Market Commentary

PORTLAND INVESTMENT COUNSEL™

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News Highlights on Current Holdings

Financial Services Companies

- RSA/Aviva - FT reports that RSA has commitments from three investment banks that they could raise at least £5bn in equity if it can pursue its bid for the UK, Canada and Ireland operations of Aviva's general insurance division. Deutsche Bank, BNP Paribas and HSBC have pledged to fully underwrite the required rights issue according to people familiar with the situation. Aviva shareholders, including Standard Life, will demand a full strategic review and possible breakup of the company after it rejected a £5bln bid from RSA the Sunday Times said without saying where it got the information. In a separate article the WSJ said it would be "hard to get a bid off the ground now" despite the potential deal offering synergy benefits.
- Axa and Allianz - could withstand a Greek debt default without suffering downgrades, Fitch, the Rating Agency stated last week. "Stress-testing of European insurers based on their euro- zone sovereign exposures has resulted in no rating actions," the firm said in a statement. The test was "based on the hypothetical scenario of a default on Greek government debt."

Dividend Paying Companies

- BHP – BHP launched a 39 bn USD hostile bid for Potash Corp, going directly to the fertilizer giant's shareholders after its board rejected an unsolicited bid of equal value earlier in the week. The board found the bid 'grossly inadequate' as it 'substantially undervalued' Potash Corp in its opinion. The original offer translated into 130 USD all cash per share, which represents roughly a 20% premium to the close price on August 11th, and a 32% premium over the volume weighted average price (VWAP) over the 30 days ending to August 11th. Offer is to close on Oct 19 at midnight.
- BHP's run at Potash is hardly surprising given the Australian's miner propensity to acquire tier 1 mining assets (large reserves and low production costs) and the penury of such assets globally. A successful bid would give BHP an operational capacity of about 20% of the global capacity (12 m tonnes), the largest single company market share as well as excellent expansion potential, with a number of brownfield projects already under development. Such a deal would also make BHP the owner of the third largest phosphate capacity and the fourth largest ammonia capacity, although arguably their interest lies mainly with the potash industry. BHP had acquired a number of potash assets surrounding Potash Corp mines in Saskatchewan. The Jansen project, which is the most advanced to date is estimated to reach its peak 8 m tonnes capacity around 2018 and BHP has already initiated agreements for rail and port facilities to support exports. Most global diversified miners, including Vale of Brazil and Rio Tinto, have recognised the fertilizer business as a promising avenue of expansion and diversification and have acquired fertilizer assets, yet they are seen as unlikely bidders for Potash mainly due to the size of the financing required, but also due to other pressing capital expansion commitments. BHP does not expect to extract significant synergies as, historically, in mining transactions synergies have been modest at best.
- The attractiveness of the potash industry resides in very favourable supply and demand structure and dynamics. While reserves and production are concentrated in Canada, Belarus and Russia in proportion of about 80%, the demand is pervasive with potash being a key nutrient for a large number of crops cultivated all over the globe. Unlike nitrogen, which is applied usually as a quick fix to boost yield, often to the detriment of quality, potash is key in delivering the quality (improved nutritional value and taste) while providing the robustness the plant needs for a healthy all season long development. Fruits and vegetables are particularly dependent on potash applications for quality crops, with Asian countries being heavily dependent of fruits and vegetables consumption and cultivation. Cereals and field crops also require potash applications to support the vegetative processes and accumulation of nutrients. With the soft commodities markets receiving a significant boost from the recent cereals market binge, the farm economics are prone to improve in many corners of the globe, increasing the likelihood of significant increase in the application of potash. There is little wonder that Potash Corp's management characterized BHP' approach as an 'ill-disguised opportunistic' attempt to ride the improved demand dynamics wave.
- Some of the changes to be expected in running Potash Corp's operations in the case of a successful takeover by BHP include an immediate ramp up of the capacity utilization to about 90% from the current level of below 80% as well as a likely exit of the Canpotex (the potash North American marketing cartel) in the medium term. The changes would not include, as stated, a reduction in the number of employees, currently at about 5,000. BHP's philosophy is based on owning only tier one assets, running them at full capacity and marketing their products themselves, under the assumption that, being at the lower end of the cost curve, they would be making money irrespective of the market conditions.
- BHP announced it fully secured the financing of the

