Market Commentary

PORTLAND INVESTMENT COUNSEL™

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Financial Services Companies

The newly merged AMP-AXA group is to target the growing $430bn self-managed superannuation market, chief executive Craig Dunn has stated. The SMS market has become the largest part of the $1.36tn super industry. In the past, traditional players such as AMP have tended to focus on the retail end of the market, which now accounts for $370bn.

Barclays -investor day outlined aspirations and targets out to 2013. Barclays provided ambitious revenue targets out to 2013, equating to an annualised growth range of 4.4% to 6.4%. Barclays Capital is the key source of management outperformance. They also provided further detail on their profitability targets (post-tax ROTE 15%, ROE 13%), including a divisional analysis. The targets assume provisions at 75bps of loans against guidance of sustainable at 90bps (worth +c1% to returns). Finally Barclays updated their Basle 2.5/3 guidance. Whilst Barclays Capital looks like it will come in some way below initial expectations (c£40bn), at a Group level the total RWA expectation is only £10bn below existing forecasts (equating to £1bn of free equity or c8p a share). The market in our view is already anticipating a poor quarter for Barclays Capital. Overall, Barclays continue to emphasise evolution not revolution. In our view the shares are too cheap, currently trading on 0.7x prospective 2011 tangible book value. Adjusting for Basel 3 capital implies the business will generate a sustainable return on tangible equity of only 8%, compared to management's target of 15% target.

Intesa SanPaolo's € 5bn capital increase which closed on Friday 10th was over 99% subscribed Il Sole 24 Ore said on Saturday.

ING - Capital One has confirmed it is to buy ING US Direct for $9bn in cash and stock. The disposal of ING US Direct happened sooner than expected and is a positive read across relating to a possible acceleration of the rest of the restructuring, including its Latin American insurance. ING will receive $6.2bn in cash and $2.8bn in shares of Capital One. ING will have a 9.9% stake in Capital One after closing. The sale will release €2.9bn in capital. It is estimated to be a positive impact on ING's core tier I capital of 85bp for 2011 (after Basel 2.5) and 78bp for 2012 (fully loaded Basel III). ING has disposed of ING US Direct at about 1x book. However, ING will realise a capital gain of about €0.5bn which is a result of the revaluation reserve which is a positive. The deal is likely to close in 4Q11. What has been slightly disappointing is that ING and the Dutch State changed the structure of the Illiquid Assets Back-up Facility (IABF) on the Alt-A RMBS. Bottom-line is that ING will provide a "guarantee light" which is importantly not a first loss guarantee on the total portfolio and not a market value based guarantee. Under the original transaction terms agreed between ING and the State in January 2009 the State assumed the risk on 80% of the Alt-A mortgage securities. Under the new terms, the government receivable will be transferred from ING Direct USA to ING Bank. In return, ING Direct USA will receive on its balance sheet an amount in cash from ING Bank. The 20% of the Alt-A portfolio not covered by the IABF will remain on the balance sheet of ING Direct USA and will move to Capital One as part of the sale of ING Direct USA. In order to serve the interest of the Dutch State with regard to the Alt-A portfolio, ING will provide a counter guarantee to the Dutch State covering 25% (€3.1bn nominal) of the 80% part of the Dutch State. This guarantee will cover realised cash losses if they would exceed the 35% that is implied by the current market value of the portfolio. Cash losses to date on the portfolio are less than 1% of nominal value and so the inherent risk on ING of this guarantee being called is most unlikely although this adjustment does lower the risk exposure for the Dutch State. The potential capital and P&L impact of the alignment for ING Bank is expected to be limited in our view. We believe faster than expected asset disposals are key positives because ING would realise its sum-of-the-parts value and lower the risk profile of the group. The next positive catalyst in our view could relate to a sooner than expected disposal of the LatAm insurance business in the second half of 2011.

