



## News Highlights on Current Holdings

### Financial Services Companies

Australia & New Zealand Bank will look to acquisitions in Asia to achieve aggressive growth targets. The bank's deputy chief executive, Graham Hodges, told investors in Canada last week that turmoil on global markets was throwing up buying opportunities. ANZ has raised US\$1.25bn from an issue of five-year covered bonds, the first such issue from an Australian lender since laws were changed to allow banks to offer this kind of debt security. The bank priced its notes at 115bp over the mid-swap level, in line with guidance.

Bank of America agreed to sell 10.4 billion shares of China Construction Bank about three months after it shed roughly half its stake in the giant state-owned lender. BofA announced it would sell 10.4 bil of the 12.5 bil shares it holds in CCB via private transactions to improve its capital ratios. The sale does not come as a surprise and is in line with CEO Brian Moynihan's Strategy to reduce non-core assets. The sale is to be completed by month-end. BofA will maintain a 0.9% stake in CCB post-sale (which is subject to an Aug 2013 lockup). No information was provided on the purchasers. The stake is to be sold at a 10% discount to current market value (in line with discount on the 5% stake BofA sold in Aug) netting about \$2.9 billion in profit or \$1.8 billion after tax.

BNP Paribas said that it plans to cut almost 1,400 jobs, or close to 7% of staff, at its corporate and investment bank in response to Europe's deepening sovereign-debt crisis.

Deutsche Bank said that CEO Josef Ackermann won't take over as chairman of the supervisory board when he steps down in May, and it is proposing Allianz financial chief Paul Achleitner for the position instead.

Intesa San Paolo CEO Passera has been appointed Development and Transport Minister in Monti's new Italian government – this is in line with recent Italian press speculation. Deputy CEO / General Manager Marco Morelli (Head of the Banca dei Territori Division and ex-MontePaschi CFO) is named interim CEO.

J.P. Morgan is investing about \$200mn to help set up a financial company that will guarantee loans to small Chinese firms, which have traditionally struggled to get credit from the country's banks.

SANTANDER: launched an offer to exchange existing securities (with aggregate nominal values of Eur 5.5bn and GBP 1.14bn) for new debt securities to be issued as non-subordinated

instruments in GBP and in Eur maturing in Dec15, in total a debt exchange offer relating to a total of EUR6.6bn of securities. The debt outstanding (subordinated and Tier 2 instruments) will be exchanged at rates of 87%-99.5% of par (current market values 81%-95%, Bloomberg data) On Net Interest Income, Santander has guided the impact will be broadly neutral, on the basis that the securities would be exchanged for 4-year senior debt paying midswaps+150bp and taking into account step-up rates (instruments callable in 2012-14 when rates step up). On capital its estimated that a 50%-full take up of the offer would generate a gross capital gain of cEur 225 m - EUR630m, implying a potential uplift to core capital of 4bp - 8bp (after tax). Also, it's possible that these gains be allocated to provisions (the positive impact in coverage ratio would be from 1% to 2.1%..

Also, Santander - filed a prospectus indicating it may sell up to 310.8mn ADRs in Santander Brazil worth ~\$2.6bn at \$8.4 per ADR and equivalent to a 8.2% shareholding, of which 5% or 189.5mn ADR seems to be preparing for an anticipated conversion of the Mandatory Convertible Note sold to Qatar Holding in Oct 2010 and maturing in Oct 2013 ( which already counts as capital) and 121.8mn ADRs or 3.2% could be a new placement of shares in the market. Santander owns 81.4% in Santander Brazil and has a commitment with Bovespa to increase the free float by lowering its stake to 75%. The potential sale of additional 3.2% in Santander Brazil would be worth ~€0.7bn (\$0.9bn) so a small addition to capital via minorities and a small additional dilution in their ownership although not too far from the 75% targeted ownership.

UBS provided long-awaited details on its plan to shrink its investment bank by unwinding risky assets and to put more focus on its profitable business of managing the wealth of rich clients. "We have chosen to substantially reduce the risk profile of the bank by exiting and downsizing businesses which aren't value added to our client franchise or deliver unattractive risk-adjusted returns," the CEO said. UBS will aim for return on equity of between 12% and 17% starting in 2013 as it shrinks the investment bank to concentrate on wealth management. The bank also plans to pay a dividend of 10 centimes a share for 2011, its first cash payout since before the start of the financial crisis.

