Market Commentary

PORTLAND INVESTMENT COUNSEL™

June 28, 2010

US Banks - Updates on the financial reform bill

- **Volcker rule:** Originally the Volcker Rule proposed restrictions and/or an outright ban on proprietary trading and principal investing including the management, sponsorship, and investing in a hedge or private equity fund. The revisions allow a bank to utilize a de minimus amount of its own capital, 3% of Tangible Common Equity, to invest in its own alternative investment products. No exemption was made for proprietary trading although what constitutes proprietary trading versus market making was left up to the discretion of regulators. More importantly, we interpret that banks can retain their role as money manager although as an added restriction the bank can also only invest up to a maximum of 3% of any individual fund's capital. The time to implementation could take 6 years.
- **The timeline is as follows:** Regulators conduct a study for 6 months and then have 9 months to write the rules. The financial institutions will then have two years to become compliant, but there is also the potential to receive 3 one year extensions. All in, it could be as long as 6 years – a welcome period to adjust as banks with private equity investments (like JP Morgan) can now manage down their investments over the course of the next few years and either IPO the businesses or sell them individually.
- **Derivatives:** Interest rate swaps and FX swaps can stay in the bank which represents the bulk of their derivative earnings. Credit default swaps are excluded and existing derivatives at the bank can stay at the bank via a 'grandfathering' agreement. There will be a two year implementation period.
- **Bank Tax:** Its smaller than thought, just like the UK. Originally, it was potentially as high as $120 billion, but has been reduced to $19 billion. Currently, financial institutions over $50bill in assets would be responsible for the fee and hedge funds over $10bill would be included as well. But, it remains to be seen who is included under the definition of "financial institution".
- **Timing:** Both the House and Senate have to sign it in its current form…. the goal appears to be getting it to the President's desk for signature around July 4th.
- **Bottom Line:** The bill still comes down on the banks, but it is not as bad as once feared and the longer timeline relieves a lot of near term pressure to exit the impacted businesses. We view the finality of this Financial and Regulation as a positive catalyst for the large-cap banks we own and that hopefully markets will now get back to studying their fundamentals

Global Banks – Update on reform

- Plans by global regulators to compel banks to set aside significant extra capital to cope with future crises are now expected to be pared back after intense lobbying by the industry…. the most significant change to the proposed Basel committee reforms is that there is now unlikely to be a 'net stable funding ratio' wherein the maturity of assets and liabilities were to be much closer aligned… instead a form of oversight will be considered… so averting the concern that funding costs / borrowing costs would need to be raised to cope with the extra demands for liquidity. In addition, the overriding aim to seek a level competitive playing field still means – in our view – that any agreed actions will be given several years to adopt … much like is now evident in the US reforms mentioned above.

G20 Summit

- G20 concluded by pledging to focus on growth and cut deficits. New bank capital rules will be applied but implementation will be delayed- beyond 2012 (expect more details at the next summit in Seoul, November, 2010.) The G20 leaders unsurprisingly called the global recovery "uneven and fragile" with unemployment at "unacceptable levels".

News Highlights on Current Holdings

Financial Services Companies

- **Lehmans / Barclays / JP Morgan / Nomura** …. Lehman commenced a long-anticipated lawsuit against JPMorgan in May claiming JP Morgan precipitated the collapse of Lehman by abusing its role as lead clearing agent – demanding increased collateral to enable Lehman to continue to trade whereas Lehman now claim the extra amounts were to cover existing trading exposure. This week Barclays' CEO and President will take the stand in Lehman's lawsuit against Barclays to answer claims that Barclays underpaid by $11 billion for the North American brokerage, effectively structuring the purchase to produce a hidden accounting gain. Nomura is also being sued for filing claims in derivative trades that were terminated upon its bankruptcy. In total the lawsuits exceed $20 billion with the lawyers and advisers reported to already have charged $800 million …. The fact that the bankruptcy filings have now got underway is a probable reason why the 3 banks named, Barclays in particular, have experienced pull back on their share prices…. Although, as with most other similar lawsuits we expect the ultimate costs to be a fraction of the claims – with only the lawyers' fees being the likely cost to increase.

