Market Commentary

PORTLAND INVESTMENT COUNSEL™

May 17, 2010

News Highlights on Current Holdings

Financial Services Companies

- **Financials litigation:** public scrutiny is increasingly underway with: (i) New York Attorney General Cuomo and Securities Exchange Commission investigating whether rating agencies were "duped" by 8 banks (Goldman Sachs, Morgan Stanley, UBS, Citigroup, Credit Suisse, Deutsche Bank, Credit Agricole and Bank of America) over ratings of synthetic Collateralised Debt Obligations and; (ii) in Germany Deutsche Banks' CEO Josef Ackermann told a Dusseldorf court that the lender wasn't responsible for the 2007 funding crisis that forced IKB Deutsche Industriebank AG to seek a bailout and; (iii) The US Financial Reform Bill has included a late entry – to reduce the interchange fee that banks receive from debit card purchases.
- **Morgan Stanley:** Federal prosecutors are reportedly investigating Morgan Stanley surrounding certain mortgage-derivatives transactions. The investigation, if any, remains very preliminary (Morgan Stanley has not been contacted by the Justice Department and has not received any related Wells notices). We believe Morgan Stanley's positioning in the Collateralised Debt Obligations business was more limited when compared to peers but acknowledge near-term headline risk remains high and the regulatory/litigation overhang is likely to overshadow brokerage sector valuations for a while. Nonetheless, with Morgan Staley's shares trading at approximately its current book value we believe concerns are more than fully reflected.
- **Bank of New York –** Ivy Asset Manager, owned by Bank of New York, has been charged by the New York Attorney-General's Office with fraud.. being accused of misleading clients about investments tied to Bernard Madoff in order to protect fee income. The allegations relate to 1998 when Ivy Asset Mgt placed client money with Madoff…. Bank of New York bought Ivy asset Mgt in 2000 since when the business has been effectively shrinking … with Bank of New York expressing disappointment that the complaint has been filed involving " a legacy business".
- **Deutsche Boerse -** reported 1Q 2010 results last week. Net profit of €157mn was marginally below €159mn consensus with sales revenues of €519mn slightly light of consensus €526mn. Within this, both Eurex (futures exchange) revenues and Clearstream (post-trading services unit) - the most "stable" division in the group - reported revenues inline with expectations and the group's underlying clean operating expenses of €271mn were better than expected and the underlying 2010 cost guidance is unchanged at €1.21bn (excluding €40mn expenses related to the cost initiatives). Deutsche Börse remains our favoured play in the European exchanges space given its resilient diversified business model. We see the business as ideally positioned to benefit from positive operating leverage as volumes recover (a trend seen in April). The business remains very well-placed to exploit the opportunities from looming OTC regulatory reforms.
- **ING -** Reported Net Income E 1.33 billion, well above consensus of E 981 million and importantly the 'clean' commercial result looks good too. Reported net is helped by lower banking provisions and lower market impacts. Strong shareholders equity +13% q/q, helped by higher profits and FX. Capital ratios improved across the board with Core Tier 1 ratio of 8.4% and a Solvency ratio of 261% Banking Net Interest Income held up, the cost of credit improved and the earnings were boosted by a strong trading result. Tax rate increased to 43% which muted the overall contribution. In our view ING continues to trade well below the sum of its parts and so the group's ability to sell its insurance business remains a major swing factor for the share price.
- **Unicredit -** Reported a 1Q net profit of E 520 million, easily beating consensus of E364 million, due to lower provisions and better trading income. Enthusiasm for results were tempered by confirmation that UniCredit has E 31 billion of Italian sovereign debt exposure, albeit in our view that's hardly a surprise given this is an Italian-based bank. Commissions are good, helped by the Asset Management unit. Increase in total impaired loans is slower than recent quarters - Central and Eastern Europe credit risks showed most improvement and Italy least with Non Performing Loans coverage of 61.7%. Core Tier 1 is better than expected at 8.5%. Divisionally, the strength comes mainly in the Corporate & Investment Banking unit. Unicredit also advised they are examining strategic options for their asset management business Pioneer, deeming the unit not large enough (assets under management E 185 billion, making it the 17th largest asset manager in Europe) …and so seeking a strategic partnership (we view it as too big to be a boutique and not large enough to enjoy economies of scale in diverse markets) . Bank of America (i.e. Merrill) has been appointed advisor with CEO Alessandro Profumo stating a disposal was not an option under current market conditions.
- **Julius Baer -** announced an Interim Management Statement last week for the first 4 months of the year: Net new money inflows were up on the 2nd half 2009 rate, but the 4 months of 2010 pace remains slightly below their 4-6% (of AuM) annualized medium-term target. In context, we look for CHF5.0bn of inflows in 1st Half 2010 (which would be an annualized 6.5% in 1st Half 2010). Julius Baer still expects