UniCredit, one of Italy and Europe's largest banks, announced a €0.5 billion (\$10.2bn) capital increase and a shake-up of its investment-banking operations, cutting 6,200 jobs, after the Italian lender reported a €0.64 billion loss for the third quarter in lieu of significant goodwill writedowns and Greek bond impairments. The capital raising will increase its core tier 1 ratio to 9.3% by 2012 - bringing it in line with the Basel III and recent regulatory upgrade to be at 9% by June 2012. Its aim



is to achieve about a 12% return on tangible equity by 2015. Moody's have placed Unicredit's A2 debt ratings on review for possible downgrade. The decision to review the ratings was triggered by its 3Q results according to the report and will focus on the €0.2bn write down of goodwill and certain other assets. Separately, according to the Financial Times, Unicredit may double the fees to about 2.5%-3% it will pay banks underwriting and arranging its €5.5bn rights issue compared with its 2009 share sale to compensate the syndicate for the elevated uncertainty swirling around the eurozone banking system and Italy. The bank already has support for as much as 70% of the rights issue through core investors such as its banking foundations, local businesses including fashion label Max Mara, and long-term funds such as Abu Dhabi's Aabar, the Financial Times says. In addition, following the announcement of their capital raise CEO Federico Ghizzoni told *Il Sole* that he doesn't see his bank becoming a takeover target and that the bank's 9% stake in Mediobanca remains strategic and a sale would destabilise the Italian financial system.

## Financial Infrastructure

ICAP's 1H11 results, in a fairly buoyant volume environment, underlying revenue and PBT were up only 3% and 2%, respectively. Disappointment here was compounded by implicitly cautious comments on outlook, which suggest that a normalisation of trading would need to occur in 4Q12 in order for the consensus earnings range (£358mn to £390mn) to be met. Whilst ICAP continues to look well-positioned for a new regulatory environment, the market in the near term is more challenging as investment banks are curtailing their Fixed Income Currency and Commodities activities (albeit more heavily in esoteric long-dated derivative and structured products, versus ICAP's strength in flow products).

## Dividend Paying Companies

Bayer – detailed its China strategy in Shanghai last week, setting ambitious goals for the company through 2015. Bayer is expecting to be doubling its sales to China by 2015, estimating a €6bn level, with its Healthcare business contributing more than 50% to the targeted growth. The company forecasts substantial volume growth for some of its legendary brands, including Glucobay (diabetes), Adalat (hypertension), Bayaspirin (cardio), Avelox (anti-biotic), Nexavar (liver cancer) and Women's Health products, with new drug launches expected to contribute as well. Xarelto, the company's blockbuster-to-be blood thinner, is expected to be on the Chinese market for stroke prevention in atrial fibrillation by early 2013.

Vivendi – announced its third quarter and first nine months of the year results, with revenues of €1.03bn, earnings before interest and tax (EBIT) of €0.87bn and adjusted net income of €0.52bn ahead of the expectations. The company's net debt as of September 30th stood at €3.3bn, well within the requirements for its BBB credit rating, while the company is going through an acquisitive phase, with the most recent additions being EMI music and the Polish media group TVN. Key contributors to the group's expectations beat were robust growth at its majority controlled Activision Blizzard digital entertainment company as well as an one-off gain at SFR, its wholly owned telecom business. The company had to restate its full year adjusted income target to €0.85bn from €0.9bn, however, as earnings will be impacted by a higher than expected tax burden, a consequence of France trying to reduce its budgetary deficit. The management stated that acquisitions, including the buy-out of its Canal + partner's 20% stake, are on hold for the time being, as the company is focused on maintaining its financial discipline. The company confirmed its intention to propose an increased dividend payable in 2012, consistent with its long term progressive dividend policy.

## Economic Activity, Consumer and Business Conditions

US – A number of mostly positive US macro-economic data-points did little to improve the mood of the markets last week as investors were focusing on the European drama. Of note, the all important consumer sector turned out to be more resilient than expected. The October US retail sales advanced by 0.5%, on top of September's strong 1.1% growth and ahead of the expected 0.3% rate, as Americans increased their expenditures on autos, electronics, home and garden and sporting goods. The retail sales excluding sales of motor vehicles were higher by 0.6% in October, ahead of September's 0.5% rate of growth, and way better than the expected 0.1% advance. The strong retail momentum kept going while the inflation remained moderate, with a headline consumer price index (CPI) year on year reading for October of 'only' 3.5%, below the expected 3.6% level and lower than September's 3.9% reading. The core CPI, which excludes the more volatile series such as food and energy, revealed a 2.1% level, as expected. Encouraging consumer related news came from the labour market as well, with the initial jobless claims continuing to retreat for the week to a 388,000 claims level.

