



## News Highlights on Current Holdings

### Financial Services Companies

Bank of America reported 2Q12 EPS of \$0.19. Consensus was \$0.15. Debt securities gains were \$354mn, gains on debt repurchases/TruPS exchanges were \$505mn, Debt Value Adjusted losses were \$156mn, mortgage-ligation costs were \$100mn and Mortgage Service Rights gains were \$194mn. Net these added \$0.04. Loan loss reserve releases totaled \$1.9bn (\$0.11). Operating revenues declined 18% y-o-y and decreased 10% sequentially. Its Basel III Tier 1 common capital ratio on a fully phased-in basis is now estimated at 8.10%. This compares with its previous guidance of 7.50% by the end of 2012. Tangible book rose 3% to \$13.22 (trading at 0.6x). During the quarter, it retired \$5.5bn of debt and Preferred Shares. This is expected to add \$300mn to quarterly net interest income (\$60mn in 2Q). Its Global Excess Liquidity Sources were \$378bn, down \$28bn from 1Q12. It reduced long-term debt by \$53bn. Its mortgage repurchase provision was \$395mn, up from \$282mn in the prior quarter. Its reserve increased \$197mn to \$15.9bn. Outstanding claims jumped 41% to \$22.7bn with GSE claims up 35% and privates up 77%. BAC said that due to the significant uncertainty related to its differences with the GSEs, it is not possible to reasonably estimate the outcome or range possible loss may be. It continued to estimated range of possible loss related to non-GSE representations and warranties exposure of up to \$5bn over existing accruals. Net interest income fell 11% or \$1.3bn from 1Q12. Its net interest margin dropped 0.30% to 2.21. However, excluding premium amortization and hedge ineffectiveness it declined a lower 10bps. Average earning assets were stable with 1Q12 as loans declined 2% and securities increased 4%. Fee income declined 9% from 1Q12. Expenses declined 6% led by a 14% decline in personal costs. The Bank revealed it expects New BAC Phase II savings of \$3bn (earlier expected \$2-\$3bn), bringing its total expected New BAC savings to \$8bn by mid-2015. Investment banking fees declined 6% to \$1.15bn. FICC trading was stable y-o-y and dropped 38% from 1Q12 to \$2.6bn. Equity trading declined 26% on both a y-o-y and linked quarter

basis to \$778mn. It noted volumes remained at low levels significantly impacting trading and commission revenues. Its nonperforming assets ratio declined 0.23% to 2.87%. Loan loss reserve releases totaled \$1.9bn (\$1.5bn in consumer, \$335mn in commercial), up from \$1.6bn in 1Q12, and included a reserve reduction in home equity. Its reserve/loan ratio decreased 18bps to 3.43%.

Bank of New York Mellon's second-quarter profit fell 37% as lower revenue and a \$350 million pretax litigation charge weighed on the trust bank's earnings. Rival Northern Trust, however, saw profit rise 18%.

Citigroup reported 2Q 2012 EPS of \$0.95. Consensus was \$0.89. Excluding the impact of positive Debt Value Adjustments (\$219mn; \$0.05) and a net loss on the previously disclosed sale of a 10.1% stake in Akbank (\$424mn; \$0.09), EPS was \$1.00, marked by better than expected Fixed income, currencies and commodities and Investment Banking revenues. Results included a \$920mn loss (\$0.31) in Citi Holdings. Relative to 1Q 2012, results evidenced lower (-3%) net interest income (39% of revenues) as average earning assets were stable (Citicorp loans +3%) and its net interest margin declined (-9bps), lower fee income, reduced expenses, and a lower cost of credit (-7%) as both non-accrual assets (-7%) and net charge-offs (-10%) improved. Tangible book increased 2% to \$51.81 (so trading at roughly half its tangible book value). For the combined Citicorp and corporate/other its return on tangible common equity was 14.7%, excluding DVA and Akbank.

