Market Commentary

PORTLAND INVESTMENT COUNSEL™

July 2, 2012

News Highlights on Current Holdings

Financial Services Companies

Aviva Shortlists Prudential, Manulife for Malaysia sale: Reuters reported this morning that Prudential Plc and Manulife are among four potential buyers that have made it through to a second stage of bidding for Aviva's insurance business in Malaysia in a deal worth about $500 million. The hunt for the Aviva stake underscores the industry's focus on growth opportunities in emerging Asian markets. Aviva, Britain's second-ranked insurer is selling its 49% in an insurance joint venture with Malaysia's second-biggest lender CIMB Group Holdings Ltd as part of a global retreat. The joint venture has struggled against rivals such as Great Eastern and Prudential plc , and a new partnership could re-shape the competitive landscape in Malaysia. Potential buyers are attracted by CIMB's 320 branches across the country and the ability to sell insurance products to the bank's customers. Also, CIMB could sell a significant portion of its 51 percent stake, allowing a new owner to control the business.

Barclays gave its first in-depth account of the interest rate fixing scandal that led to the exit of the British bank's chief executive Bob Diamond last Tuesday by releasing a document it will present to British lawmakers. Barclays detailed in its account to parliament how it thought British authorities had indicated they were happy for it to make a lower submission to the London interbank offered rate - known as Libor - when markets were in turmoil and confidence in banks fraying.

Santander – last week announced an offer to buy back in cash up to £1,144mn (£1,305mn but already owns £206mn) of 8 different issues of subordinated notes originally issued by Abbey National and Alliance & Leicester. Some £500mn of these securities trade at ~80% on average of par and Santander is offering ~85%, while other £650mn trade above par at ~108% on average and Santander is offering ~3% more. Overall its expected there will be a combined profit from the buy back and the cancellation of the related swaps but it will depend on participation levels and how Santander has accounted for the issues that trade above par and related swaps.

Wells Fargo – The Financial Times reports that Wells Fargo spends more on lobbying from its Washington office than any rival, paying millions of dollars to influence mortgage rules, just as the San Francisco-based lender extends its lead in the market for home loans.

Financial Infrastructure Companies

Thomson Reuters announced that it has entered into a definitive agreement to acquired FX Alliance which was publicly listed in February 2012 at $12 per share and closed at $15.70 on Friday. Thomson Reuters is paying $22 per share in cash, or approximately $680mn (net of $70mn in cash). FX Alliance provides electronic foreign exchange trading solutions to corporations and asset managers. Thomson Reuters is tendering for shares, but FX Alliance's board has unanimously approved the acquisition and 32.5% of shares have already agreed to the tender offer. The company expects the acquisition to close in 3Q12.

Dividend Paying Companies

Bayer – announced the acquisition of AgraQuest, a California based agricultural biotech company, for $425mm plus milestone payments as it is aiming to strengthen the fruit and vegetables business part of the CropScience division. AgraQuest's specialty is breeding fungi-killing bacteria to fight plant disease. This type of biological pesticides has a lower risk of resistance (i.e. mutation of weeds, fungi and insects to withstand prevailing pesticides) development. The fruit and vegetable business, which is AgraQuest's addressable market, accounts for about 25% of Bayer's CropScience division revenues. Management targets €3Bn in revenues in this segment by 2020.

Bayer and its partner Johnson&Johnson received priority review status from the US Food and Drug Administation (FDA) for Xarelto, an anti-blood-clotting pill, for the treatment of deep vein thrombosis and pulmonary embolism. The priority review also includes the drug's use in the long-term prevention of venous thromboembolism in patients who have already suffered an attack. An FDA priority review takes six months rather than the usual 10 to 12 months.

Syngenta – announced that the US Environmental Protection Agency (FDA) granted registration approval for two refuge-in-a-bag trait stacks. The Agrisure Viptera 3220 E-Z Refuge and Agrisure 3122 E-Z refuge feature 5% blended refuge and multiple modes of action for insect control in corn. Both products are expected to be available for the 2013 planting season and will offer growers superior convenience and flexibility, while enabling them to comply with refuge requirements and to manage the development of resistant insects. The Viptera trait offers breakthrough control of broad lepidopteran pests.

Syngenta announced a $50mm investment to build a new processing plant for corn and sunflower seeds in Argentina, a key agricultural market. The company is also expanding facilities at seed production farms and continues to invest in seed development at its network of field stations.

Vivendi – Following the departure of its chief executive Jean-Bernard Levy a couple of weeks ago, the company is rumoured to be exploring a number of options including divesting some of its assets. More recently, Reuters cited a source close to the Vivendi board saying that the company asked a bank to go and talk to possible buyers for Activision, the biggest US video game publisher by market capitalization. Vivendi owns a 60% stake and could potentially receive up to $10Bn for it. Possible acquirers include Tencent of China, Time Warner, Microsoft, as well as private-equity firms KKR, Providence and Blackstone. Activision two biggest franchises are Call of Duty and World of Warcraft. The company has suffered from a poor reputation while Jean-Marie Messier was CEO, some 10 years ago, and has had a tough time shaking off that perception. Recent moves are encouraging insofar as realizing some of the value locked-in the conglomerate structure.