- Barclays - Axa, CNP and La Mondiale are the three remaining candidates that are interested in Barclays French Life insurance unit according to La Tribune, Barclays are thought to be selling a 50% stake in the unit for around €65mln.
- **AXA** has agreed to sell part of its UK Life Insurance unit to Resolution for £2.75bln. Axa said the sale does not call into question the insurers commitment to the UK market but is consistent with their strategy of growing wealth management in the UK. We view this as a good deal for Axa as selling off a low margin/low IRR operation in order to redeploy capital/cash to higher margin/IRR businesses.
- **Santander –** Bloomberg reported last Friday that Santander has agreed to buy $3.2bln worth of auto loans from Citigroup and also entering into a servicing agreement for a portfolio of $7.2bn that Citi will retain. The purchase will expand the bank's US consumer lending business and is consistent with the bank's US expansion which is expected to make up 5% of the group's earnings this year. Santander said it was paying 99% of the value of the gross receivables in the portfolio and expects the deal to close in Q3 2010. Applying an 8% Core Tier 1 ratio implies ~€200mn capital impact with a likely positive contribution to earnings from day 1. At the end of 2009 Santander did a similar deal with HSBC Finance acquiring $1bn auto loan portfolio and entering into a service agreement for another $6.7bn retained by HSBC. They also acquired $0.6bn from Toyota and other smaller portfolios.
- **Unicredit -** Aabar Investments, an Abu Dhabi state linked investment vehicle became the largest voting shareholder of Unicredit last Thursday after buying 4.99% worth €1.8bn. Unicredit warmly welcomes the investment made by Aabar, "which enlarges the stable shareholderbase of the Group", Chairman Dieter Rampl said. Aabar has had a relationship with UniCredit since investing €49m in the bank's hybrid equity-linked securities in March 2009. Aabar's entry means the bank's largest foreign owners, including the Libyan Central Bank, Allianz and Blackrock the asset management firm, now hold almost 16 per cent of the bank. The largest banking foundations hold about 12 per cent while Mediobanca holds 5.1%.

Dividend Paying Companies

- **BHP Billiton:** we believe BHPB would be most interested in acquiring BP's stakes in Gulf of Mexico assets Atlantis (BP 56%, BHPB 44%) and Mad Dog (BP 60.5%, BHPB 23.9%, Chevron 15.6%) should these form part of BP's slated US$10bn asset sale program. However the Board of BHPB will have to make an assessment as to the reputational, operating and financial risk of increased Gulf of Mexico exposure.

- **BHP Billiton/ Wesfarmers –** The Australian Labor Party, the party in power in Australia, replaced its leader and the country's Prime Minister, Kevin Rudd, with his deputy, Julia Gillard, who thus becomes the first women to hold the position in a string of 27 Australian Prime Ministers. It is widely perceived that the tabling of a proposed resources super-profits tax a couple of months ago contributed to the rapid deterioration of Rudd's popularity, already in decline after the shelving of a carbon trading scheme implementation. The resource tax proposal was met with vehement critique from the country's all important mining industry, as well as from the opposition. The unpopular measure is seen as an unnecessary significant alteration of the country's status as an investment friendly and stable business environment.

- Following the appointment of the new PM, the proposed tax is expected to be significantly watered down if not scrapped all together. In her first press conference as a Prime Minister, Julia Gillard, announced that the government is open for negotiation with the mining industry, a step forward from the 'consultative' process that had been taken place in the previous couple of months.

- **BHP Billiton** announced an agreement with the state of Western Australia which effectively increases royalty rates paid to the state for the various grades of iron ore being mined. In exchange, the company will enjoy greater flexibility in its transportation and blending of the products operations, across networks operated by both BHP and Rio Tinto. Effectively we believe this means BHP and Rio Tinto are a step closer to a proposed iron ore joint venture meant to leverage both company's capabilities in exploiting the largest iron ore deposit in the world in the Pilbara region.