acquisition and it is expected that, at the current level, would not put a significant strain on its financial flexibility. The rating agencies however placed the company's rating on a negative watch, should the company decide to raise its bid. BHP is being advised by JP Morgan, TD, Santander, Barclays, BNP and RBS, while Potash benefits from the services of Goldman Sachs, RBC and Bank of America Merrill Lynch. The investment banking fees are expected to amount to close to 200 m USD. The expectations are that BHP would have to attempt to sweeten the deal, whether or not a competing bidder shows up, if the deal is to become a negotiated deal (have Potash's board agreement). We are of the view that BHP is unlikely to exceed a bid of 160 USD/share if they are to accrue the benefits of the transaction in a manner consisted with their return on capital targets.

- Wesfarmers – Wesfarmers' full year 2010 results for the fiscal year ending at June 30th, announced last week in Perth, were mildly below the consensus expectations with net profit at 1.57 bn AUD versus 1.59 bn AUD, yet 2.8% higher than the 2009 net profit. The drop in the resources division profitability (coming out of a cyclical trough) was more than offset by good performance in most other divisions, primarily good progress in the turn-around of Coles (grocery chain) and Kmart (hard discount stores).
- Profitability improved in many divisions, including Coles, which now commands a 3.7% earnings before interest and tax (EBIT) margin, a 40 basis points improvement over the 2009 level. Coles is responsible for 58% of the group revenues and 33% of the group's EBIT. The outlook for Coles is still challenging and is even more so for the non-food retail businesses of Wesfarmers (Target, Kmart, Bunnings) as the government stimulus is unwound and interest rates have been raised. The resources division outlook is significantly improved though as bulk commodities pricing has strengthened towards the end of the fiscal year and are likely to stay strong in short to mid term. Mining volumes will also increase as the Curragh mine, a top quality low cost metallurgical coal mining operation, is undergoing expansion to 8.5 m tonnes by mid fiscal 2012 from the current 6.5 m tonnes currently.
- The group generated about 3.3 bn AUD of operating cash flow, with a strong 130% cash realization ratio. About 2.2 to 2.4 bn will be spent in capital expenditure commitments, mainly for refurbishments at Coles and on financing the Curragh and Bengalla (subject to board approval) mines expansions. The company aims at maintaining a strong balance sheet and the S&P credit rating agency placed its BBB+ rating on a positive watch. Wesfarmers declared a final dividend of 0.70 AUD per share, which brings the full year dividend to 1.25 AUD per share yielding about 3.6%.
- Schindler Holdings – Schindler Holdings, the global elevators and escalators leading provider, announced first half year results for 2010 which were ahead of consensus, with good performance across the business lines and geographies. Order intake was higher by 9.1% than for the first half of 2009, revenues were 0.4% higher, while earnings before interest and tax (EBIT) improved by 1%, with the EBIT margin relatively flat at 12.1% from 12%. Business was stronger in the new installation business with several large orders being received during the first half, including orders from Los Angeles International Airport, Costanera Center in Chile, ITCC complex in Riyadh, Saudi Arabia, the Beijing subway and so on. The highest growth rates in the modernization business were achieved in Asia/Pacific and South America, while the maintenance business made gains across all regions. The management maintains its 2010 guidance which calls for results broadly in line with 2009.

