Market Commentary

PORTLAND
INVESTMENT COUNSEL™

August 30, 2010

News Highlights on Current Holdings

Financial Services Companies

Royal Bank of Canada reported Q3/10 cash earnings of $1.25 billion, or $0.87 per share, compared to $1.5 billion, or $1.07 per share in the year ago period, well below the consensus estimate of $1.02 per share. Overall, it was a disappointing quarter for RBC. This was primarily driven by disappointing trading revenues due to industry-wide declines in client activity and lower trading margins, particularly in Europe. Trading revenues came in at $188mn versus $1.0bn in Q2/10. While weak capital markets results account for the vast majority of the miss, the earnings mix was also less than ideal. Particularly disappointing was that new disclosure highlighted that Q2/10 normalized trading was effectively closer to $800mn than $1bn. Canadian Banking earnings were strong as expected (with 14% volume growth) whereas Wealth Management and P&C earnings were solid but were weaker than the results reported by the other Canadian banks. As expected asset quality continued to improve this quarter with specific loan losses of $437m. Capital was strong but the Tier 1 ratio declined 50 bps in the quarter to 12.9% as risk-weighted assets increased to $259bn from $249bn with approximately half of the increase attributable to growth in market risk.

Santander has bought a portfolio of US Car Loans from HSBC for $4bln, the loans have a nominal value of $4.3bln. Santander will not have to raise capital to finance the acquisition according to CEO Alfredo Saenz. Santander is also believed to be in talks with Apax partners regarding a joint bid for Allied Irish Banks stake in Polish bank Zachodni accordimg to an article in the Sunday Times both parties declined to comment.

Dividend Paying Companies

BHP – BHP Billiton's full fiscal year 2010 results announced last week were broadly in line with the market expectations and underlined the favourable commodity markets conditions, which boosted company's revenues and profits relative to previous year. The strong set of results also provides the company with more leverage in the hostile bid process targeted at Potash Corp, while at the same time acting as a deterrent to any potential counter-bidder.

The group's top line grew by 5.2% in 2010 versus 2009 as record sales volumes were recorded in iron ore, metallurgical coal and petroleum. The company registered its 10th consecutive record production in iron ore and its 3rd consecutive record production in petroleum, at the 159 m boe (barrels of oil equivalents) for 2010. Improved pricing environment contributed to better profitability, with underlying earnings before interest, tax, depreciation and amortization (EBITDA) 10% higher than the prior year and underlying basic earnings per share up 16%, to USD 2.24. Underlying attributable profit (net income) reached the USD 12.5 bn level. The results are a continuation of the company's strong performance, with the underlying EBIT margin at over 40% for the 6th year, while the return on capital (ROC) was higher than 25% over the same timeframe, also a reflection of the broadly diversified portfolio of tier 1 (large reserves with low production costs) assets that BHP holds.

Cash flow generation was also strong during the fiscal 2010, with net operating cash flow of USD 17.9 bn. The company's philosophy of fully utilizing its assets and ramping up capacity to capture favourable demand trends led to investments in iron ore, coal and petroleum assets of about USD 9.3 bn, supplemented by exploration and other investments of about USD 1.7 bn. The company is committed to similar levels of capital expenditure going forward. At the same time, the group has paid down debt, lowering its net debt position to USD 3.3 bn, which is equivalent to a gearing rate of 6%. A final dividend of USD 0.45 per share was announced, which brings the total dividend for the year to USD 0.87 share, a 6% increase and roughly 3% yield for the London listed units.

Novartis – Novartis announced the completion of the 77% ownership in Alcon, the eye-care global market leader, which it acquired from Nestle in two steps for a total of USD 38.7 bn cash consideration. The company is keeping its options open in regards to the remaining 23% minority shareholders of Alcon, although, according to the Swiss legislation, it is allowed to "squeeze out" the minority holders. Its current offer to the minority holders is of 2.8 Novartis shares for each Alcon share, which translates to about USD 141 per share, roughly 12% below Alcon's share price and 13% below the average price Nestle received for the majority stake. Novartis is hoping that time would lead to an appreciation of its own share, or a reduced speculation in Alcon shares, which would make the offer compelling.