Credit Suisse pre-released 2Q12 and announced a multi leg CHF15.3bn capital increase including a CHF3.8bn Mandatory Convertible Note (18% increase in share count), with the majority of the rest coming from hybrid/coco issuance. Capital (on Swiss National Bank basis) to jump from 5.9pc in 1Q12 to 8.5% by July 2012, 10.8% by end 2012 and 12.2% if we add the extra bonds due to convert in 2013. Credit Suisse have also announced a cost target boosted from CHF2bn to CHF3bn. Results were more or less in line with expectations. Investment Banking saw its revenues decrease 25% sequentially, with a significant drop in Fixed Income Sales & Trading (-38%) while Equity Sales & Trading held up a bit better



(-13%). These decreases are more or less in line with peers who have already reported, with Equities holding up better. Wealth Management was a positive surprise given the difficult environment, with the gross margin increasing slightly to 115bps from 111bps in Q1 2012 and pre-tax profit increasing from CHF406m in Q1 2012 to CHF551m in Q2, driven by higher interest income and lower costs. Net new money flows were also positive, with CHF5.5bn in Q2 despite CHF3.4bn outflows resulting from the integration of Clariden Leu.

Goldman Sachs reported 2Q 2012 EPS of \$1.78, well above expectations (consensus \$1.12) on better than expected investing & lending, investment banking, FICC and investment management results were also supported by solid non-compensation expense control and a bigger than expected share buyback (\$1.5 Bn this quarter); equities was the one business line that came in below our forecast. Nonetheless, in real terms total revenues of \$6.6 billion were down 9% yr/yr and down 33% from seasonally stronger first quarter levels as the global trading slump impacted trading activity. The sequential quarter pullback was largely driven by a step down in Institutional Client Services (-32%) and Investing & Lending results (-89%). Investment Banking (-17% yr/yr, +4% qtr/qtr) and Investment Management revenues (+5% yr/yr, +13% qtr/qtr) were sequentially stronger—the latter was driven in part by a modest acquisition (purchased Dwight Asset Management which added \$17bn to its assets under mgt). Total expenses of \$5.2 billion reflected increased compensation expenses which were accrued at 44% (the same as last quarter but up from 42% in 2011) while non-comp expense of \$2.3 billion fell 4% qtr/qtr. However a 5% return on tangible equity is unimpressive but still, in our view, doesn't justify the firm trading at 0.8x tangible book value. It seems likely that Goldman will ratchet down further their costs / staff levels/ staff compensation to improve shareholder returns. Goldman Sachs is to open an office in Perth, making Australia only the fourth country in the world after the United States, Canada and China where the investment bank has more than two offices in a single country. Goldman's Western Australia branch will work alongside the bank's Sydney and Melbourne offices.

HSBC did business with firms linked to terrorism, failed to guard against money-laundering violations in Mexico and bypassed US sanctions against Iran, according to US Senate investigators. HSBC affiliates worldwide gave terrorists, drug cartels and criminals a portal into the US financial system, the Permanent Subcommittee on Investigations said in a 335-page report yesterday detailing a decade of lax controls. Lawmakers plan to question senior executives from the bank at a hearing in Washington today. (Source: Bloomberg). HSBC's chief compliance officer resigned from his post during a US Senate hearing following publication of a damning report alleging that Britain's biggest bank may have inadvertently allowed the laundering of Mexican drug money.

Reuters article reports that HSBC will sell its Vietnam insurance business. HSBC holds 18% stake in government-controlled Baoviet Holdings. Deal value could be around US\$ 400m. Market value of the stake is around US\$ 250m but high premium is expected because of Baoviet's top market position and the potential to raise the ownership level at a later stage. Small capital gain of around US\$ 50m to US\$ 100m possible. A deal would be a positive since HSBC is exiting non-core businesses and is delivering on its restructuring initiatives. Sumitomo Life is named as a potential buyer.

Intesa Sanpaolo - In a statement last week, Intesa announced that they are offering to buy back as much as €1.5bn of its own bonds to boost capital. The bank is tendering for €1bn of subordinated securities and €500mn of senior notes. Intesa Sanpaolo is offering prices ranging from 80.5% of face value to 102.25% for the 28 securities in euros and pounds. Overall it should give ~€150mn after tax, so 1% of market cap.

JPMorgan : Jamie Dimon, JP Morgan's CEO, bought more than \$17m of shares last week according to filings on Friday.