Lloyds has started the sale of 600 of its bank branches and sent prospectuses to about 10 potential buyers including NAB, The Co-op, Virgin Money and NBNK. Bank of China also requested details about the slice of more than 600 branches in advance of a possible bid for the network. The government apparently wants the buyer to be a significant competitor to the big 4 which would appear to favour NAB and The Co-op. It also appears that Lloyds' CEO is looking to cut another 15,000 jobs, to save another £1bn of costs, Lloyds has already reduced payrolls by some 28,000 jobs since the HBOS takeover.

Royal Bank of Canada : announced the sale of its U.S. regional bank for US$3.5 billion to PNC Financial who have already purchased branches from in Florida so this extends PNC's footprint from the Mid Atlantic to the Florida region. The transaction is expected to close in March 2012 and consideration is in cash (US$2.5 billion) and PNC shares ($1 billion). The transaction is approximately 1x tangible book for this troubled franchise and so is expected to be accretive for RBC by $0.10 (the U.S. regional bank operations lost $0.06 during the first two quarters of fiscal 2011). The sale is also positive for RBC's capital, adding roughly 100 basis points to Tier 1 common under Basel II. From 2000 to 2008, RBC did invest $7-8 billion in U.S. regional banking and the decision was made that further investment would have yielded relatively weak returns. With stronger competitive positions in global wealth management and global capital markets, RBC should be able to generate more attractive returns in these businesses which should help sustain ROE.

Dividend Paying Companies

Carrefour – made a couple of announcements last week including the appointment of Noel Prioux as the executive director for France and a related profit warning for the first half of the year, driven by the underperformance of the French business unit. Profits at group level are expected to be down about 35% for the first half of the year compared to the prior comparative period as a combination of promotional mix, competitive actions and disruptions from the implementation of supply chain systems have driven down profitability. The rest of European operations are affected by the tough macro-economic environment. By contrast, Asian and Latin American units are expected to deliver strong profitability growth over the same period. Following weak French performance, the group management fired James McCann, now with Loblaw, and appointed Noel Prioux, a Carrefour veteran, with experience in running hypermarkets in France as well as the company's businesses in Turkey, Colombia, South Asia and Spain. Most recently, Prioux occupied the Executive Director Europe position, where he was replaced by Thomas Huebner, formerly with McDonald's. Further clarification on the strategic direction of the company should result from the group's AGM this week, while progress towards the French business turnaround, including the re-vamping of the hypermarket business, known as 'Carrefour Planet, should be apparent in the second part of the year.

Carnival Corp – adjusted guidance for the second half of the year, down by $0.20 per share, to $2.35-$2.45 share for the full year, as the prolonged conflicts in Middle East and North Africa continued to affect the South Mediterranean business, the Japan earthquake and nuclear disaster affected the Far East routes, while the sustained high fuel prices are also expected to impact earnings by $0.05 per share, included in the $0.20 per share above. In addition, the company cited softness in bookings in UK and Southern Europe, yet it emphasized strong revenue performance in its North American brands. More details should be available Tuesday, during the company's second quarter announcement.

Fortum : Finland's new six-party Government, published its new Program last Friday evening. From Fortum's perspective, the Government Program contains three negative items: firstly, it plans to implement windfall taxes; secondly, it has committed to not handing out any new nuclear licenses during its 4-year mandate period and finally, it is exploring the possibility of implementing uranium taxes. Regarding windfall taxes, the Government Programme is budgeting EUR 170m in annual windfall taxes. Assuming that these windfall taxes are targeted at existing nuclear and hydropower capacity, its estimated that Fortum's annual extra tax burden would be around EUR 80-85m (4% of earnings before interest and taxation), given that Fortum owns, directly and through minority stakes, some 47-49% of Finland's existing nuclear and hydropower capacity. The initial proposal on uranium taxes linked the tax to CO_2 prices, implying that these taxes could rise as a function of CO_2 prices..this would be an additional burden on Fortum although not expected to be of the same magnitude as the windfall tax. This time there is a high likelihood that this tax will be implemented as, unlike last time, Government does not seem to be seeking tax exemption for industrial companies that own power-generation capacity. Instead, it will neutralize the impact of windfall taxes on industrial companies by lowering energy taxes for energy-intensive industries. Government's refusal to grant any new nuclear licenses is also negative for Fortum, although not very surprising.

