Market Commentary

PORTLAND INVESTMENT COUNSEL™

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News Highlights on Current Holdings

Financial Services Companies

JPMorgan reported 4Q Earnings per share of $1.12, versus consensus $0.99. Net income rose in all major lines of business except Retail Financial Services. JPM again produced core underlying quarterly EPS of around $1, while funding needed reserve builds (primarily for mortgage put-backs) through releases of other excess reserves, and realization of portfolio gains. We believe 10% resultant “core” ROE is impressive at a time when consumer-credit loss rates remain very high and expect this to improve to ~11% in 2011. Investment Banking had solid results in a mixed trading market with earnings better than the prior 2 quarters. At least the Investment Bank showed compensation discipline, with Comp/ Revenue ratio at (adjusted) 35%, the low end of guided range. We expect standard seasonal trading revenue lift in Q1; Jamie Dimon, CEO, noted a solid early start. Retail Financial Services released $1.2B of reserves in the “core” home-lending book, and Cards released $2B, as delinquency improved again; this funded a $2.1B reserve build in the acquired WaMu book, where purchase-accounting “marks” have not proved sufficient but still left the reserve/ loan ratio at the very supportive level of 4.46% (previously 5.12%).

Importantly, quarterly loss guidance on the “core” portfolio was cut again, suggesting further reserve releases. Operating expense absorbed considerable foreclosure-related costs. The Treasury & Securities Services business’ assets under custody were $16.1 trillion, up 8% year on year and Asset Management recorded record revenue with long term assets under management inflows of $69 billion in 2010. The group posted a Tier 1 capital ratio of 9.8% and an estimated Basel III Tier 1 ratio of 7% … i.e. it has already met the regulatory guidelines to be established from 2013 through to 2019. Dimon spoke of ‘… signs of stability and growth returning to both the global capital markets and the US economy” and that JP Morgan is “well positioned with the capital strength necessary to make the right investments to take advantage of opportunities for the benefit of our shareholders.”

JP Morgan In an interview with CNBC last Tuesday, JPMorgan Chairman & CEO Jamie Dimon relayed that the company plans to raise its annual dividend from its current rate of $0.20/share to $0.75-1.00/share once the Federal Reserve completes its second round of stress testing. He also noted that finalization and implementation of Basel III is positive for the sector, as it paves the way for capital deployment / acquisitions. Finally, he noted that credit availability/lending standards are improving, boding well for the economic recovery. The potential dividend increase, along with financials being leveraged to improving economies bode well for the better managed financials – not least JP Morgan in our opinion.

Morgan Stanley has agreed to spin off its last big proprietary trading desk, Process Driven Trading, by 2012 in a move that brings it a step closer to meeting new US rules on banks investing their own capital. It seems all the banks with large proprietary trading desks have decided to accelerate these spin offs to earn credibility with regulators and politicians. Of course, although the banks will lose traders, by helping to fund them into new hedge funds they have the prospect of gaining prime brokerage revenues from those same traders’ hedge funds.

SocGen has agreed to buy RBS Sempra Commodities’ North American power and natural gas assets according to the Wall Street Journal. SG will take on 130 employees but no other details were disclosed.

Franklin Resources reported December Assets under management of $670.7bn, an increase of 4.4% from November. Given fund performance for the period this suggests net long term inflows of +$4.8bn in December, equivalent to ~9% annualized organic growth.

Invesco reported November Assets under management of $616.0bn, an increase of 0.8% from November, and long term active AUM of $467.3bn, up 4.4% from last month. December AUM was reduced by the previously announced $18.6bn redemption of a low fee passive mandate, partially offset by $5.4bn of acquired AUM (from AIG Global Real Estate). Excluding these items, management noted about -$2bn of long-term active outflows.

