



## News Highlights on Current Holdings

### Financial Services Companies

Barclays - UK Treasury has indicated Barclays did not act according to the spirit of the tax law in avoiding taxes on debt buybacks whereas Barclays are indicating the loopholes used were in-line with those used by others. Barclays is a signatory to a 2010 code under which banks pledged to obey the spirit as well as the letter of UK tax law. UK Treasury will be closing the loopholes on a retrospective basis (certainly a reminder of the times we're in) and indicating the taxes involved are >£500mm. Indications are Barclays will take a charge of ~£150mm (1% marketcap, -5% group net income).

Bank of America – last week a federal appeals court decided that the private label put back settlement between BK Mellon (as Trustee) and investors represented by Gibbs & Bruns regarding Countrywide-originated loans (now housed under Bank of America) should be sent back to state court. We believe this means it likely narrows the scope of the review against Bank of America and the settlement it faces, and increases the probability that it gets approved in the proposed \$8.5 billion range which would be another contributing factor towards BoA approaching 'normalised' earnings.

Credit Suisse has bought the remaining \$6bn Maiden Lane bonds from the Fed, the bonds were taken on as part of the gov't's AIG rescue, this follows on from Credit Suisse's first purchase of Maiden Lane bonds in January, where they bought \$7bn worth. Credit Suisse also sold a 5% stake in Aberdeen Asset Management last Wednesday at 240p per share (closing price 253.4p), Credit Suisse has taken their stake down from 20-15% with the sale.

JPMorgan is using size to its advantage, leveraging the various components of its business to help increase annual earnings more than 25% over time, CFO Doug Braunstein said last Tuesday. At the bank's investor day, Braunstein said JPMorgan was targeting \$24bn in annual net income, up from the \$19bn it earned last year. JPMorgan's management team struck a positive tone at yesterday's investor day, highlighting opportunities to leverage previous investments and capitalize on cyclical expense leverage to grow earnings despite a difficult environment. The company reiterated previous business unit Return On Equity targets and a company-wide over-the-cycle goal of 16% Return on Tangible Common Equity, as well capital return aspirations for 2012 (modest dividend increase, buybacks on par with last year's \$9b).

Prudential Britain's biggest insurer, Prudential, is considering moving its headquarters from London to Hong Kong to escape European rules that may force it to hold billions in extra capital.

Santander and KBC have announced that they will merge their respective Polish units, Bank Zachodni and Kredyt Bank. Bank Zachodni will offer 6.96 shares for every 100 Kredyt Bank shares. At current market prices, the transaction values Kredyt Bank at PLN15.75 a share and BZ WBK at PLN226.4 a share. Santander will hold approximately 76.5% of the merged bank, Poland's third largest bank, and KBC around 16.4% but KBC will attempt to lower its stake below 10% immediately after the merger and to this end Santander have committed to buy up to 5% of the merged bank. KBC then intends to divest the remaining stake with a view to maximising its value and raising capital.

Standard Chartered: posts 9th year of record income and profit boosted by strong performance in developing economies. Profit Before Tax included a charge of \$206mn for Korea restructuring versus guidance of 10's of millions so, ex this the results are better than expected. On outlook StanChart is sticking to double digit revenue, EPS and mid teen ROE target. The year is off to a strong start with Wholesale revenue "well" ahead and Consumer banking "ahead". Costs and bad debts remain well controlled. Hence on track for 10% income and EPS guidance in 2012. Group Income of \$17.6bn and group Net Interest Margin expanded from 2.2% to 2.3% (1H11 2.3%) as StanChart benefited from selective rate rises across the franchise. Wholesale income of \$6.8bn was up 9%. Client income was 80% of the total. Consumer income of \$6.8bn was up 12%. Overall income trends look encouraging and StanChart seem more optimistic about India. Costs of \$9.9bn were a bit higher than we expected, although the FY results includes a higher than expected early retirement costs from Korea (\$206mn, vs \$50mn initially expected). Cost growth including the UK levy. Bad debts came in at \$1.0bn and non performing loan trends continue to improve. Geographically, The stand out performer was Singapore, with PBT of \$1bn. Driving this was Wholesale banking, revenues were up 25% and costs were flat. Hong Kong PBT was \$1.6bn. At \$0.2bn Korea was weak but this was driven by the higher restructuring. Importantly India looks to have stabilised. Despite a 10% drag from FX, PBT was up slightly HoH. The currency is down 9% since year end and management appear more confident about the outlook in India. StanChart's core tier 1 ratio stood at 11.8%, vs 1H11 11.9%. Group Tangible /Net Asset Value Per Share was \$13.5.

