Market Commentary

PORTLAND INVESTMENT COUNSEL™

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News Highlights on Current Holdings

Financial Services Companies

Aegon : reported underlying earnings profit of €425m, compared with consensus of €419m. Although the US is weaker than expected at €292m (entirely due to the life operations, largely explained by higher mortality charges and employee cost), this is more than offset by better results in the Netherlands, UK and new markets. The UK benefits from some cost phasing, which means the underlying is in line. Although new markets has a similar benefit, the main driver of the beat there is a doubling of profits from AEGON asset management due to strong performance fees, which likely is not sustainable. The company reported shareholders equity of €21.1bn, largely driven by the higher net profit and unrealised gains. The core capital ratio improved to 74.2%, on target to hit 75% by year end. IGD solvency improved to 201%, while the company reported cash flow of €805m, of which €400m is related to markets. In addition to the Q1 results, the company also reported the FY 2011 embedded value, which comes in better than expected at €20.7bn

Aviva: the rise in shareholder activism prompted the resignation of Aviva's CEO Andrew Moss, notwithstanding his earlier decision to forego a salary increase. Following a series of critical press articles and an AGM defeat on compensation, the CEO of Aviva has stepped down with immediate effect. Chairman designate John McFarlane will take on an executive role pending the appointment of a new CEO. This process is expected to take a number of months. Pat Regan, CFO, has been asked to take a pivotal role in realigning the group's priorities and so is a likely front runner to be CEO. Regardless of who is appointed, we do not expect material changes quickly as a breakup of Aviva is extremely difficult (i.e. the benefits of risk diversification), particularly in this new world of costly bank financing and higher capital requirements. Rather, it seems a combination of (i) rebasing the dividend to all-cash and/or (ii) potential sale of Asia/ US/ Canada operations which would generate a capital release with a likely partial offset via loss of diversification benefit.

Reuters reported last week that Aviva has put its Malaysian operations up for sale and is close to hiring a bank to help with the sale process, as the British insurer moves ahead with a plan to exit non-core markets. The deal, which is in its early stages, could fetch about $200 million. The strong economic growth of Malaysia should attract interest from AIA Group, Sun Life Financial and Manulife Financial Corp.

Bank of America said at its AGM last week that it has started contacting more than 200k customers who may be eligible for forgiveness of a portion of their loan balances under a national mortgage settlement reached this year. Potential candidates for this assistance started receiving letters last week, and most of the letters will be mailed by 3Q of this year, the bank said. Qualifying customers will see their monthly mortgage payments reduced by an average of 30%.

Barclays - is moving into the US retail banking market for the first time in decades, the Financial Times reported. Barclays is to launch an on line savings account designed to secure cheaper and more stable funding for planned growth in its international credit card business. Barclays has no retail branch presence in the US and has no plans for one. "We are launching a spectrum of rates – paying from 0.35% to 1.75%" said Steve Carp, Managing Director for Barclays US. "This is attractive funding for us". Barclay's move is likely to be well received by regulators, who increasingly want banks to match overseas liabilities with money raised in local markets.

HSBC beat in earnings expectations – HSBC reported US$ 6.8billion underlying pre-tax profit, US$ 4.3billion reported pre-tax profit; US$ 16.2 billion revenues. Revenues were impacted by $ 2.6bn negative fair value adjustment on own debt, $0.2bn disposal gains and $0.2bn positive move on non qualifying hedges. Costs were negatively impacted by $ 0.44bn provisions for mis-selling of Payment Protection Insurance (PPI). Reasons for the beat in earnings expectations were i) HSBC Finance USA ii) strong Global Banking and Market result iii) strong Emerging market result - Asia in particular was very good (revenues, loan loss provisions and costs). HSBC Finance Corp USA (includes legacy Household Financial Corp.) improved on lower bad debts : Loan loss provisions were $0.85bn; with pre-tax loss of $0.25bn and run-off portfolio further declined to $47.5bn in 1Q12 after $49.5bn end 2011. Outlook given by HSBC is typically cautious in particular for developed markets but more positive for Emerging markets. HSBC "Since 31 March, the performance of the Group has been satisfactory". Reported Core tier 1 capital ratio was 10.4% with Risk weighted assets +U$4bn QoQ and core tier 1 +U$4.4bn. These results show good progress on costs with run-rate savings of U$2.0bn achieved by end 1Q12 (U$1.2bn P&L benefit so far) underpinning the achievement of the 2013 cost target.