Tesco – reported group wide sales for the first quarter of its fiscal year, which were higher by 6.7% excluding petrol. Like for like sales for the European markets were up by 2%, growing somewhat slower compared to the quarter prior, while the Asian markets, including South Korea, China and Thailand, experienced accelerated growth, reaching 3.2% increase in like for like sales. The laggard this time was the home UK market, retreating by 0.1% in like for like terms, as growth in the upmarket food range was not enough to offset a retreat in sales in the non-food ranges, in particular electrical goods. The UK consumer has been under pressure from a relatively weak job market and a significant increase in fuel and utilities costs.

Vivendi – announced the completion of the acquisition of Vodafone's 44% stake in SFR. The group currently owns 100% of the leading French telecom operator, SFR. An agreement extends the commercial co-operation with Vodafone for a further three years.

The French telecoms regulator is one of the first to kick off the process of auctioning fourth generation (4G) mobile licences, for which it expects to raise around €2.5bn. Two frequency bands will be auctioned, with the 800 MHz being the one more technologically and commercially important. Under the pressure of private operators, including SFR, Bouygues and Iliad, the government agreed to cap the amount of band a company could license, to half of the spectrum.

Economic Activity, Consumer and Business Conditions

China (CBRC) once again last week raised the reserve requirements by 50bps to 21.5% after data showing the annual inflation rate climbed to 5.5%. Like the last one on May 12th, it came the same day as the main macro data release. We don't interpret this as tightening, when the USD is relatively weak, and so forex inflows into China strong, the Central Bank of China has to raise the reserve ratio to prevent money supply growth from accelerating. This does show though that the Central Bank doesn't want to loosen either.

US : Chairman of the US Federal Reserve, Ben Bernanke, has warned that the country's creditworthiness is at risk if its borrowing limit is not raised. He said the US could lose its coveted AAA credit rating if Congress did not vote in favour of lifting the US$14.3tn debt ceiling. If there is no deal by August, the US may start defaulting on obligations. President Barack Obama and the Speaker of the House of Representatives, John Boehner, want an agreement by 4 July.

A mixed bag of macro-economic news south of the border, coupled with European sovereign debt concerns, caused a spike in volatility on the worlds market.

Less encouraging news came from the US consumer sector, with retail sales for the month of May retreating by 0.2%, somewhat better than the expected 0.4% drop, driven chiefly by a reduction in the sales of motor vehicles. Retail sales excluding autos were actually higher by 0.3% in the month, in line with the expectations. Consumer sentiment is a key driver of consumer expenditures and for June, the University of Michigan measured a drop in its consumer sentiment index, to 71.8 from 74.3, much worse than the expected 74.0 reading, with both current conditions and expectations components leading to the retreat.

The National Association of Home Builders (NAHB) measure of the housing market dropped back to last September's level of 13, unexpectedly so as the consensus was calling for a flat reading of 16. All the index components contributed to the decline.

On the positive side, the US housing starts pulled itself off of the recent low level moving higher to 560,000 units annual rate, exceeding the expectations for a 540,000 units annual rate level. Similarly, the US building starts moved unexpectedly higher, to 612,000 units annual rate way ahead of the consensus of 558,000 units annual rate, however still at very depressed levels by historical norm.

The initial jobless claims continued to improve, down to 414,000 last week compared to 430,000 the week prior and expectations of a 420,000 level, yet still too high to be consistent with a sustainable net jobs creation level. The US leading indicators index, a broad gage of the business activity forecasts, surprisingly jumped 0.8% higher in May, compared to the expected 0.2% improvement and April's 0.4% retreated, helping offset some of the bad manufacturing and economic activity new over the last couple of weeks.