Economic Activity, Consumer and Business Conditions

US – A relatively light week in macro-economic releases was dominated by the employment report issued Friday by the Department of Labour and which revealed weaker than expected non-farm payroll additions in June, at only 80,000 positions, compared to the consensus expectations of 90,000 positions. June was the third month in a row in which the employment numbers were sub-par. The private payroll gains of 84,000 were weak compared to expectations for 102,000 job additions. The manufacturing sector added 11,000 jobs in the month, which was ahead of the expected 5,000 positions, yet not enough to make a difference. As the participation rate held steady, the job additions were not large enough to lead to a reduction in the unemployment rate which was unchanged at 8.2%, in line with the expectations.

The poor showing in the employment numbers was foreshadowed by the Institute for Supply Management's (ISM) non-manufacturing Purchasing Managers Index (NMI). Growth in the services sector, the chief provider of employment opportunities, is likely to slow down, with the June reading of 52.1 missing the expectations for a 53.0 level. A few days earlier its manufacturing counterpart indicated contraction for the first time in about three years.

Canada – The employment report for June on this side of the border was somewhat better, as the 7,300 jobs added, albeit modest, were ahead of the expected 5,000 additions, while the headline unemployment rate dropped a tenth to 7.2% in the month. The job additions came chiefly from the public sector, perhaps not the most desirable development, while jobs in manufacturing, agriculture and hospitality retreated.

The forward looking Ivey Purchasing Managers Index (PMI) followed in its US counterpart's footsteps, recording an 11.5 index points drop for June and, at 49.0 index points, indicating contraction in the Canadian manufacturing sector.

Greece - the new Greek government has dropped plans to seek softer terms for its second bailout after warnings it would be rejected by international lenders. Finance Minister Yannis Stournaras said the coalition would need to accelerate reforms before asking for modifications to the €174bn programme. The Prime Minister Samaras reiterated his commitment to accelerating reforms but avoided any timetable change during his first meeting with the Troika. The Troika have made clear that economic arguments could be made for extending the programme but Greece would then need an extra bailout. Greece has missed key deadlines for structural reforms with Finance Minister Stournaras saying the programme was "off track".

The Bank of Japan upgraded its assessment of all nine regions in its quarterly Regional Economic Report for July, the first time since October 2009. The BOJ said that most regions saw a mild recovery in economy, with seven regions seeing consumption increasing, and eight regions noting a rise in capital spending. We see this as the latest data suggesting the resilience of Japanese domestic economy. We believe an improved economy will benefit the banking sector.

Financial Conditions

China surprised markets and cut its deposit rates by 25 bps and cut the benchmark lending rate by 31 bps. In addition, banks will be able to offer loans of as much as 30% less than the benchmark rate. China has now cut rates for a second time in two months as it attempts to bolster slowing growth in the world's second-largest economy.

The Bank of England left rates unchanged at 0.5% but increased the asset buying program by £50 Billion to £375 Billion. Fears are growing that the UK economy will be mired by recession. Inflation has fallen faster than expected and the domestic and global economy look to have slowed in momentum.

The ECB cut its main refinancing rate 25 bps to record-low 0.75%, as expected. The lending and deposit rates were cut by a similar amount to 1.5% and 0%, respectively. The latter is particularly notable, as the ECB will no longer pay interest on deposits, which is intended to incent banks to put money currently on deposit at the ECB to work and will make many institutional money market funds functionally not viable any longer. This is something other central banks have resisted and it could negatively impact the functioning of money markets. Nearly €800 bln were on deposit at the ECB yesterday, a potentially significant flow if the money is put to work. Other policy options (e.g. another LTRO) were not discussed. Indeed, the ECB believes the full impact of the prior two 3-year LTROs is yet to be seen. The rate cut was driven by "dampened" inflation pressure, as "some of the previously identified downside risks to the euro area growth outlook have materialised." Moreover, "the risks surrounding the economic outlook…continue to be on the downside," and "heightened uncertainty" is weighing on confidence. Draghi also stated that high unemployment and balance sheet adjustments will weigh on growth. Bank lending, which he characterized as "weak", isn't helping either.

Eurozone bank regulator - The Wall Street Journal reports that senior eurozone officials, moving ahead of a plan to create a single banking supervisor for the 17 nation bloc, are setting a framework to create a new agency reporting to the ECB to police the largest banks in the currency union. The talks were based around the idea of creating an agency under the ECB that would be charged with sole supervision of the top 25 or so largest banks. They said smaller euro-zone banks would remain under the purview of their national financial-market regulators. But these national regulators would be brought under the control of the euro-zone supervisor, which could be based in Brussels rather than Frankfurt, At the recent summit, leaders made the establishment of the supervisor as a precondition for agreeing to allow the bloc's bailout fund to inject capital directly into struggling banks.

US – UK: US Federal Reserve policymakers remain 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 extension 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 until mid to late 2014. The U.S. 2 year/10 year treasury spread is now 1.27% and the U.K.'s 2 year/10 year treasury spread is 1.38% - 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 3.62% - (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 is at 6.6 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 32 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 17.10 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.

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