Market Commentary

PORTLAND INVESTMENT COUNSEL™

August 6, 2012

News Highlights on Current Holdings

Financial Services Companies

BBVA published Q2 net profit of €505mn, 25% below market consensus. However, the composition of the P&L was mixed: revenues were strong (4% beat); operating expenses were about 5% worse than expected and total impairment and provisions came in at €2.3bn versus €1.2bn estimate, because BBVA booked part of the new regulatory provisions in Q2 (30% of the total requirement). On a divisional basis, results for the operating units were below our estimates in Spain, South LatAm and Mexico with the US franchise the main positive surprise. Management reported a 34% Non Performing Loan ratio with housebuilders (vs. 27% in March). Total troubled assets stood at €14.5bn (37% coverage). BBVA reported a Core Tier 1 ratio of 10.8% which falls to 9.2% under European Banking criteria but still sufficient to exceed the EBA's 9% threshold. The loan-to-deposit ratio in Spain deteriorated to 179% as the commercial gap was negative in Q2.

BNP Paribas - 2Q results. Clean Profits Before Tax €2.8bn slightly ahead of consensus €2.75bn. Positive news on deleveraging with 90% of 2012 target completed and loss estimate from loan sale programme reduced from €0.8bn to €0.4bn. 2Q loan sales resulted in a small profit (€75m). Non Performing Loans ratio stays at 4.4% (as in March) and coverage rate is 80% (81%). Exceptional items were mainly limited to a EUR 75M gain in loan disposal. Management posted new guidance for the cost of downsizing its Corporate & Investment Bank group , the previous guidance of Euro 800M cost is now reduced to Euro 400M. Probably three quarters of the plan is already done. BNPP generated 20bp of capital this quarter and another 20bp with the benefits of the scrip dividends in June. Current Tier 1 capital ratio is at 10.9% and the Basel III fully diluted ratio is 8.9%, close to the end of the year target of 9%. This includes a 40bp charge for holding Italian sovereign bonds (EUR 11.2 in banking book)

HSBC: Revelations of lax anti-money laundering controls at HSBC are "shameful and embarrassing" for Europe's biggest bank, its boss said last week, and it may have to pay out well over $2 billion for the scandal and in compensation for UK mis-selling. HSBC set aside $700 million to cover fines and other costs after a U.S. Senate report criticized it this month for letting clients shift funds from dangerous and secretive countries, notably Mexico. (Source : Reuters)

HSBC remains cautiously upbeat over the outlook for growth through Asia's banking markets as its first half profits were masked by attractive gains on businesses it sold and provisions on previous mistakes (e.g. re money laundering mentioned above). Underlying profits were about 3% lower than last year at $10.6 billion but still about 20% better than consensus estimates. "Asia has been an absolute powerhouse for us," chief executive Stuart Gulliver told reporters last week. He said the bank was able to post double-digit rates of revenue growth from its Asian businesses, easily outpacing broader rates of economic growth in key markets. And despite signs of a slowing China, he remains optimistic it will have a "soft landing". HSBC's pre-tax profit in Hong Kong for the June half was up 22% to US$3.76bn and up 17% to US$4.37bn for the rest of it businesses across Asia Pacific, including Australia. Mr Gulliver pointed out much of HSBC Asia's growth is coming from market share gains as under-pressure European rivals start pulling back. "What's happening as an offset to that slowdown is we're taking market share, because you'll find a number of European banks are having to retreat domestically," Mr Gulliver said. Such European banks were looking to offload some Asian-based lending books, he noted. But there was little of interest for HSBC, due to the assets on offer being mostly long-dated leasing portfolios which chew-up expensive regulatory capital.

ING announced in a press release that they are reviewing the position of ING Direct in Canada and UK. In 2011, ING direct Canada had €109mn (2010: €139mn) of pre-tax underlying profits and UK made a loss of €46mn (€36mn) out of total group underlying profits of €5.1bn (€4.7bn), including total bank of €4.7bn (€5.7bn) so these are relatively small businesses in terms of earnings contribution. At the end of 2011, funds entrusted were €23bn / €14bn in Canada / UK out of total ING Direct of €255bn and total bank of €522bn. Canada was the great success story whereas UK was the big question mark for the ING Direct business model. There should be several Canadian banks interested. ING Direct Canada was established in 1997 and, in our view, has established a valuable brand associated with high interest savings accounts. Based on OSFI filings, ING Direct has $30 billion of loans, of which 98% are residential mortgages, as well as $30 billion of deposits, virtually all from individuals. 59% of the residential mortgage book is insured. Book value at Q1/12 was $1.7 billion, and ROE over the last twelve months was 7%. Scotia and National Bank should be seen as the natural buyers of this business. ING has been quite keen on integrating its banking businesses so although it is good news to release more value to shareholders it is disconcerting if this outcome results from the rest of its strategy not going to plan.