HSBC Plc also announced that it would sell four more South American businesses. Specifically, HSBC is looking at selling 62 branches mainly in Peru and Colombia (and a smaller number in Uruguay and Paraguay) with total assets of US$4.5 billion. While no other financial details were disclosed, these branches, as a group, could be worth US$400-600 million to an acquirer.

JPMorgan Chase & Co. Chief Executive Officer Jamie Dimon said the firm has incurred significant mark-to-market losses of about $2 billion on synthetic credit securities after an "egregious'" failure in its Chief Investment Office (CIO) , which the bank says focuses on hedging. "This portfolio has proven to be riskier, more volatile and less effective as an economic hedge than the firm previously believed," the bank stated in a quarterly securities filing. Synthetic credit products are derivatives that generate gains and losses tied to credit performance without the owner buying or selling actual debt. The losses occurred as the company sought to unwind a portfolio of the instruments used to hedge JPMorgan's credit exposure. "In hindsight, the new strategy was flawed, complex, poorly reviewed, poorly executed and poorly monitored," Dimon said. JPMorgan said the losses were partly offset by gains from the sales from its available-for-sale credit portfolio, resulting in a net loss for the firm's corporate division, which includes the CIO, of about $800 million after taxes. The losses could widen or narrow during the rest of the quarter, Dimon said. The bank is "repositioning" the synthetic credit portfolio, and the CIO "may hold certain of its current synthetic credit positions for the longer term," the firm said. JPM's 10-Q report went on to say, within the Corporate/Private Equity segment, net income (ex. Private Equity results and litigation expense) for 2Q12 is currently estimated to be a loss of $800mn. The compares to prior guidance of a $200mn gain (a $1bn swing equates to $0.17 per share). Still, it cautioned actual 2Q12 results could be substantially different from the current estimate and will depend on market levels and portfolio actions. This $1bn loss is comprised of the $2bn trading losses (on $375bn overall CIO portfolio) partially offset by $1bn in securities gains (unrealized AFS gains were $5bn at 1Q12). JPM restated its CIO VAR calculation rose from 67 to 129 as it reverted back to a prior VaR model. Also, its Basel III Tier 1 common ratio goes from 8.4% to 8.2% (Basel I unchanged). JP Morgan has historically been viewed a strong risk manager and this announcement could taint that near-term, as well as hurt management's credibility. Already 3 executives from the CIO have departed the company over the weekend. However, the company last year generated profits of $19 billion and has previously said it expects to actively repurchase shares under $45. It stated its Comprehensive Capital plan is not impacted by this loss. In March it authorized a new $15bn share repurchase program, of which up to $12bn is approved for 2012. The $12bn represents 276mn shares, and 7.2% outstanding.

National Australia Bank : Pre-announced cash Net Profit after tax of $2.83bn. NAB worked hard on lowering costs to counter Net Interest Margin weakness (NIM fell 0.11%). Capital growth was solid with Tier 1 ratio at 10.17% (reflecting Risk Weighted Asset optimization, via $7bn reduction). NAB stated that its 7.58% APRA Basel III proforma tier 1 ratio would exceed 8% by the 1 January 2013 cut-over date. A -1% sequential cost growth and cost to income ratio of 43.3% (45.0% 2H11) underpinned in future periods by sequential headcount reduction of 3% and UK restructuring initiatives, displays cost discipline while credit quality was ok outside the UK.

Royal Bank of Scotland Group says that it will finish repaying £164bn in emergency loans from Britain and the United States next week. The repayments cover £75bn that RBS received from the credit guarantee programme, which was a key plank of the government's bailout of banks in October 2008 at the height of the financial crisis.