Wells Fargo plans to increase the size of its wealth management and insurance divisions through acquisitions as well as buying



more assets from shrinking European banks, its CEO John Stumpf has told the Financial Times. Wells Fargo agreed to buy BNP Paribas' North American energy business last week and last year bought Bank of Ireland's asset-based lending business. Its focus remains US centric. The Updated business brief is attached.

## Financial Infrastructure

Hong Kong Exchange reported net profits of HK\$5,093mn, up 1.1% Year on Year, which were broadly in line with consensus estimates (HK\$5,088mn). Dividends up 1% YoY to HK\$4.25. Income for the full year was up 3.8% YoY, offset by double digit expenses growth, primarily staff costs, which were up 15.5% YoY. Looking at 4Q11, market turnover related income fell 18.8% QoQ to HK\$1,164mn, similar to the 18.3% QoQ drop in turnover. Investment income returned to a profit of HK\$155mn in 4Q vs. a HK\$6mn loss in 3Q. Overall, income was flat QoQ, though operating profit was up 1.5% QoQ on lower cost QoQ. Stable income trajectory and high cost efficiency are encouraging with a cost-income ratio of 23% (2010A: 21%) and headcount of 940 (2010A: 866); but growth rather muted. Despite a 43% YoY decline in total equity funds raised in 2011, stock exchange listing fees remained stable, benefiting from a steady 11% growth in annual listing fees. HK retained its world number 1 ranking in terms of total IPO funds raised at HK\$260bn. Latest Jan-12 market data, however, suggest a relatively soft start with total funds raised in HK of HK\$5bn, down 93% MoM and 78% YoY.

Pearson mirrored the pattern of recent years by reporting earnings per share marginally ahead of previously raised guidance. At 86.5p this was +12% YoY but the majority of this growth was due to lower interest and tax. Adjusted EBITA was just 0.4% higher YoY at £942m. The dividend was raised 9% to 42p. Within the divisions, it was all about margins. US Education was the big positive, with a 19.1% margin, +130bps YoY as favorable mix (less School, more HighEd), cost actions and digital growth reaped strong returns. On International Education the opposite was true, with margins down 10bps, leaving profit >10% behind estimates. This reflects heavy investment into emerging markets, building on acquisitions such as SEB. Elsewhere, the Financial Times and Penguin surprised positively, both on sales and margins. Pearson's 2012 outlook includes further share gains for most divisions; a continued transition to digital; revenue and profit growth, ranging from "good" in International, to "modest" for US Colleges, to likely subdued in US Schools. 2012 forecasts are complicated by acquisitions/disposals, ongoing investment and restructuring, plus uncertain end markets. There are numerous changes to the divisional mix

but the biggest shift is the assumption aggressive investment into Emerging Markets hampers International margins near-term: potentially short-term pain for long-term gain. However, this is broadly offset by higher US margins near-term, as digital migration reaps rewards, particularly in High Education, where Pearson is so strong.