Standard Chartered : reported 1st Half 2012 Profit Before Tax of U$3,948mn, slightly ahead of expectations. Income is +8.5% year-on-year at U$9,511mn. Costs of U$4,963mn are +6.1% Year-on-year (4% underlying). Loan impairment charges were better at U$583mn although Non Performing Loans increased 25% Quarter on Quarter. Strong Wholesale Banking result and weak Consumer Banking result. Hong Kong, Singapore and Americas/UK strong while India, Mid-East & South Asia and Africa weaker. All financial targets are re-confirmed. Standard Chartered reported 116 cents (+11% yoy) normalized EPS for 1st half 2012 which is c3% ahead of expectations. Standard Chartered reported stronger trading income but lower Commission income (down 9% yoy) and slightly higher Loan Loss Provisions than expected. Net Interest Margin was stable and the loan deposit ratio stood at 77.6%. Return on Equity is up to 13.8% from 13.0% in 1st Half 2011. Tangible Book Value Per Share increased by 4% to US$ 14.1 and core tier I ratio is down to 11.6% (-20 bp on end 2011) due to lower scrip dividend take up and 6% growth in risk weighted assets. Management remain confident of double-digit year-on-year revenue growth in 2012.

Standard Chartered has been accused by New York's Bank regulator that it illegally handled $250 billion in transactions with Iranian authorities as a result of which it may lose its New York banking licence. Standard Chartered has responded saying 99.9% of the transactions complied with the rules leaving $14 million in error - and that the bank ceased relations with Iran clients over 5 years ago, that no payments have been found designated as terrorist by US Government and that the bank is to contest the position of New York regulators. The bank has to appear before the Department of Financial Services (DFS) on August 15th.

UBS Clean pre-tax profit of CHF1.1bn versus consensus CHF1.4bn. Miss is mainly in Investment Banking and Wealth Management as well as a larger Corp Centre loss. On the positive side, capital is much stronger with Basel 3 Core Tier 1 at 8.8% versus 7.9%, consensus. Risk Weighted Asset reduction targets have been increased by CHF30bn. Also strong net new money inflows into Wealth Management (CHF9.5bn vs. consensus CHF5.1bn) shows that the franchise is still recovering and so growing strongly. The bank is moving ever closer to returning capital to shareholders. 2013 guidance for Basel 3 Core Tier capital ratio 1 fell 0.90% to 11.3% but this is still well ahead of peers and the reduction reflects that about 0.60% of that decline is to be due to higher consensus dividend forecasts, which is a positive. Nonetheless a return on equity of 4.7% is under half last year's and well below its cost of capital and so the unacceptably high cost to income ratio of 85% needs to be reduced.

Financial Infrastructure

Deutsche Börse's Q2 results were in line with consensus forecasts. Net revenue of €507mn and adjusted operating costs of €224mn, resulting in adjusted EPS of €1.01. Full-year cost guidance was unchanged at ~€1,200mn. Despite a tough market backdrop, the Q2 results highlighted good growth in nascent product lines, including recent derivatives contract launches and collateral management. Although still small in the context of the Group, Global Securities Financing (GSF) net revenue was up 18% year-on-year, to €15mn. As regulation exerts ever greater pressure on capital, we expect demand for this service to grow steadily over time. We think Deutsche Börse remains well positioned for long-term structural growth, particularly in derivatives and post trade, but acknowledge near-term headwinds. Subdued volumes imply a lack of earnings momentum, but we believe valuation remains attractive.

Willis reported 2Q12 adjusted earnings of $0.59. Adjusted for currency, Willis' $0.53 per share of operating earnings missed consensus of $0.58 per share. Further, earnings were aided by a $4 million fund and reserve release (about $0.02 per share) related to potential legal liabilities. Organic growth was 2% due to a 3% drop in North American growth and a slowdown in International growth. Once again, growth was strongest in the global segment and the organic growth in that segment accelerated to 7% sequentially. The 20.7% adjusted margin was 0.8 points below the year ago figure and the most notable pressure was observed in North America. Willis bought back 1.04m shares for approximately $37m in the quarter. During July its estimated Willis repurchased $16m worth of stock and has about $26m left to repurchase to reach its $100m 2012 target.

Dividend Paying Companies

ABB – has won an order worth about $55mm to supply three new substations and transmission infrastructure for the Brazilian utility Eolicas do Sul. The substations will be installed in the southern state of Rio Grande do Sul, while the transmission lines will connect a new 400MW wind power plant to the national Brazilian electricity grid. Brazil has added significant wind power in the past few years and currently has over 1500MW of installed wind capacity with another 7000MW in the pipeline over the next five years.