Spanish banks - Numerous local press articles suggest that, as part of the real estate clean up regulation, Spanish banks will have to make further provisions. The Spanish government and the Bank of Spain are working on a proposal to increase the provisioning rate on loans to developers (that are still performing) up to 30% from the current 7% on top of the Non Performing Loan Commercial Real Estate requirements. At 30% coverage its estimated Santander will need to provision a further €2.4bn, BBVA €1.3bn, BKIA €4.6bn, Caixa €2.9bn, and Popular Bank €3.2bn. Post even a 30% charge, we think the stronger quoted banks – especially Santander and BBVA, still end up at reasonable capital levels (POP SM the tightest). For Santander & BBVA it would be a P&L rather than capital event.

Financial Infrastructure

Hong Kong Exchanges 1Q12 net profit fell 7% year-on-year and 10% quarter-on-quarter to HK$1,148mn. Revenues were better, benefitting from investment income, which grew 105% year-on-year and 47% quarter-on-quarter to HK$227mn (highest since 4Q08), on fair value gains and better deposit rates which appears difficult to sustain. Turnover-related income fell 10% year-on-year, as expected, reflecting underlying market conditions. Overall, while revenues fell, costs rose 20% year-on-year and 21% quarter-on-quarter, with staff costs up 21% year-on-year and 24% quarter-on-quarter (headcount up 10% year-on-year). Its expected the high cost base and high cost growth will remain permanent features in the next few years, while revenues should continue to move in tandem with market activity, which remains softer year-to-date.

Dividend Paying Companies

GEA Group – the German engineering group leading innovation in food processing, farm technologies, refrigeration and heat exchange technologies, reported first quarter results last week, highlighting a very strong order inflow, up 24% year on year, lead by the process engineering, food solutions and refrigeration technology divisions. All divisions recorded order growth in year on year terms. Sales were up by 22% in the quarter, with all divisions contributing double digit growth. Book-to-bill ratio reached 1.22x in the first quarter, which compares favourably with the fourth quarter of the last year at 1.04x. The operating profitability suffered in the quarter, mostly as a result of a poor performance at the newly integrated Food Solutions division, plagued by weak order execution and quality issues leading to cost overruns. A one-off cost of €35mm was recorded for the division. Operating earnings before interest and tax (EBIT) at the group level reached €74.9mm, up 9% on year on year terms. Geographically, the order intake was particularly strong in North America, Western Europe and Latin America. Base orders (orders smaller than €1mm each), which tend to be more profitable, reached the highest level since 2008, at €1,012mm. For the full year 2012, the company expects at least 5% order intake growth, at least 5% sales growth and an underlying EBIT margin at least equal to last year's 9.7%.

Syngenta – presented its corporate strategy for the Corn and Cereals crops during a capital markets day last week. The group generated sales of $4.3Bn (32% of the group sales) from the two crops (both seeds and crop protection solutions) for 2011. The company targets a sales growth of 7% compounded annual growth rate (CAGR), up to $7.8Bn post 2015, with about $5.0Bn from corn and $2.8Bn from cereals related sales, a significant upgrade from last year's estimate of about $6.5Bn sales post 2015. New chemistry as well as the integration of the crop protection and seed offerings should drive growth in the cereals portfolio by 7% CAGR, roughly twice the market rate of growth. Similarly, for corn the growth target is 7.5% CAGR, driven by new biotech traits as well as rolling out of the new technology in the emerging markets.

Toyota – announced, during its earnings release for the last quarter of its fiscal year, that it targets an operating profit of more than $12.5bn, for the current fiscal year, which will end in March of 2013. The improvement in the operating profit, a trebling of the current level, is predicated on a significant improvement in vehicle volumes, set to reach 8.7mm units, and an improvement in the operating margin, which at 1.9% last year, were heavily impacted by the Japan March 2011 earthquake/tsunami/nuclear disaster and the Thai floods. The operating margins are expected to improve to 4.5% in the new year, as the company will continue to tap into its tradition of incremental improvement, 'kaizen', and will speed up product launches.

Economic Activity, Consumer and Business Conditions

US – The US consumer surprised with a better than expected reading of the sentiment, as measured by the University of Michigan, which reached 77.8 index points in May, ahead of both April's 76.4 read and the consensus expectations, pegged at 76.2. the improvement was chiefly due to an improvement in the 'current conditions' component of the index, up to 87.3 from 82.9. A cautionary sign, the 'expectations' component of the index actually retreated in the month, to 71.7 index points from 72.3, below expectations for an improvement to a 72.5 level. The rosier move of the US consumer could be partly explained by a continued expansion of the consumer credit. For the month of March consumer credit grew by $21.36Bn, double the pace of the previous month and ahead of the expectations calling for a $9.8Bn additions.

