financial services industry accelerates – favouring we believe the stronger, better managed banks. Typically banks acquiring collapsed bank franchises from the Federal Deposit Insurance Corporation (FDIC) are paying little or no premium for deposits, assets are purchased at a discount and are covered by loss sharing agreements – so that such deals can be expected to be Immediately accretive to earnings per share.
- A concern which remains is the extent to which loan modifications are an exercise in loss deferral but for the larger franchises the quantum of proactive provisioning continues to act as a differentiator of quality which we believe has still to be fully appreciated.
- The VIX (volatility index) is 19.6 substantially below the levels experienced last August/September (and well off the highs of 70-80 witnessed late September/October). While, by its characteristics, the VIX will remain volatile, it is we believe further evidence of markets reacclimatizing to risk – typically we believe a VIX level below 25 augurs well for quality equities.
- We believe the next few years will highlight the growing polarization between strong and weak institutions. Financial

services companies that have capital strength will buy assets from those required to divest. Companies that have a strong presence in emerging markets will likely grow quicker than those that do not. Banks that have strong retail deposit franchises will take market share from those that rely on wholesale markets to fund loan growth at attractive margins. Financial services companies that have breached client trust will keep losing business to those reputations that have been enhanced by the crisis. We believe all the Funds are extremely well positioned to benefit from the strength of their portfolios of strong, dominant, attractively priced financial services companies.

Closed-End Funds

Spreads on the closed-end funds are narrowing but remain wide and so in our view are very attractively priced to purchase.

At the close of business on Fridays and at the end of each month we publish the Net Asset Values (NAV) of our funds onto our Portland website at http://www.portlandinvestmentcounsel.com/Funds/WeeklyPricing.aspx. The NAV for the AIC Global Financial Split Corp. can be found on the AIC/Manulife website at http://www.aic.com/EN/PricePerformance/AICClosedEndFunds/Pages/Price.aspx and the Copernican World Financial Infrastructure Trust, Copernican World Banks Split Inc. and the Copernican International Financial Split Corp. can be found on the Copernican website at http://www.copernicancapital.com/Funds/WeeklyPricing.aspx.

The details published last Friday are replicated here below from which you can see we also highlight whether the funds share prices are trading at a premium or discount to their respective Net Asset Value.

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