though to hit their target for 2010 and cites the "impact from the changing regulatory environment in the core European countries" as a negative, with the positives being the performance in growth markets. Assets under management rose +14% (from FY09) to CHF175bn at the end of April. Gross Margin was not quantified but indicated as an improvement from the 2nd Half 2009 level, so we anticipate 103-106bps (i.e. 1-4 bps up from 2nd Half 2009). Tier 1 ratio looks to have slipped ~3ppts in 2010 to date to ~21%. This drop from end- 2009 is mainly attributable to the closing of the ING Suisse deal.

- **Hong Kong Exchange:** 1 Q 2010 net profit at HK$1,127 million was in line with expectations but down 8% on last quarter reflecting lower equity turnover and higher operating expenses, partly offset by better derivatives volumes. Depository & custody fees were down 36% Quarter on Quarter – which is seasonally weak, accounting for about 10% of group profits. Hong Kong remains the listing venue of choice across Asia.
- **Credit Agricole-** delivered a net profit of E 470 million, slightly above consensus of E451 million and characterised by a positive earnings trend in French Retail and in Specialised Financial Services , as cost of risk stabilizes, but recorded €184m losses in Emporiki, its problematic Greek subsidiary. The Corporate & Investment Banking and Asset Mgmt divisions were in line with expectations with CIB being in profit in 1Q2010 – for the first time since 2007. Nonetheless, from our meetings with management we'd expect ongoing derisking at CIB will naturally limit future contribution from its Capital Markets franchise. The group's Return on Equity of 4%, a cost income ratio of 66% and loan loss charges of 94bp (a decrease on 121bp recorded in 4Q09) are in our view lagging the improving profile of other large European banks (like BNP Paribas) such that a catalyst is more likely to be how it tackles its Greek subsidiary – and this will take time with expectations it will remain loss making for rest of this year and break-even next. The group's stated core Tier 1 ratio stood at 9.2%, a high level albeit this includes hybrids which could be discounted upon implementation of Basle III capital requirements although this is likely to be 2-3 years in the making.
- **Santander:** press reporting they may sell their insurance unit due to new banking regulations making it too expensive to own.
- **Barclays:** said to be opening Japanese trading operations next week.
- **Standard Chartered –** announced last week (as expected) that it is to proceed with an Indian listing (aimed at raising $500mn-$750mn via the sale of IDRs), StanChart's Finance Director, Richard Meddings is reported as saying the company believe profits from India could exceed those from Hong Kong next year.
- **Spain's Savings Banks:** although prudent regulation by the Bank of Spain meant lenders were spared exposure to US toxic subprime mortgages, Spain's savings banks 'cajas de ahorros' are heavily exposed to inflated Spanish property prices and are finding it very challenging to raise wholesale finance except via the European Central Bank. The Spanish government's Prime Minister has announced " By June 30, we'll have the 'definitive restructuring map for the cajas' … which we anticipate means the probable reduction in their numbers from 45 to about 30. We anticipate both Santander and BBVA will seek to play an active role in this consolidation process and already note their eagerness to exploit the cajas' difficulties by attracting savers by offering interest rates of up to 4% - a rate that few cajas can afford to compete against.
- **RBS -** has agreed to settle a money-laundering case with the US government for $500mn; this is a legacy lawsuit from ABN Amro. ABN were alleged to have helped governments and banks of Iran, Libya, Sudan and Cuba with money-laundering. RBS say the $500mn is covered by a provision from the ABN days.
- **Goldman Sachs' -** an article in the Financial Times last week recognises that Goldman's trading operations made money every single business day in the first quarter, a feat that was a first for the bank, but could fuel criticism of its business model and market behaviour. The Financial Times also comments that Goldman Sachs has stated it expects more shareholder lawsuits and regulatory investigations related to its CDO offerings and acknowledges that such actions could have an 'adverse' impact on its business.
- **Goldman Sachs -** An investing arm of Goldman Sachs is reported by Reuters to be in the final stages of an agreement to buy AXA's $1.05 billion 15.6% stake in Taikang Life, a deal that could give Goldman a substantial stake in China's No.4 life insurer. A deal would allow France's AXA to shed a non-core asset, while granting Goldman a piece of China's growing insurance industry. Like any auction, the deal is subject to last minute changes, and given that it concerns foreign investment, the Chinese authorities will give the acquisition a thorough final check.
- **AXA** acquired Switzerland's Winterthur in 2006 and through that deal gained the stake in Taikang. We understand that AXA had little control over management decisions at Taikang and that tensions between AXA and Taikang Chairman and Chief Executive Chen Dongsheng had been growing. Chen