The US foreign trade balance widened more than expected in March as growth in exports was outpaced by the growth in imports, in particular of oil and consumer products. The international trade balance reached a $51.8Bn deficit level, down from a $45.4Bn deficit in February.

US House Prices: rose in March for the first time since last July, helped by tighter housing inventory, data analysis firm CoreLogic said. CoreLogic's home price index gained 0.6% from February, but was still down 0.6% compared with March a year ago. Excluding sales of distressed properties, prices climbed 0.9% on a yearly basis. Homeowners in danger of foreclosure, or in "distress", often sell their homes at significantly reduced prices. (Source : Reuters)

Canada – The Canadian economy surprised everyone by posting a much higher job additions figure than expected for the month of April. Strong job gains in the private sector, including good performance in the manufacturing and construction sectors, but also in the transportation, finance and resource sectors, led to a 58.2 thousand net additions, way ahead of the expected 6 thousand level. The improved job prospects drew more people into the labour force, which explains a flat 7.3% unemployment level.

The Canadian trade balance recorded its fourth positive reading in a row, although at less than $400mm, it is miles away from what the historical average used to be. Both imports and exports retreated in March, impacted somewhat by lower prices.

The housing market in Canada continues to be strong, to the exasperation of the policy makers, worried about the prospects of asset bubbles and increased household leverage. Housing starts reached a 244,900 annualized level in April, way ahead of March's 214,800 level and the expectations for a 202,000 level, while building permits were higher by 4.7% in March, ahead of expectations for a 2.8% retreat. Meanwhile the Canadian new housing prices moved higher by 0.3%, ahead of consensus.

Greek elections – last week leftwing Syriza party leader Tspiras called for the ripping up of the "barbarous" austerity programme and asked for anyone entering into a potential coalition with their party to renounce support for the EU rescue if they want to enter government. The Head of New Democracy, Samaras rejected the request, saying he was being asked "to put my signature to the destruction of Greece." The most likely outcome is another election in June. Meanwhile Jörg Asmussen, an ECB executive board member, for the first time raised the possibility of a Greek exit from the euro in a Handelsblatt interview he said "Greece can't renegotiate its fiscal reform program if it wants to keep the euro".

The board of the European Financial Stability Facility, the €700bn bailout fund administered by the 17 countries that use the euro, has agreed to make the scheduled payment, which will allow Greece to meet near-term bond redemptions and other obligations. An initial €4.2bn was paid on Thursday, while the remaining €1bn will be paid out later, "depending on the financing needs of Greece," a statement said. (Source: Reuters).

Financial Conditions

The UK government last Monday said it is on track to pass legislation that will protect the retail operations of banks from the banks' more risky investment-bank activities by the end of this parliament in 2015. (Source Wall Street Journal).

Spanish Banks last week the Spanish government injected public funds into the bank sector and took a 45% stake in Bankia (the 3rd largest bank in Spain). Meanwhile Bankia's Executive Chairman, Rodrigo Rato, has resigned and has proposed former BBVA head Jose Ingacio Goirigolzarri to succeed him. Any further steps to recognise losses and inject capital into the banking sector is ultimately positive but considerable uncertainty remains in the near-term. Bankia was listed last summer, raising $3.3 billion and those investors have already lost over 50% since the listing.

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 is now 1.52% and the U.K.'s 2 year/10 year treasury spread is 1.49% - 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 3.83% - (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 improved to 6.4 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 increases 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 24 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 19.89 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

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.

Chris Wain-Lowe
Executive Vice President
Portland Investment Counsel Inc.
Phone: 905-331-4250 Ext. 4232
Fax: 905-331-4368
www.portlandic.com

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Portland Investment Counsel Inc., 1375 Kerns Road, Suite 100, Burlington, Ontario L7P 4V7 Tel.:1-888-710-4242 • www.portlandic.com • info@portlandic.com

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