As such, Novartis is planning for both scenarios, the status quo of a controlling 77% stake and a possible 100% takeover. Under the status quo scenario Alcon would function as a separate entity, fully consolidated in Novartis results, which would have to recognize the minority interest on its income statement. Approximately USD 200 m of annual synergies are expected to be freed up under this scenario, primarily with the help of arm length cooperation between Alcon and Novartis' current eye-care (consumer health) division. The synergies are likely to stem from reduced costs of goods sold, marketing and sales and general and administration expenses. Under the take-over scenario, Alcon would be merged into Novartis, forming a new eye-care division to which Novartis current eye-care businesses Ciba Vision and Ophtha would be added. Synergies under this second scenario would likely amount to roughly USD 300 m.

The rationale behind the acquisition of Alcon, besides the abovementioned synergies with existing businesses, is also supported by Novartis' belief in the attractiveness of the eye-care area. The company points out to the aging population trend, the significant unmet medical need in treatment of glaucoma and age-related macular degeneration (AMD), as well as the increased penetration of eye-care in emerging markets. Novartis is also emphasising the complementary nature of Alcon and own eye-care businesses. As a result, the anti-trust regulators only requested the divestiture of products worth USD 100 m for a business with a pro-forma sales level of USD 8.7 bn. The financing profile of the transaction is favourable, with an all-in cost of external financing (the company used USD 17 bn of its own cash) of roughly 2.5%. The transaction is expected to be accretive to the core EPS starting with 2011.

Novartis – A US judge ruled against blocking the sales of a generic version of Sanofi-Aventis' blood thinner Lovenox. The drug is being co-marketed by Sandoz, a subsidiary of Novartis, and Momenta Inc. The drug had been approved by the US Food and Drug Administration (FDA), being the first generic drug approved which is based on a complex molecule. The approval process had lasted five years and the judge asserted that just because the FDA 'reached a position at odds with the position advanced by Sanofi, does not mean that the FDA's decision was arbitrary or capricious". The judge also stated that the public would be harmed, should the generic drug, which is about 30-35% cheaper than Lovenox, be blocked.

The US FDA approved Tekalmo tablets for the treatment of high blood pressure. The drug is a combination of two active ingredients aliskiren (brand name Tekturna) and the widely used amlodipine. The combination has been shown to significantly reduced the blood pressure compared to either of the two ingredients alone. Novartis is hoping to be thus better prepared to respond to the needs of about 1 billion high blood pressure sufferers and stem some of sales losses expected once Diovan, a blockbuster drug, will lose patent protection in 2012. On a separate announcement, Novartis said that the Swiss regulator approved Tasigna for adults in chromosome-positive chronic myeloid leukemia in chronic phase. The approval came following a fast track review process.

Carrefour – The company is fighting in court Anhui Jiale, a Chinese retail chain of some 160 supermarkets, accused of illegally using Carrefour name and logo. The Chinese name of Carrefour is "Jialefu", which stands for "happy family". The local retailer is asked to change its name and pay roughly USD 1 m in compensation.

Toyota – Toyota is recalling roughly 1.3 m Corolla's and Matrix in the United States and Canada as a defective engine module is suspected of causing the cars to stall. Toyota tested 32 engine control module from cars in service and four malfunctioned under intense heat and cold conditions, which triggered the recall. The fix would take about 40 minutes for each car at a Toyota dealership. GM is also expected to recall about 200,000 Pontiac Vibes, a sister car of Toyota Matrix, being equipped with the same engine modules, manufactured by the parts maker Delphi.

Economic Activity, Consumer and Business Conditions

Global economy - the WSJ writes after the Jackson Hole meeting that current and former central bankers from around the world said an uneven global economic recovery was likely to stay on track despite worries about the vitality of the U.S. economy. They also endorsed Ben Bernanke's comments on Friday according to the article.