German Bank Levy - Germany’s biggest banks may face higher tax bills than expected under the planned levy on financial institutions that is due this year. The Financial Times says it has seen a draft of the plans and that a cap on the annual charge, originally thought to be set at 15% of profits, may not fully apply. Banks whose contribution is capped in one year will still be liable to pay the amount due in excess of the cap in subsequent years. This would hit bigger banks with more volatile earnings from investment banking activities such as Deutsche Bank and Commerzbank.

US Farm credit banks won exemptions from almost the entire Dodd-Frank financial law, including the new consumer protection agency and the regulatory council overseeing systemic risk. Now the banks are seeking a carve-out for their $47 billion swaps business. CoBank ACB of Greenwood Village, Colorado, St. Paul, Minnesota-based AgriBank FCB and the three other lenders in the U.S. farm credit system might be required under the law to move their swaps to clearinghouses and set aside hundreds of millions of dollars in margin.

AIG has agreed to sell its Taiwan life unit to a consortium led by local industrial groups Ruentex and Pou Chen for $2.16 bn.

RBS, Barclays, Lloyds, HSBC and Santander are in negotiations with the government to come to a "peace deal" whereby they can pay bonuses if they commit to higher lending targets. The Financial Times says the commitment could be as much as £220bln of business lending and the banks would be monitored by the Bank of England in order to ensure they maintained their commitments. Santander could however pull out of these talks joining Standard Chartered who pulled out in November.

Credit Suisse is forcing several hundred US managing directors to give 2.5 per cent of their 2010 bonuses to good causes. CS estimate the scheme would raise up to $30m for charity and is likely to extend the arrangement globally in future.

Barclays Capital has cut about 200 jobs following an internal review. Investment bankers and UK support have been cut according to sources on Bloomberg. The bank plans to cut between 500 and 600 jobs globally in the division.

Dividend Paying Companies

Carrefour – announced fourth quarter sales last week, which were just over the expected €26.91bn, at €27.13bn, as weather - struck French sales were offset by good results in the key emerging Asian and Latin American operations, where sales recorded double-digit growth. The management kept its previous 2010 underlying profit target of €3.025bn. The company also announced it completed its internal audit reviews in Brazil and five other countries and it boasted a 'clear and transparent accounting situation' at the group level. Challenging business conditions in Europe were brightened by good results in Belgium, where the company recorded first like for like sales growth in six years, as well as in Spain. Carrefour is committed to its cost reduction program, announcing cost cuts of €520mm, above the initial target of €500mm. The group's hypermarket transformation program, titled 'Planet Carrefour', is 'very promising', with 5 of the 6 pilot stores in Europe reporting successful performance.

ABB has won orders worth USD 32m to supply five new transformer substations and build overhead transmission lines to serve 14 wind farms with a generation capacity of about 300 MW. The orders were placed in Q4 by Renova Energia SA, a Brazilian power company.

Hutchison Whampoa: The Hong Kong Economic Journal reported that Cheung Kong is looking to list Hong Kong's first RMB-denominated IPO - a Rmb10 bn (S$2 bn) REIT with its China assets, which include Oriental Plaza, a mixed development in Beijing within walking distance to Tiananmen Square, which is 33.4% owned by Cheung Kong and 18% by Hutchison.

Economic Activity, Consumer and Business Conditions

US – Robust results were reported by the goods producing area of the US economy, with industrial production 0.8% higher in December, double the rate of growth expected. The capacity utilization moved higher to 76%, above the 75.6% expected level. While still below the historical norm, the recent level changes are certainly in the right direction, slowly closing the gap. The US trade deficit closed in the month of November to $38.3bn, as the rise in exports outpaced the growth in imports, largely helped by a more competitive currency.

The US consumer price index (CPI) moved 0.5% higher in December, leading to a year on year rate of change of 1.5%, compared to the previous reading, mainly driven by an increase of the price of gasoline. The core (excluding food and energy) CPI reading stayed put at 0.8% year on year rate of change, still close to deflationary territory, which is of course a concern. In this environment, the retail sales for December were a tad disappointing as the US consumer had less income left after paying the over 8% higher prices at the pump. The headline number moved 0.6% higher compared to November, yet below the expected 0.8% improvement, while the retail sales excluding motor vehicles moved up by 0.5% compared to expectations of a 0.7% month on month growth.