Lloyds Bank announced last week that heads of terms have been agreed with the Co-operative Group for the EU mandated retail and commercial divestment known as Verde. Overall this is a much smaller transaction than expected. We had expected disposal to generate c£1.5bn of capital. Now looks like it will absorb "worst



case" c£500m - a net loss of c3p a share. However, earnings impact much smaller as only losing £100m of PBT compared with £500m expected. Even on only 5x earnings this is worth c£1.5bn or 2p a share. Key question is whether it is sufficient to meet EU requirements. EU required the disposal of 19% of Lloyds mortgage business. This looks like c5%. EU have proved flexible with others and no doubt reflects Co-op funding requirements, but they may still be required to sell more mortgages.

Nordea's Q2 2012 total income was 7% above consensus, while costs were 1% above. Commission income was 2% above estimates and net interest income was 4% above and up 3% q-o-q. Nordea says that "lending margins increased somewhat while deposit margins declined due to lower interest rates and continued fierce competition in savings deposits in the quarter". Corporate lending volumes were up 2% from Q1 2012 and deposit volumes were up 2% q-o-q. Trading income was 24% above consensus mainly "driven by a periodization effects between the quarters in Others and eliminations (EUR 117m)." Nordea's impaired loans were up 12% in the quarter. On a geographical basis, Danish loan losses stood at 62bp, Finland was at 1bp, Sweden had loan losses of 4bp and Norway was at 6bp. Q2 2012 shipping loan losses remained still high at 185bp and Baltic net loan losses were 14bp. Regarding Denmark, Nordea states "individual losses increased due to clarified and stricter rules for loan loss provisioning introduced by the Danish FSA. The new individually assessed loan losses were to a large extent covered by collective provisions that have consequently been released, thus the new rules did not have any significant impact on the total level of loan loss provisions in Denmark". The full Q2 2012 Basel II core tier 1 ratio was up to 11.7%. Nordea states that "Basel III will lower the Core Tier 1 ratio by ca 100bps, and IAS 19 (as end of 2011) will lower by another 20bps. This will be offset by roll-outs and efficiency gains, thus the Core Tier 1 ratio after these actions is expected to be at around the same level as today, or 11.7%." The key positives in the Q2 12 report is the strong Net interest income and improving CT1-ratio. Key negatives are the higher than expected new loan loss provisions.

Northern Trust reported 2Q 2012 EPS of \$0.73. Consensus was \$0.75. Results included \$3.6mn (\$0.01) of restructuring, acquisition, and integration-related charges. Results also included software write-offs of \$10.5mn, up from \$4.6mn in 1Q12.

Operating revenues rose 3% y-o-y and increased 2% from 1Q12. Expenses rose 5% from the prior year but declined 1% linked quarter. Global Assets under custody declined 2% to \$2.5trn. Assets Under Management declined 2% to \$704bn. Its Basel I Tier 1 common ratio was 12.4%, up from 11.9% at 1Q12. It posted an ROE of 9.9%. It repurchased 0.8mn shares in 2Q12, up from 0.3mn in 1Q12. It said its repurchase authorization was replaced in March 2012, pursuant to its authorized to purchase up to 9.2mn additional shares after June 30. Fee income rose 3% from 1Q12 and Net interest income rose 3% y-o-y and declined 1% from 1Q12. Average earning assets declined 3% sequentially with loans up 2%, securities up 1% and money markets assets down 13%. Its net interest margin rose 4bps to 1.28%, reflecting a lower cost of funding, primarily within non-U.S. office interest-bearing deposits; and lower levels of Fed deposits; partially offset by lower yields on certain categories of earning assets. Its Non Performing Assets ratio declined 8bps to 0.89%. Its reserve/loan ratio was stable at 1.01%.

Santander have announced a 'reinsurance agreement' with Abbey Life Assurance (owned by Deutsche Bank) with respect to their life risk insurance portfolio in Spain and Portugal, generating a capital gain of EUR490m. Essentially Santander have sold the existing (agreement doesn't cover future production) earnings stream of the life insurance portfolio. Santander generates a capital gain upfront, but clearly lose the earnings going forward. Overall impact fairly limited. Gain will be used to offset provisions and be used towards meeting the requirements to strengthen capital.