## Dividend Paying Companies

Bayer – reported full year results in Leverkusen last week, broadly meeting the market's expectations, as a relatively weaker performance in the Materials Science division (specialty plastics) was offset by robust performance in its Health Care and Crop Science divisions. Overall sales advanced 4.1% in the year, boosted by a 9.0% improvement in the emerging markets, while earnings before interest and taxes were 52% ahead of the previous year's at €1,149mm. The management continued to show confidence in its four most promising drugs, including the blood-thinner Xarelto, which combined are expected to deliver about €bn in peak sales. The favourable market environment is persisting for the Crop Science business, as soft commodities pricing has stayed strong. While all regions contributed to the performance of Bayer's agribusiness, North America and Latin America stood out with double digit improvements. The Materials Science business was affected by a steep increase in raw materials costs (crude pricing driven), which could not be matched by a corresponding increase in pricing among flattish volumes and increased competition. The company sees an increase in sales of about 3% in 2012, adjusted for portfolio and currency, as well as a slight increase in the earnings before interest, taxes, depreciation and amortization.

Nestle – is seen as the lead contender for Pfizer's infant nutrition business, for which a combination of Danone and Mead Johnson is also expected to bid. The division Pfizer put on the selling block is a high-growth \$2.1bn in revenues business, with over 70% derived from emerging markets and a key position in China. Experts are estimating the value of the unit at about \$10bn. While both bidding parties would likely face antitrust issues, the combination of Danone in Europe and Mead in the US would likely get to keep more of the assets. On the other hand, Nestle's deeper pockets and the seller's preference for dealing with single party bidder seem to be tipping the balance the Swiss giant's way.

Siemens – won a \$230mm contract to supply 20 Desiro UK trains to a couple of British railway operators, the Go-Ahead Group and the First Group. The trains are scheduled to be delivered in 2013 and 2014 and will be maintained at Siemens' depot in Manchester. The reliability of Siemens' current British



Desiro fleet helped it win the contract over Bombardier's offer. Siemens is also going against Bombardier, Hitachi and CAF in a \$1.6bn contract to supply trains for the London Crossrail project.

Vivendi – Europe's largest telecom and entertainment group, achieved a 9.4% rise in the group adjusted net income, to a record €95bn, for the fiscal year 2011, driven chiefly by strong profitability at Activision Blizzard, a leading video game business, and GVT, a leading alternative telecom Brazilian unit. The company was impacted however by adverse regulation, with "excessively favourable conditions" granted to a new mobile operator in the home market of France, as well as a series of valued add and corporate taxes hikes in France, to help cut the national budget deficit. The tax increases are estimated to have led to more than €50mm in extra costs. In the face of the increase regulatory uncertainty, which is expected to affect business over 2012 and likely 2013, the management decided to change the structure of its existing dividend, paying €1.0 per share in cash, as well as offering an additional share for each existing 30 shares. The company is guiding for a 45% to 55% payout ratio (previously more than 50%). 2012 is expected to be a difficult year and adjusted net income would likely drop to €5bn, yet growth is expected to resume in 2014.

## Economic Activity, Consumer and Business Conditions

US – the relatively upbeat US business activity outlook took a hit last week, as durable goods orders unexpectedly retreated 4.0%, impacted by a drop in investment in capital goods (in particular machinery) in the month of January. The drop was more severe than expected, with consensus calling for only a 1.0% pull-back. Durable goods orders excluding transportation, which is the more volatile component, was also down, by 3.2%, while expectations were for a flat reading. Later on, the February reading of the Purchasing Managers Index (ISM PMI) confirmed the down-beat bias in the manufacturing sector, as the index unexpectedly retreated to 52.4 points, against an expected improvement to a 54.5 level. Fortunately, the PMI's services counterpart, the non-manufacturing index (NMI) surprised on the upside for the same month, reaching a 57.3 level, with 14 of the 18 industries being surveyed reporting expansion in the period. The revised GDP numbers for the last quarter of last year moved the scale upwards to 3.0% annualized, from 2.8%, yet inventory build-up continued to account for most of the growth in the quarter.

On the US consumer side, the personal income and consumption report gave little comfort, as the nominal personal income growth fell short of expectations in January, at 0.3% versus 0.4%, which in real terms translated to a flat reading of the personal income growth, relative to expectations for a 0.3% improvement. Personal consumption expenditures fell short of the expectations as well, inching higher by 0.2% in the month, against expectations for a 0.4% advance. Part of the same report, the core personal consumption expenditures pricing index (core PCE), the Fed's favourite inflation gage, moved higher to 1.9% year on year, ever closer to the now fixed 2.0% inflation target. One ray of light in the consumer space came from the Conference Board's consumer confidence index reading for February, which jumped to 70.8, way ahead of the expectations calling for a 63.0 index level.