Bayer – Bayer's second quarter results exceeded expectations, as the company reported adjusted earnings before interest, taxes, depreciation and amortization (EBITDA) of €2.17Bn (up 6.7%) on stronger than expected results from its crop protection business, which benefited from markedly higher prices for key agricultural commodities. The stronger business outlook, together with a fallen euro led the company to revise its revenue guidance, aiming now for a €39-€40Bn level, up from the previous target of about €37Bn. The group also increased its EBITDA target, for which it now expects a high-single digit gain for the full year, compared to a slight increase previously. The second quarter's reported income was a more modest €494mm as it was impacted by a €500mm provision meant to deal with litigations in connection with its Yasmin/Yaz birth control pills. Bayer's pharma division reported underlying core earnings higher by 8%, driven by growth in emerging markets. The company estimates that four of its most promising new drugs, including the blood-thinner Xarelto, have the potential to reach more than €5Bn in peak sales.

BHP – After numerous reports speculating on curtailments of key capital expenditure projects, expected to amount to about $80Bn, BHP issued a statement saying that no decision had been made on which projects would go ahead and which would be postponed/cancelled. Most recently, speculation ran high on a delay of BHP's $20Bn Port Hedland outer harbour expansion. The outer harbour would take about eight years to complete, at which point would be able to handle 240mm tonnes of iron ore a year, adding to the 220mm tonnes the company is targeting in an inner-harbour expansion already under way. Other projects under scrutiny include a $30Bn proposed expansion of the Olympic Dam mine in South Australia and the Jansen potash mining project in Saskatchewan.

BHP will take a $2.84Bn charge on a recently acquired US shale gas business and a $450mm writedown on its Australian nickel business. Chairman Jac Nasser said the writedown was 'very disappointing' after low gas prices (which halved since the time of the acquisition) cut the value of Fayetteville business it bought last year. BHP paid $4.75Bn for Fayetteville, one of the biggest shale gas plays in the US. It also paid $12Bn plus $3Bn in debt for Petrohawk US shale gas business. The latter was not impacted by the writedown as it liquid rich characteristics made it preserve its value better. The writedown was anticipated, as other big producers, including BP and BG, had to recognize impairments of their US shale gas assets. Both Marius Kloppers, the group CEO, and Mike Yeager, the head of petroleum, were denied their bonuses on account of the significant writedown.

BHP Billiton and its partner Mitsubishi Developments are believed to have made the world's largest out of court settlement of its type with insurers over flood damage to their Bowen Basin coalmines in 2007/8. Exact details of the settlement are not known, but it is understood that it totals at least $350 million and is 3.5 times the size of the previous record, which involved a negotiated settlement for flood damage and business disruption to a mining company relating to a Chilean copper mine. That settlement was for more than $100 million.

Novartis – and the University of Pennsylvania announced an exclusive global collaboration to research, develop and commercialize targeted chimeric antigen receptor (CAR) immunotherapies for the treatment of cancers. The parties will jointly establish a new R&D facility on the Penn campus, to be named the Center for Advanced Cellular Therapies (CACT). The move underscores Novartis' commitment for immunotherapy as one of the exciting frontiers in cancer research.

Siemens – German engineering conglomerate Siemens said it has started a share repurchase programme worth up to €3Bn, to be carried out by the end of this year. The buy-back, which represents about 3.5% of the group's market capitalization, will server primarily to reduce its capital stock, but also as employee and executive compensation and against some of its convertible bonds and warrant bonds.

Toyota – reported results for the first quarter of its 2012-2013 fiscal year which were ahead of expectations and constituted the best set of quarterly results in term of operating profit in four years. As demand for its Camry and Prius models strengthened in key markets such as the US and Japan its first quarter operating profit reached ¥353Bn ($4.5Bn) ahead of expectations for a ¥314Bn operating profit level. Toyota, which regained its crown as the world's best-selling automaker in the first half of 2012, moved its sales target 2% higher for the calendar 2012 to 9.76mm vehicles. For the Toyota and Lexus brands combined, it now targets 8.87mm units, a 2.5% upward revision. In the US, Toyota sales moved higher by 28% through July, albeit on easy comparatives, the biggest gain for any major automaker, while, at the same time, managed to achieve higher transaction prices.

Vodafone : After following Telefonica's lead in withdrawing handset subsidy for new acquisitions in April, Vodafone has decided to re-introduce subsidies for a limited period 'summer promotion'. This seems to be a retaliation against France Telecom who have so far resisted pressure to join the two larger operators in Spain with complete acquisition subsidy withdrawal. The reduction in subsidy has clearly improved Telefonica's Spanish margins, while France Telecom recently reported much stronger margins.