Santander is also set to shut 96 UK high street branches as part of its effort to complete the integration of the British lenders it bought during the financial crisis, according to the Sunday Times. The bank will open 20



new branches over the next two years in areas where it has little presence, the report said.

Swedbank reported a 2Q 2012 SEK3.2bn profit - in line with consensus. Return on NAV remains strong and ahead of any peer at 16.8% (+0.3% QoQ). The bank experienced 2% better revenues (half net interest income, half trading) and most importantly 2% better costs as it executes its cost cutting plan. Reported loan losses were in line. Capital also improved further to Basel II Core Tier 1 16.6% (+70bp) and Basel III Core Tier 1 of ~15.5% (14-14.9% with few adjustments on mortgages, corp RWA & IAS19). The continuous accumulation of excess capital should, in our view, be rewarded in the share price through a reduced risk premium and for the ensured competitive dividend yield of 5-6% (and extra capital distribution potential). By 2015 when the "Swedish finish" to capital requirements is implemented we think it will be translated into a Basel III Core Tier 1 ratio of about 14% - which suggests excess capital of SEK 14bn to support buy backs and / or high dividend payouts.

## Dividend Paying Companies

Novartis – posted \$1.38 earnings per share for its second quarter, marginally ahead of the consensus expectations, which were calling for a \$1.33 earnings per share level. The sales were substantially in line with expectations and, at \$14.2Bn, were down only 4% from a year earlier, impacted by patent expiration of a few key drugs, including Diovan, the company's high blood pressure blockbuster. The company was forced to revise its outlook for the currency impact, to a 4% headwind on sales and 3-4% reduction in operating profit as the US dollar continued to outperform. The company however kept to its full year constant currency sales guidance as well as to its estimation of core operating profit being slightly below the 2011 level. The group also announced that limited production has resumed at its consumer health manufacturing site in Lincoln, Nebraska. Sales of the company's newest drugs rose by 8% in the quarter helping to offset declines of Diovan, which went off patent in Europe last year and will lose exclusivity in the US in September. Gilenya, the multiple sclerosis pill, sales reached \$530mm in the first half of the year, on track to exceeding \$1Bn of sales in 2012.

The US Food and Drug Administration on Friday approved Afinitor, a Novartis drug, to treat women with a certain type of breast cancer. The European Medicines Agency in June also endorsed Afinitor as a breast cancer treatment. The drug, also known as everolimus, is already approved to treat patients with four other types of cancer, including kidney and a rare type of pancreatic cancer.

Siemens – received an order for 300 giant wind turbines, of 6MW installed capacity each, from Dong Energy, a Danish state owned group which plans to install the turbines offshore Britain. The deal matches a 2009 order from the same client for 500 turbines of 3.6MW each. That order was the world biggest at the time. Though financial consideration for the order was not disclosed, a rule of thumb says each megawatt of wind-power capacity costs €1mm, putting the order in the neighbourhood of €1.8Bn. The turbines, a 75-metre blade model, are scheduled to be installed offshore Britain from 2014 to 2017.

Reuters reported rumours of Siemens being involved in talks with Ansaldo Energia, for which it could pay around €1.3Bn in a bid to increase its market share in the gas turbines market. Ansaldo Energia is a joint venture between the Italian group Finmeccanica and the US fund First Reserve and has the bulk of its clients located in the Middle East. If consummated, the deal would be Siemens largest since the 2007 \$6Bn acquisition of Dade Behring diagnostics business purchase. Siemens and GE are said to be controlling about 60% of the gas turbines market, with Siemens trailing its US rival in production capacity. Current valuation for power equipment producers are depressed, which increases the attractiveness of the deal to Siemens.

Vivendi – The French anti-trust regulator approved the acquisition of two television channels, previously owned by Vincent Bollore, a French business-man, by Canal+, a Vivendi subsidiary. The purchase was agreed in September, for a €465mm consideration, payable in Vivendi shares. The deal will end up making Vincent Bollore Vivendi's biggest shareholder.



Bollore announced he sought to hold roughly 5% of Vivendi, with some of the share being acquired on the market. The acquisition of Direct 8 and Direct Star will be subject to a number of limitations including how Canal+ can use premium sports and cinema content acquired for its pay-TV business on free-to-air channels. The acquisition is seen as an ideal opportunity for Canal+ to expand into the newly opened up free-to-air digital broadcasting market.