Economic Activity, Consumer and Business Conditions

- US – The hopes of US economic recovery got some lift from the industrial production report released last week. The US industrial production grew by 1% in July, twice as fast as expected, and is sitting 7.7% higher than in July of 2009. The growth was led by the manufacturing sector, 1.1% higher with the auto sector standing out. However, the gains were widespread, with the capital equipment, consumer goods and construction supplies all registering positive growth. Part of the same report, the capacity utilization improved as well to 74.8% in July after a mild retreat in June, yet well below the historical norm of just above 80%. There are little signs of inflationary pressures in the productive sector with the producer price index (core finished goods) up 0.3% in the month and 1.5% year on year change, despite a significant increase in the raw materials price index. To balance the good news, the initial jobless claims weekly up-date continued to disappoint, with the seasonally adjusted figure hitting the 500,000 dreaded mark, 12,000 claims higher than the previous week and significantly worse than an expectation of a 12,000 claims drop. The four week average is currently sitting at 482,500, the highest since December of last year. The US leading indicators index did not fare much better either, with the July reading only 0.1% higher (the expectations were for a 0.2% increase), pointing to a slower economic expansion pace.
- The news coming out of the US housing market continue

to depict a sluggish market at best, with the National Association of Homebuilders' (NAHB) survey pointing to continued weakness. The overall index dropped one point in August to 13 from July's reading of 14 and in spite of an expected improvement to 14. Both the current component and the 6 months outlook took a dip in the month, with the prospective buyers' traffic holding steady at the 10 level, close to the historical low. The housing starts grew by 1.7% in July to the 546,000 units level, yet the June figure was revised downward by 2.2% to 537,000 units. The modest growth in the month was due to an increase in the less important multi-units area. The building permits, a leading indicator of housing starts, declined as well to 565,000, lowest level since May of 2009.

- Canada – The Canadian June manufacturing shipments managed to squeeze another month on month increase, up 0.1% on expectations of about 0.4% retreat. The Canadian Leading Indicators index, on the other hand did not meet the expectations of a 0.6% month on month growth in July, growing at a 0.4% slower pace, lower than the 1% change in June. The Consumer Price Index (CPI) grew by 0.6% in July, with the headline inflation at a 1.83% pace, versus 0.96% the month prior. A big chunk of the increase is attributed to the introduction of HST in BC and Ontario. The less volatile core CPI figure which also excludes the effect of indirect taxes (including HST) grew only 0.1% in the month, leading to a core inflation figure of 1.58% lower than the June reading of 1.67%. These last readings of the inflation numbers in Canada provide little reasons of concern for the Bank of Canada and make a call on the outcome of the nest interest meeting that much more difficult.
- Australia – The parliamentary elections held over the weekend in Australia led to the first hung parliament in seven decades, as the Labor party in power lost its fragile majority and is now expected to occupy 72 of the 150 seats. The opposition Liberal party is expected to occupy 73 seats. The balance of power will be held by a handful of independents and on Green parliamentarian. As it is the custom in Australia, the incumbent party has to right to approach the country's governor general to determine whether it can form a government. The backlash against the Labor party, which took hold during the tenure of Kevin Rudd, on account of a couple of unpopular decisions regarding the carbon tax and the mining resources super-profits tax, continued in the few weeks since Julia Gillard took the helm as some of Rudd's supporters, especially in the home state of Queensland, became estranged. The political uncertainty in the country is likely to have negative repercussions over the business environment and the stock market evolution in the short term.

Financial Conditions

- Policymakers continue to accommodate a recovery in bank profits. The U.S. 2 year/10 year treasury spread is 2.13% and the U.K.'s 2 year/10 year treasury spread is 2.33% - 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, Spanish and German regional banks (as identified in the European stress tests) – rather than larger more diversified global financial services companies. The number of small U.S. banks failing continues to grow (118 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.
- The U.S. 30 year mortgage market has remained low and has now fallen back to 4.42% - the lowest rate since the Federal Reserve began tracking rates in 1971, as the Federal Reserve effectively continues to seek to incentivise home ownership. Existing U.S. housing inventory has increased to 8.9 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 25.49, 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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