and his associates own a combined 14 percent stake in Taikang. Other shareholders include big Chinese state-owned enterprises CITIC Group and Sinopec.Taikang is understood to have a 7.9 percent share of China's life insurance market as of 2008, ranking Taikang No.4 behind China Pacific Insurance (Group) Co Ltd which is partly owned by the U.S. buyout giant Carlyle Group.

- **China Life Insurance Co Ltd** is the market leader in the world's most populous country, and Ping An (17% owned by HSBC is #2) ..and the Communist government is understood to be increasingly encouraging people to buy insurance as Beijing reforms its healthcare system for the sake of social stability.
- **NYSE Euronext:** has unveiled a plan to push into equities and derivatives clearing in London and Paris, by setting up a cash equities clearing house in Paris and sever ties that its derivatives exchange, NYSE Liffe, has with LCH.Clearnet. This is a further sign that the trend towards direct exchange control of clearing houses is intensifying as the lucrative business of clearing becomes an increasingly important part of market reforms in the wake of the financial crisis.
- **TD** announced another small acquisition - the acquisition of The South Financial Group (TSFG) , which has 176 branches (66 in Florida, 83 in South Carolina, 27 in South Carolina). TD is offering $0.28/sh cash or 0.004 TD shares to shareholders for consideration of $61mm to TSFG shareholders. Also, TD will pay $131mm to the U.S. Treasury to repurchase preferred stock/warrants originally issued for $347mm. TD says the transaction will be accretive to F11 EPS, and will lower the Tier 1 ratio (currently 11.5%) by 40-50bps, after issuing $250mm in common shares in Canada. The South Financial Group was being pushed by regulators to raise capital or reduce criticized assets hence the catalyst for the transaction. TSFG has loans of US$8.0 billion and deposits of US$9.8 billion are being assumed by TD (including $2.0 billion in brokered deposits). These amounts are small in the context of TD's balance sheet ($567 billion in assets, $254 billion in loans and $402 billion in deposits). TD estimates $1.0 billion in future loan losses on top of the $0.9 billion in loan losses already taken.
- **Man Group -** Man Group this morning have announced they're acquiring GLG for ~ $1.6bn. Structure will be a cash offer to public GLG holders, stock to GLG Principals. Man Group say - earnings neutrality for March-end year 2011, accretion in 2012. But in our view, 6.8% of AuM looks a pretty high price to pay, GLG's FY09 adj. net earnings were $81mn. This acquisition diversifies Man Group's product offering away from its AHL focus and is consistent with Man Group's long-stated interest in an equity long-short business. Man Group confirms FY10 (year-end 31st March 2010) total Dividend per share of $0.44, and says FY11 DPS will be at least $0.22 (i.e. effectively signaling a likely cut in dividend)
- **Prudential -** Prudential announced its rights issue terms this morning of 11 new shares for every 2 held, with subscription price at 104p. This means the approximated theoretical ex - rights adjusted price(based on Friday's close of 542.5p) is ~171.5p, with the rights at ~39% to the theoretical ex-rights price and a 80.8% discount to Friday's closing price. The Rights Issue prospectus is published in the UK today with the Nil Paids expected to start trading on June 8th and last date for acceptance and payment for UK shareholders June 23rd with new shares trading on 24th. This Rights Issue is to raise ~£14.5bn (or £13.8bn net of costs, fees and expenses) and is fully underwritten by Credit Suisse, HSBC, JP Morgan and a larger banking syndicate.
- **Australia's** government isn't considering any kind of new tax on the profits of financial services firms along the lines of a controversial proposal to impose a 40% tax on the so-called "super-profits" of the mining sector, Financial Services Minister Chris Bowen said last Monday.