- **Carnival –** Carnival Corporation, the leading global cruise operator, announced its second quarter results and provided guidance for the second half of the year. The results beat expectations, with earnings per share of 0.32 USD, 0.06 USD ahead of consensus, despite headwinds of about 0.02 USD/share from the volcanic ash and the Chilean earthquake. Net revenue yields improved by 2% in local currency. The improvement was mainly due to improvement in the North American brands yields. The net ticket yields improved by 1.6%, while the net onboard and other revenue yields improved by 3.1% in local currency. In our view, this is a particularly good performance, given that in the same time period, the fleet capacity increased by 8%, with most of the increase happening in Europe.

- Both North American and European brands performed well in terms of volume and pricing, with the European consumer, a market still significantly underpenetrated, showing strong resilience. Going forward, the company is committed to focusing on pricing recovery and will not aggressively push promotions to fill up its capacity. The third quarter bookings are ahead of last year's, while for the fourth quarter they're slightly behind, yet the pricing is significantly higher across the board. On the cost side, there was a reduction of 4.9% versus the comparable prior period and costs are projected to be down 2.5% to 3.5% for the full year. The company maintained its 0.10 USD quarterly dividend and it did not rule out a dividend increase in the coming quarters as it enjoys good financial flexibility and it targets significant capital expenditure reductions.
- **GEA – GEA Group** announced in Frankfurt Thursday that the order intake for the month of May is up 21% on a year on year basis.
- **Nestle** – In an effort to protect its fastest growing 'billionaire' brand (brand with sales in excess of 1 billion dollars). Nestle managed to persuade the French 'Nespresso' authorities to seize coffee capsules made by Ethical Coffee Co, on patent infringement grounds. Ethical Coffee's chief executive, Jean-Paul Gaillard, managed Nespresso in the early 90s, when the brand was a start-up. A week earlier Nestle sued Sara Lee in France for allegedly infringing on its Nespresso patents.
- **Tesco** – According to the most recent regulatory filing, Warren Buffett raised his stake in Tesco to more than 3%.

Economic Activity, Consumer and Business Conditions

Bank of England policy maker Andrew Sentance made the first push for an interest-rate increase in almost two years this month, opening a split among officials on the strength of the economic recovery.

U.K. mortgage approvals rose to the highest in five months in May after the Bank of England maintained emergency stimulus for the economy, the British Bankers' Association said.

UK Austerity measures : there has been positive rating agency (Fitch) comments last week on UK austerity measures, with Fitch indicating the measures should "materially strengthen confidence" in UK AAA rating.

In Summary:

VAT. 20% from 17.5% (raises £13bn pa; hike excludes food, books, children's' clothing)

Bank Levy. Raises £2bn pa (vs. speculation of 3bn) effective from 2011, includes Banks, building societies and UK subs of foreign banks (with assets of £20 billion or more) ; The levy will be balance sheet based at a rate of 7bps against total liabilities less Tier 1 capital, insured retail deposits, repos on sovereign debt, insurance policyholder liabilities and derivatives, with 3.5bps applied to >1 year wholesale funding. For 2011, it will be applied at a 4bps rate, and 2bps on >1 year wholesale funding. It will not be tax deductible. £2bn pa which will be partially offset via lower corporation tax and across the five UK banks, the cost is approximately equivalent to 5-6% earnings impact excluding Standard Chartered which is estimated to be 2%.... i.e. considerably less than first anticipated when the US Administration proposed a 15 bp levy. Germany and France said they will follow suit.

Public Sector. Two-year salary freeze (excludes -workers making <£21,000) plus government department cuts of -25% (saves 30bn pa)

Public Benefits. Welfare, child benefits, lowering tax credits, limiting housing benefits (saves 11bn pa)

Corporate Tax Rate. From 28% to 24% (to be lowered 1% pa) in 2014; small business tax rate lowered to 20%
Capital Gains Tax. From 18% to 28% effectively immediately for high income earners.

Pension. Accelerating timeline to age 66 for state pensions; may consider lowering pension relief further

Asset Sales. NATS, Tote, Hispeed1, student loan book, Royal Mail, etc.