US – Signs of US economic slow-down were evident last week with the second estimate for the second quarter GDP downgrading the growth rate from the initial 2.4% annual rate to 1.6% annual rate, however marginally better than the expected 1.4% consensus second quarter GDP growth estimate. The contribution of the housing sector, government spending and inventory rebuilding got revised downwards, while the upward revision of consumer spending, business investment and net exports was no sufficient to offset the decline. Growth in the manufacturing sector, the one area that had shown some consistent growth coming out of recession, posted a couple of weak results as well, with the durable goods orders up a meagre 0.3% in July versus June, on expectations of a 2.8% advance. The transportation sector, courtesy of the notoriously volatile plane orders, was responsible for most of the growth. Excluding transportation, durable goods orders were down 3.8% in July, significantly worse than the expected 0.5% gain. In an effort to dispel the fears of a double dip recession, the Fed Chairman Ben Bernanke announced that the central bank will do all that it can to secure economic growth and laid out the tools it has at its disposal to do so. The Fed is committed to maintaining the current size of its balance sheet by rolling over its holdings in agency and government securities, it could take a more specific stance in its language regarding interest rate and could also decrease the interest it pays on banks' reserves held at the Fed, in that order of preference. The Chairman also added that the preconditions for growth are being met for 2011.

The personal income report released Monday morning revealed a slower than expected income growth in July at a 0.2% month on month rate, while the consensus was expecting a 0.3% growth figure. In real terms, after adjusting for inflation, the personal income fell 0.1% in July after a 0.1 % increase in June. The personal consumption expenditures rose 0.4% in the same month, better than the consensus expectations of a 0.3% improvement. Such a growth pace however is not sustainable, given the subpar growth of the real personal income, unless the employment level starts improving. The household savings rate retreated to a 5.9% of the real disposable income, from the 6.2% the month prior. The core personal consumption expenditure (less food and energy), the Fed's preferred gage of inflation, inched higher in July by 0.1% and is sitting at a year on year level of 1.38%, only marginally higher than the prior 1.36% level, yet enough to ease some of the deflationary fears.

The housing numbers did what they do best, disappointing once more in the week that passed. The new housing sales hit a new historical low, at the 276,000 units annual rate in July, down from June's 330,000 units level and below May's revised level of 281,000 units. The day before, the existing home sales level had dropped to the annualized level of 3.83 million units, down 27% from the June level. The supply of existing home sales at the current sales pace spiked to 12.5 months. The one positive out of this is that it is widely perceived that the home sales numbers can only improve from these extremely low levels although some sluggishness is still likely as a significant number of transactions have been pulled forward by the government incentive programs earlier in the year.

A bright spot in the series of economic data was a positive surprise in the number of initial jobless claims, down to 473,000 on an expected improvement to only 490,000, down from the prior week's 504,000 revised number.

Canada – Canadian retail sales grew by only 0.1% in June, much lower than the expected 0.4% rate, explained to some extent by a drop in prices, lead by a reduction in gasoline prices. The weakness in prices is also present upstream, as depicted by the industrial product price index which inched higher by 0.1% in July, less than the expected 0.4% growth. However, the weakness is only likely to be temporary, as the raw materials price index jumped 1.8% over the same timeframe.

Canada's current account deficit widened to CAD 11 bn in the second quarter, mainly as the merchandise trade posted monthly deficits during the quarter. While an unusual situation for Canada, which normally runs merchandise trade and current account surpluses, it is not surprising given the slowdown in US, by far Canada's largest trading partner. The balance of payments is well balance given the massive capital inflows in Canadian direct investments and securities over the last quarters.

Germany – The German business sentiment improved to its highest level in more than three years for the month of August, as captured by the Munich based IFO survey. The business climate index rose to 106.7 from the 106.2 level in July, on a 105.7 consensus expected level. The high levels of confidence are in sync with robust economic growth, Germany growing at 2.2% in the second quarter, the highest in 20 years, on the back of soaring exports and higher levels of consumer spending. As a result of the increase confidence, hiring is also back into companies' business plans, with the unemployment rate falling to 7.6% in July.

Financial Conditions

Policymakers continue to accommodate a recovery in bank profits. The U.S. 2 year/10 year treasury spread is 2.08% and the U.K.'s 2 year/10 year treasury spread is 2.24% - 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 4.36% - 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 12.5 months supply of existing houses – much 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 25.59, 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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PIC10-0134-E(09/10)