Dividend Paying Companies

- **BP:** Over the weekend, and following a number of setbacks, BP managed to place a 'riser insertion tube' into the Macondo (Gulf of Mexico) broken riser, effectively capturing some of the leaking oil & gas stream from the well. Whilst the 'insertion tube' is not a complete solution, this breakthrough in the containment effort is set to partially reduce the leak. Now other solutions have been set aside as the focus has turned to (1) capturing as much of the leak as possible with the insertion tube and (2) to kill the well over the next 7-10 days injecting heavy drilling mud through a manifold connected to the bottom of the blowout preventer. Meanwhile BP continues drilling the relief wells that should provide a permanent solution.
- While some progress is being made on containing the spill, political and environmental pressure is mounting on BP. President Obama's recent criticism of the lengthy process of stopping the leak has been followed by a letter from the administration urging BP to clarify its legal liability position. As repeatedly indicated by management, we do not expect BP to seek to limit its liability to the US$75m legal limit. On the environmental front, BP and the authorities have

reiterated their estimate of 5,000 b/d were being spilt – prior to this week-end's news.

- **Toyota Motor Corporation** announced positive full year results for the fiscal year ended in March 2010, returning to profitability for the year, with the operating income increasing to 147.5 billion JPY from a loss of 461 billion JPY the year prior. The results are impressive considering the significant headwinds stirred up by the quality issues that plagued the leading brand over the last year. The number of units sold during the year decreased by 4.4% compared to the year before, yet significant measures to streamline the operations during the downturn paid off, supporting the company's return to profitability.
- **All regions** contributed to the improvement in the operating profit, with the most significant role being played by North America, up 475.6 billion JPY year on year. The financial services segment also added to the bottom line, with the 246.9 billion JPY in operating income being facilitated by lower loan losses and residual losses and improved lending margins as a result of a declining funding cost. The management expects unit sales in the current year to only grown marginally, by 53 thousand units to 7.29 million units, while the operating profit is forecasted to grow to 280 billion JPY. The company also announced a 45 JPY per share dividend for the year, yielding roughly 1.3%.
- Strategically, **Toyota** aims to advance in two major directions: improving its hybrid cars technology and expanding in the emerging markets. The company aims at rolling out a new premium compact hybrid soon and targets the launch of a plug-in hybrid vehicle for 2012. A new plant is set to open in China in the first half of 2012, while a new model, Etios, was specially conceived to answer the needs of the Indian market.

Economic Activity, Consumer and Business Conditions

- **Europe:** Eurozone Q1 GDP rose 0.2% QoQ slightly above market expectations. After a pause in the upswing in Q4 (flat GDP) the region thus returned to modest growth in early 2010. GDP now stands 0.5% above its level in Q1 2009. Europe unemployment climbed to a 16-year high in Q1 with the people claiming jobless benefits falling 27k vs estimates of 20k. In the UK last Wednesday Gordon Brown resigned, with Conservative party leader David Cameron taking over in coalition with the Liberal Democrat party.
- The **revised austerity** measures announced by Spain and Portugal in our view are constructive and are likely to pass Parliament (Portugal already assured).

Spanish Austerity Measures

- Public sector wages -5% for 2010 and wage freeze for 2011 (E 15bn projected savings)
- Pensions to be frozen in 2011
- Permanent elimination of "baby check" (E2500 for each newborn) beginning in 2011
- E 6bn cut in public investments for 2010-11
- New measures projected to reduce government deficit from -11.2% in 2009 to -9.3% / -6.5% in 2010/1 vs. previous projections of -9.8% / -7.5% for 2010/1. Spain to meet -3% target for 2013.

Portuguese Austerity Measures

- VAT +1% to 21%
- Income tax rates:
- - 5% higher for corporates with income >2mm (2.50% apiece for government and local administrations);
- - 1% higher for individuals earning <E18,000
- - 1.5% higher for individuals earning >E 18000
- - New 45% marginal rate for individuals earning >E150000
- Lowering subsidies for state-owned companies and delaying investments in railway projects (1bn projected savings)
- Salaries -5% for senior government officials and executives at state-owned companies
- Unemployment benefits maintained at 65% gross salary but now subject to a cap of 75% of salary after tax
- Announced measures are to remain inforce through the end of 2011 and are projected to reduce government deficit from -9.4% in 2009 to -7.3% / -4.6% in 2010/1 vs. previous projections of -8.3% / -5.1% for 2010/1. Market projections are the cumulative reductions equate to 3% GDP. Portugal to meet -3% target for 2013. Portugal this week also sold 1bn euros of 10-year bonds at 4.52%.