GDP. 2010-12e +1.2% / +2.3% (from 2.6%) / +2.8%
Unemployment. To peak at 8.1% this year and to fall to ~6%
Deficit. To lower deficit to 1.1% in 2015 from 10.1%

In our view this was a tough Budget. Although the additional fiscal tightening of some 2% of GDP was not enormous on its own, when added to the tax increases and spending cuts already planned by the previous Government, the total fiscal squeeze over the next five years adds up to some 8% of GDP. That is likely to have a major negative effect on the performance of the economy and reinforces our view that monetary policy will need to remain extremely supportive (i.e. low interest rates) for a prolonged period.

Australia - Kevin Rudd stepped down as Australia PM with Julia Gillard (previously his deputy) taking over the reins. Her first order of business is to negotiate with the miners on the super profit tax. In her first press conference Gillard mentioned that she intends to "throw the door open" for discussion on the mining tax with the mining companies. Although she did indicate that the tax would not be dumped entirely. BHP in reaction suspending advertising campaign against the mining tax - and said it was encouraged by comments from the new PM.

US – The fallout from the withdrawal of the home-ownership tax incentives at the end of April was confirmed in the new home sales number in May, when a new historical low was reached, at 300,000, down 32.7% from the month prior. The consensus was calling for a 410,000 figure. At the current selling pace, the inventory of new homes is back up to 8.5 months. Although not as dramatic, the fall in existing home sales, announced a couple of days earlier, of about 2.2% to 5.55 million units annual rate, was in stark contrast with the expected 9% improvement, or 6.12 million units annual rate. The only positive out of these numbers is perhaps that things can only improve from here.

The manufacturing sector continues its recovery, with the orders for durable goods excluding transportation moving 0.9% higher in the month of May, with new orders for machinery leading the pack.

On the employment front, the latest initial jobless claims number, down 19,000 to 457,000, provided some relief. The final reading of the Consumer Sentiment for June, showed a significant improvement, to 76.0, from the previous month level of 73.6. The third estimate for first quarter's GDP growth however was not favourable, with the rate of growth indicated at only 2.7%, versus the previous estimate of 3.0%. The final sales to domestic purchasers, which excludes GDP growth driven by the change in net exports and inventory rebuilding, was adjusted downwards to 0.8% from 1.4%.

The US Federal Reserve has become slightly more pessimistic about the economic recovery in the US, identifying the weak housing market and recent events in financial markets as holding back the pace of any rebound. The Fed made no change to interest rates last week and committed to leave rates exceptionally low for an extended period.

Canada – The inflation numbers for Canada for the month of May showed a taming of the pricing pressures, with the headline figure down to 1.4% from 1.8%, while the core inflation reduced from 1.9% to 1.7%. On the flip side, the raw material pricing index has been growing steadily, as have the average weekly earnings, with the latest reading showing an increase of 3.3% year on year.

A 2% pull-back in April retail sales could be followed by more consumer retrenchment as the Canadian household leverage has been rising to record levels of over 147%, while the Bank of Canada is rolling out interest rate increases. The main drag on retail sales this time around were auto and clothing sales.

Financial Conditions

Policymakers continue to accommodate a recovery in bank profits. The U.S. 2 year/10 year treasury spread is 2.42% and the U.K.'s 2 year/10 year treasury spread is 2.63% - enabling financial services companies' assets booked at these levels, to be very profitable.

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 (86 to-date in 2010) and we expect will exceed last year's 140 which was the highest annual tally since 1992. This supports our view that 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. The FDIC changed 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.

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The U.S. 30 year mortgage market has remained low and has now fallen back to 4.69% - the record low as the Government and Fed continue to encourage new home owners. Existing U.S. housing inventory has reduced to 8.4 months supply of existing houses – but that is still higher than what we believe is a more normal range of 4-6 months. We believe it remains premature to consider a recovery in house prices but a measure of stability from which to build is welcomed….particularly for those financial services companies holding such assets in their portfolios.

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 28.53, which is below the levels experienced prior to the ECB bail out and substantially lower than last August/September. While, by its characteristics, the VIX will remain volatile, 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. 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 the Funds we manage 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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