The US consumer price index (CPI) grew by 3.6% year on year at the headline level, driven, as expected by strong food prices, while the core CPI moved higher to a more comfortable level of 1.5%, helping alleviate deflationary worries. At the producer level, the inflationary pressures are more pronounced, with the headline producer price index (PPI) moving higher by 7.3% in year on year terms, while the core reading indicated a still benign 2.1% level year on year. With the amount of slack in the economy, in particular the poor job prospects, transmission of the inflationary pressures remains, in our view, unlikely to happen any time soon.

Canada – Canada's reading of capacity utilization surprised on the up-side for first quarter of the year, reaching a 79% level, ahead of the expectations for a 77.2% level and an impressive 2.2% higher compared to the last quarter of 2010.

Financial Conditions

Bank of England Quarterly report highlights that banks have made much more progress re-paying the Governments Special Liquidity Scheme than expected – they have paid back all but £37bn of the £185bn they borrowed, using their mortgage backed securities as collateral, as liquidity dried up in the second half of 2007 and 2008 (with £54bn paid down from Feb to end of May) leaving the residual £37bn to be refinanced before early 2012. Amongst the quoted banks, Lloyds is the only one with material amounts under this scheme and was a principal user of it. We already knew from Lloyds' 1Q Interim Management Statement that they were paying it off rapidly (highlighted approx. £26bn outstanding). The banks profit margins are being hit due to early repayment of this inexpensive debt that must be replaced with more costly wholesale and retail deposits - as the cost of this funding is c.100bps lower than normal.... but the acceleration of reduced govt support further prepares the two banks – RBS and Lloyds to operate with reduced and ultimately zero, govt ownership.Separately, a government minister last week disclosed that Britain's biggest banks are on schedule to beat lending targets set in the Project Merlin accord.

Greece : Standard & Poor's Ratings Services has lowered its long-term sovereign credit ratings on Greece to CCC. The outlook is negative. S&P defines "CCC": 'Extremely vulnerable financial security. Questionable ability to meet obligations unless favorable conditions prevail'. Greece has become the lowest-rated country in the world in the rankings of S&P, putting it below Ecuador, Jamaica, Pakistan and Grenada. The rating agency cut Greece three notches and warned it would view a likely debt restructuring as a default.

Greece: EU ministers remain divided on how to resolve the Greek debt crisis. Germany has softened its stance on compulsory haircuts for Greek debt-holders - ahead of recent meetings to discuss the rescue package for the beleaguered economy, Belgian Finance Minister Didier Reynders said that Euro-area finance ministers may fund only a €6bln loan, half the amount that had been agreed for July, to tide Greece through bond redemptions in July, while further aid hinges on Greek budget cuts. "We will in any case try to release the necessary funds for the short term," Reynders said. After the meeting the leaders had not agreed on an aid package and Luxembourg Prime Minister Jean-Claude Juncker said "We forcefully reminded the Greek government that by the end of this month they have to see to it that we are all convinced that all the commitments they made are fulfilled," This ramps up pressure on the Greek government to enforce further austerity measures. The country is expected to be able to roll some short-term debt this week however a larger repayment due in August will depend upon extra funding from the rest of Europe.

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 2.54 % and the U.K.'s 2 year/10 year treasury spread is 2.43 % - enabling financial services companies' assets booked at these levels, to be profitable.

Later cycle issues continue to challenge 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 – rather than larger more diversified global financial services companies. The number of small U.S. banks failing continues to grow (48 in 2011) compared to 157 in 2010 which was the highest annual tally since 1992 (140 in 2009). 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 U.S. 30 year mortgage market has remained low at 4.50 % - (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 9.2 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 would be 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 21.85 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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