On the housing front, the 20 metropolitan areas housing pricing, as measured by the Case-Shiller methodology, further worsened, to a negative 4.0% year on year, which was worse than consensus expected but which we don't find that surprising given the large amount of distressed sales. We expect housing pricing to get marginally worse before improving significantly. Please consult our 'Portland Insights' letter of last week titled 'A Perspective on the US Housing Market' for further detail.

Canada – The transmission of inflationary pressures in Canada does not seem to provide enough reasons to be concerned for the policy makers as the producer prices in January only moved higher by a 2.3% year on year rate, while the raw materials pricing pushed higher by 4.3%. Not the same can be said though by the manufacturers' margins which are likely to get squeezed as a result.

The December GDP by industry report showed a 0.4% advance, ahead of the consensus expectations calling for a 0.2% improvement, while the fourth quarter GDP grew by 1.8%, as expected, driven by the consumer spending, business investment and net exports.

German MPs have voted by 496 to 90 to back the second EU/IMF bailout for Greece. Chancellor Angela Merkel had urged them to back the deal, while conceding there was "no 100% guarantee" it would work. Germany will have to pay more than any other country for the €30bn package, agreed by eurozone states last week. BBC News

## Financial Conditions

U.S. banks increased lending by \$130 billion in the last three months of 2011, posting the largest quarterly pickup in four



years and marking a possible upswing in the economic rebound. Financial Times

US bank regulators will probably delay implementation of the “Volcker rule”, a small victory for bankers who have objected to a provision that will most likely crimp their trading profits. Ben Bernanke, Fed chairman, told a congressional committee that the Fed probably will not have the rule in effect by its congressionally-mandated start date in July. Financial Times

Long Term Refinancing Operation – 2 – 800 banks took EUR529bn of 3yr paper at the ECB auction last Wednesday. So the two operations have now provided a trillion of funding to the banking sector (and a few non bank financials – like auto and pharma companies). This capital is covering a significant portion of the funding requirements for the sector over the next couple of years.....and some of it will be ‘used’ to cover the funding requirements of sovereigns.

Federal Reserve policymakers appear determined to flatten the yield curve as much as possible, having indicated they expect ‘exceptionally low levels’ of interest rates “at least through late 2014”. which is still an “exceptionally low level” in the grand scheme of things. Fed Reserve Chairman Ben Bernanke has indicated 1% or less would be considered exceptionally low. The advent of the US ‘twist’ ( whereby the Federal Reserve is selling 3 year and less maturities to buy 6 years and longer) means all parts of the yield curve will benefit from a near-zero anchor for essentially the next 3 years. The U.S. 2 year/10 year treasury spread has been falling and is now 1.71% and the U.K.’s 2 year/10 year treasury spread is 1.74% - meaning investment banks can no longer profit from a steep yield curve and instead are seeking operational efficiencies, including job cuts and lower compensation, to maintain acceptable levels of profit, i.e. above their costs of capital. It seems the top tier 8-10 investment banks will continue to command their market and possibly increase their share – as barriers to entry for newcomers have in our view been raised.

Influenced by the US ‘twist’, the U.S. 30 year mortgage market remains very low at 3.90% - (3.87% 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 fallen / improved to 6.2 months supply of existing houses. So the combined effects of record low mortgage rates, near record high affordability, a more promising economic recovery, job creation, and low prices are finally supporting the housing market with housing inventory well off its peak of 9.4 months and we believe now in 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 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 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 beginning 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.

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 12 in 2012 (compared to 95 in 2011 and 157 in 2010 which was the highest annual tally since 1992). 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 VIX (volatility index) is 17.29 and while, by its characteristics, the VIX will remain volatile, we believe a VIX level below 25 augurs well for quality equities.

# Market Commentary



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## 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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