- **Greek Banks –** On Friday, Deutsche Bank's CEO Ackermann has opined that it's unlikely that the country will be able to fully pay back its debts as tougher austerity measures impact its economic potential. He believes a restructuring of Greece's debt must be prevented (although he acknowledges this may still be considered if the proposals for Greece do not have the required impact), with pressure on Greece to tackle its fiscal problems.
- Press reports (Bloomberg) are **Nakheel** (Dubai World-owned property company best known for building palm tree-shaped islands) has reached an agreement with trade creditors for

>50% claims. Nakheel is seeking to restructure $10.5bn debt. Trade creditors are being offered 100% claims recovery with 40% cash upfront and 60% in publicly tradable bonds with 10% yield….i.e. this restructuring leads to losses due to the increased utilization of Net Present Value cashflow methodologies in calculating impairment charges on the publicly traded bonds … but in our view this approach is considerably better than absolute write-offs ..and may well be an approach required to be taken by Greece in due course.

- **Australia:** Australian employment jumped 33,700 versus the expected 22,500. The unemployment rate was steady at 5.4% in April from the newly revised 5.4% previous. Those that left the work force appear to be coming back as well and this is welcome news to an economy that is close to full employment. Reserve Bank of Australia Assistant Governor Phil Lowe reaffirmed the positive outlook for the Australian economy and restated the RBA's view that monetary policy was close to neutral and that the RBA retains "policy flexibility" to respond to either upside or downside risks
- **ASIA:** Hong Kong's economy expended 8.2% in Q1, the fastest pace in 4 years, as exports and retail spending rebounded from the global crisis.
- **US:** The manufacturing recovery in US is continuing, as emphasized by the Industrial Production Index, which improved for the 9th time in the last 10 months, now up 5.18% year on year. The New York Empire Manufacturing Index, issued Monday morning for the month of May, a much narrower and more volatile index, has fallen more than expected, indicating that perhaps the industrial recovery, while still present might have lost some of its steam. In the meantime, the capacity utilization rate has continued to recover slowly and is presently sitting at 73.7%.
- The retail sales, the main macroeconomic gage of the all important consumer sector, registered a 0.4% month on month improvement, the 7th in a row and are currently up 8.8% year on year. The same retail sales indicator, excluding motor vehicles sales, also improved in the month of April and is up 7.6% versus the April prior. While consumer spending has clearly provided support to economic growth in the last three quarters, one can only wonder how sustainable this trend is given the non-existing real income growth, the shrinking non-financial debt and a savings rate at a very low level which provides little room for adjustment. In keeping with the theme, the preliminary reading of the consumer sentiment, although it did improve, it did so to a lesser extent that previously expected.
- The **US trade deficit** widened further in March, with imports growth from Europe, on the back of a weakening euro, contributing the most to the imbalance. Both imports of consumer goods and capital goods rose in the month. As per last GDP reading, foreign trade subtracted 0.6% from the economic growth in the last quarter. On the bright side, the exports rose significantly as well, although not enough to close the trade gap. The US Treasury posted an impressive inflow in long term investments for the month of March amounting to 140.5 billion USD net, the result of foreign long term investments in US securities of 157.7 billion USD and US long term investments in foreign securities of roughly 17.1 billion
- **US:** in summary, strong retail sales, industrial production and inventory data all imply in our view that Q1 growth will be revised up, perhaps to the 3 ½ % - 4% range.

Financial Conditions

- **Policymakers** continue to accommodate a recovery in bank profits. The U.S. 2 year/10 year treasury spread is 2.68% and the U.K.'s 2 year/10 year treasury spread is 2.83% - 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 (72 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. We understand however that the FDIC is changing the loss share arrangement on assisted deals from absorbing 95% of losses down to absorbing 80% although this is still attractive to acquiring banks it does probably lower the Internal Rate of Return.
- 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 31.16 below the levels experienced last week (41) prior to the ECB bail out and substantially lower

than last August/September. 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, in our view, very attractively priced to purchase.

The Portland Investment Counsel Inc. 2009 Closed End Annual Reports are now available on the web site. Below you can find the link to access the closed end annual report.
http://www.portlandic.com/Info.aspx?disp=Financial_Reports

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.portlandic.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.

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