Economic Activity, Consumer and Business Conditions

US – The highlight of the US macro-economic announcements last week was the employment report for July, which revealed stronger than expected job creation in the month, as the non-farm payrolls tallied 163,000 positions, ahead of the expectations for a 100,000 jobs improvement, the manufacturing payrolls grew by 25,000, ahead of the expected 10,000 positions, while the private payrolls contributed 172,000 jobs to the improvement. The headline unemployment rate, which is derived from a parallel household-survey, actually moved higher in the month, to a disappointing 8.3%, despite a decrease in the size of the labour force.

Business outlook improved in the US, albeit at a slow pace, with the July reading of the Purchasing Managers Index (PMI) by the Institute for Supply Management (ISM) inching higher to a 49.8 index level, above June's 49.7, yet short of the expected 50.2 level. It was followed by another modest increase of its non-manufacturing counterpart, the NMI, which moved to a 52.6 index points level in the same month, up from a 52.1 reading in June. As the services indicator seems to indicate a continued, slow, expansion, the manufacturing one continues to point to a mild contraction, hardly a reason to celebrate.

The US consumer however, seems to have found improved optimism, as the consumer confidence measurement by the Conference Board moved to a 65.9 level in July, up from June's 62.7 reading and ahead of the expectations for a 61.5 level. The reason could be the better than expected personal income growth in June, up 0.5%, ahead of the expectations for a 0.4% improvement and on top of the 0.3% advance in May. Or it could be explained by a continued improvement in housing pricing, with the Case Shiller index for the 20 US metropolitan areas improving in May, while the year on year rate on change is now barely negative, at -0.7%, an improvement from April's -1.8% and ahead of the expected -1.5%.

Lastly, nothing to worry on the inflation front, as the core personal consumption expenditures (PCE) price index, the Fed's favourite inflation gage, held steady at 1.8% in June, close enough to the newly instated target of 2.0%.

Canada – An expected pull-back in the Canadian housing sector is slow to materialize as the building permits for the month of June, down 2.5%, was less than the expected 3.8% retreat, following a very strong 7.1% advance in May.

Greece - Prime Minister Antonis Samaras overcame growing differences with his two coalition partners to secure €11.5bn of budget cuts over the next two years. The socialist party leader dropped objections to further planned reductions in pensions and public sector wages, according to the Financial Times.

ECB President Draghi last week merely said that the central bank "may undertake outright open markets operations of a size adequate to reach its objective." It appears that the potential purchases will only take place if a country first requests assistance from the EFSF/ESM. That doesn't mean a full bailout request is necessary, but potentially a request for the EFSF/ESM to purchase bonds on primary markets. He emphasized that "governments must stand ready to activate the EFSF/ESM in the bond market when exceptional financial market circumstances and risks to financial stability exist." Draghi declined to respond when asked whether the ECB will sterilize possible purchases, saying the Bank won't commit either way at this point, though he did say any buying will be focused on the short-end of the yield curve. It was also noted that investor concerns about seniority (of ECB purchases) "will be addressed", but there were no specifics on that front either. The subtle change in the ECB's position on bond buying was driven by the surge in peripheral sovereign yields which "hinders the effective working of monetary policy." Indeed, Draghi said that "risk premia that are related to fears of the reversibility of the euro are unacceptable, and they need to be addressed in a fundamental manner. The euro is irreversible." Policy rates were unchanged at 0.75%, as expected, though a rate cut was discussed. With respect to other potential policy actions, further non-standard measures will be implemented "according to what is required to repair monetary policy transmission." These options will be designed over the coming weeks, with more LTROs or relaxed collateral requirements among the possibilities.

Financial Conditions

UK : Lenders in the UK approved the fewest mortgages for 18 months in June, as it emerged that state-backed banks, in particular, are cutting back their lending to home buyers, suggesting the housing market faces stiff head winds. The Bank of England lending data for June show that funding pressures on banks may be feeding through to both the availability and price of mortgages. (Source : Financial Times).

The European Banking Authority (EBA) has delayed by a year its stricter reporting rules for Europe's banks, one of the core reforms to come out of the financial crisis. The new rules enforced in the EU the Basel III banking standards which includes new requirements to report solvency and liquidity levels and leverage ratios to supervisors. The EBA said full implementation of the supervisory reporting requirements will be pushed back to January 1, 2014. (Source : Reuters)

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 1.37% and the U.K.'s 2 year/10 year treasury spread is 1.47% - 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 3.55% - (3.49% end of July was 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 40 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 15.62 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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