Vivendi is reported to be exploring the sale of GVT, a Brazilian provider of fixed telephone, broadband and TV services in 120 cities, after an attempt by Goldman Sachs and Barclays to market Vivendi's 60% stake in Activision failed to reach the desired outcome. Vivendi acquired GVT for \$2.9Bn in 2009 and invested heavily in building its infrastructure, including high-speed fibre networks. The business is one of Vivendi's key growth engines. Analysts estimate the current value of GVT at about \$8.5Bn and interest parties may include Telefonica, Oi, Telecom Italia and America Movil.

## Economic Activity, Consumer and Business Conditions

US – The US Conference Board's leading index for June contracted by 0.3%, more than the expected 0.1%, indicating that the US business activity is likely to slow-down. Earlier in the week though, the industrial production report revealed a marginally better than expected rate of growth for the month of June. At 0.4% month on month growth, the performance more than reversed May's 0.2% drop. Many industries contributed to the improvement, most notably motor vehicles and parts and business equipment manufacturing. The US capacity utilization failed to match the expected level of 79.2%, albeit at 78.9% was higher than May's 78.7% value.

On the US inflation front, the report revealed once again benign levels, with the headline year on year rate at 1.7% for June, matching May's number, while the core reading, which excludes food and energy, moved a notch lower, to 2.2%. The story for June was a 1.4% retreat in energy pricing, offset by some of the other categories.

On an overall improving background, the US housing delivered a mixed bag of updates last week, as the

dramatic improvement in the home-builders' sentiment, the National Association of Home-Builders' (NAHB) index reading jumping to 35 from 29, was shadowed by an unexpected drop in the level of existing home sales. Americans traded 5.4% fewer homes in June, at a 4.37 million units annual rate, short of expectations for a marginal improvement.

Canada – Annual inflation picked-up slightly in the month of June as a month on month reduction in both headline and core consumer pricing was no match for a bigger drop the year before. As such the headline inflation rate ended up at 1.5% in June, while the core rate advanced to 2.0% in the same month. As in the US, the biggest story was a 3.2% drop in gasoline pricing, but also a tame food pricing environment. In so far as food pricing is concerned, the environment should change rapidly, as crop shortages in the US and worldwide will likely have a ripple effect at the consumer level.

The world economy is likely to remain soft, as weakness in developing countries and Europe's sovereign debt crisis stifle the global recovery, the IMF says. The fund's World Economic Outlook, released last week, trimmed its forecasts for global growth for this year (to 3.5%) and next, warning that Europe's debt crisis continued to pose a significant risk to the world.

Germany's parliament has approved a European aid package for crisis-wracked Spanish banks that aims to prevent Spain's whole economy being dragged deeper into the mire. In the 10th German vote on European crisis measures since the debt emergency began, MPs voted by 473 to 97 to pass the package worth up to €100bn to pump in much-needed fresh cash to the Spanish banking sector.

Australia is growing faster than expected but it faces risk from the ongoing European sovereign debt crisis and a slowing US economy, the Reserve Bank of Australia has warned. The bank left the official cash rate on hold at 3.5% in July after ordering back-to-back cuts worth 75bps in the prior two months.

## Financial Conditions



The head of Europe's top banking regulator has raised the bar for lenders' capital requirements, insisting that the 9% capital ratio they had to hit as a "temporary buffer" by June is to become permanent. Andrea Enria, chairman of the European Banking Authority, said "capital conservation" was his priority, with the eurozone crisis persisting and the six-year phase-in of Basel III global capital standards set to begin next year. ( Source : Financial Times).

The Bank of England and the Treasury set out details of an £80bn scheme designed to encourage banks to increase their lending to the UK economy. Under "funding for lending", institutions will be invited to borrow money from the Bank of England for a fee that will remain low if they increase their supply of lending to British homes and households. The fee will rise if they shrink their lending books. (Source: The Independent)

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 1.20% and the U.K.'s 2 year/10 year treasury spread is 1.35% - 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 3.53% - (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 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 38 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.

# Market Commentary



PORTLAND  
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The VIX (volatility index) is 16.27 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)

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