Canada – The Canadian trade deficit reduced dramatically in November, to only $80.4mm, compared to $1.475bn in October, as a drop in imports significantly outdid a 2.0% reduction in exports. With this improvement, Canada's fourth quarter current account deficit would move away from the worrying 4%+ of GDP level recorded in the third quarter.

The Canadian housing sector seems to be holding up well, with the new housing index moving higher by 2.3% in November, while the average prices moved 2.1% higher in December on a year on year basis. The sales of existing homes pulled back by a mere 0.6% in December.

Germany – last year experienced its most dramatic economic turnaround since the country's reunification in 1990 with tentative signs of a rebalancing away from export-led growth. GDP expanded 3.6% - thereby at least partly reversing the 4.7% contraction in 2009.

Financial Conditions

Japan plans to buy bonds issued by Europe's financial-aid funds according to the Japanese finance minister Yoshihiko Noda who said "There is a plan for the euro zone to jointly issue a large amount of bonds later this month to raise funds to assist Ireland, It's appropriate for Japan to make a contribution as a leading nation to increase trust in the deal. We want to buy more than 20 percent."

Portugal's bond offering last week was oversubscribed. Portugal sold 599 million euros ($778 million) of 10 year bonds at a yield of 6.716%, according to the country's debt management agency. That compares with 6.806% at the previous auction on Nov. 10. The government also placed 650 million euros of bonds due in 2014 at a yield of 5.396%, up from the 4.041% on Oct. 27. Prime Minister Jose Socrates said Portugal doesn't need a bailout from the European Union and its 2010 budget deficit will be lower than forecast. Portugal completing this successful debt auction, eases Eurozone sovereign debt concerns.

Spain - sold bonds for the first time this year, it sold $3.9 billion of five-year bonds, meeting its target, at an average yield of 4.542 percent, lower than secondary-market yields of 4.630 percent.

Spanish electricity Bonds - Spain's 2 billion-euro ($2.6 billion) sale of electricity bonds may signal renewed demand for state-guaranteed notes after government debt yields stabilized during the holiday season. Banks priced the three-year bonds to yield 3.68 percentage points more than similar German government bonds, data compiled by Bloomberg show. The deal was the first part of a 22 billion-euro program that was suspended in November because of government debt market volatility. The notes are backed by revenue from consumer power bills and will reimburse utilities.

European Financial Stability Facility: There is increasing talk that Germany is examining the idea of increasing the EFSF to €750bn which would be designed to provide resources to support Spain were it ever required. This is a very contentious issue in Germany though and faces potential opposition through the parliamentary process required for its approval.

Australian Flood Damage - Catastrophe modeller Air Worldwide has said that it expects insured losses of the Australian floods to be in the region of $6bln.

Policymakers continue to accommodate a recovery in bank profits, albeit less than 6 months ago. The U.S. 2 year/10 year treasury spread is 2.75% and the U.K.'s 2 year/10 year treasury spread is 2.27% - enabling financial services companies' assets booked at these levels, to be 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 (3 in 2011) compared to 157 in 2010 which was the highest annual tally since 1992 (140 in 2009). 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 at 4.71% - (the lowest rate since the Federal Reserve began tracking rates in 1971 was 4.17% on Nov. 11, 2010), as the Federal Reserve effectively continues to seek to incentivise home ownership. Existing U.S. housing inventory has increased to 9.5 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 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 mortgage foreclosures have been properly documented, thereby enabling mortgages to be "put back" to the originating bank. However, from recent bank investor relations presentations it does seem the rate of "put backs" are now expected to decline, suggesting current levels of provisions should suffice. 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 15.46 and 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. 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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