On the business side, the industrial production grew in October by 0.7%, ahead of the expected 0.4% rate, and much better



than September's 0.1% retreat. The US capacity utilization inched higher to 77.8% in the month, while the leading economic indicators (LEI) advanced by 0.9%, pointing to an acceleration, compared to September's 0.1% and ahead of an expected 0.6% rate of growth.

Unexpected good news came from the housing market as well, starting with an improved reading for the National Association of Home Builders (NAHB) housing market index, now at a 20 level, three index points higher compared to September, and better than the expected 18 level. Both building permits, at a 653,000 units, and housing starts, at a 628,000 units level, improved markedly in October. Lastly, this morning, the existing home sales reading surprised with a 1.4% advance, way ahead of an expected 2.2% retreat, and reaching a 4.97 million units annualized.

US : Supercommittee: The market is waiting for an announcement that the Supercommittee has failed to reach an agreement. If the committee fails to enact savings of \$1.2 trillion (including interest), the law calls for a sequester that, together with the committee's actions (if any), would cut spending \$1.2 trillion, half from defense and half from non-defense

Canada – Much to the central bankers' relief, the inflation took a breather in October on this side of the border, with the headline CPI at a 2.9% year on year level, from September's 3.2% rate of growth, while the core reading, which excludes eight most volatile price series, including food and energy, at 2.1%, was also lower than previous month's 2.2%.

Italy's new Prime Minister Mario Monti won a Senate vote of confidence last week with a 281-25 majority. Only the Northern League voted against him. He subsequently won a confidence vote in the Chamber of Deputies.

The Spanish general elections on Sunday confirmed a comfortable absolute majority for the centre right Popular Party. The results of the election confirms the expectations in the polls and gives a very strong mandate from the population to the new Government to implement the reforms needed. In the electoral campaign the candidate and future PM Mr. Rajoy has committed to fiscal consolidation, deeper structural reforms (labor market, measures to improve competitiveness, etc) and concluding the restructuring of the financial sector. could introduce new

rules relating to further writedowns on real estate assets, and further recapitalisations. Overall, although expected, we believe this should be considered good news.

## Financial Conditions

The US banks now face a "serious risk" that their credit worthiness could deteriorate as the euro-zone debt crisis spreads into large economies such as France. "Unless the euro zone is resolved in a timely and orderly manner, the broad credit outlook for the US banking industry could worsen", Fitch Ratings agency warned last week.

Northern Rock became the first bailed-out bank in the UK to be sold back to the private sector, in a loss-making deal. Three years after Northern Rock nearly collapsed and was nationalized after a bank run, the government announced its sale to Virgin Money, a unit of Richard Branson's Virgin Group Ltd., for £747mn rising to a possible £1bn in the future if the company is sold for a profit.

The advent of the US 'twist' means policymakers are no longer accommodating a recovery in bank profits (gained via them trading on a steep yield curve) . The U.S. 2 year/10 year treasury spread has been falling and is now 1.68% and the U.K.'s 2 year/10 year treasury spread is 1.71% - meaning investment banks will need to seek operational efficiencies, including job cuts, to maintain acceptable levels of profit, i.e. above their costs of capital.

As concerns have swung from commercial real estate and unsecured consumer loans/credit card loans to European sovereign debts the number of small U.S. banks failing continues to grow, albeit at a more moderate pace with 93 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.

Influenced by the US 'twist', the U.S. 30 year mortgage market remains very low at 4.00% - albeit off its early October low of 3.94%(this is the lowest rate since the Federal Reserve began tracking rates in 1971), as the Federal Reserve effectively continues to give priority to incentivising home ownership. Existing U.S. housing inventory has steadied at 8.5 months supply of existing houses – below its recent 9.4 months high but still higher than what we believe is a more normal range of 4-7 months. While we still believe it remains premature to consider a recovery in house prices prospects of a measure



of stability are likely to increase as a result of the Fed actions – which 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 and whether bank’s have mis-represented the quality of those assets sold to Freddie Mac and Fannie Mae. Such legal debates are likely to drag on for years but from recent bank investor relations presentations it does seem the rate of “put backs” are now expected to decline and that litigation reserves have been increased suggesting overall current levels of total provisions should suffice, enabling banks to continue to post increasing earnings per share (as credit improves) over the next 2 years by when we expect more normalized earnings power to have returned. 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 32.00 and while, by its characteristics, the VIX will remain volatile, we believe a VIX level below 25 augurs well for quality equities.

## 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](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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# Market Commentary



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