Market Commentary

PORTLAND INVESTMENT COUNSEL™

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News Highlights on Current Holdings

Financial Services Companies

Axa - Il Sole 24 Ore reports that Axa is preparing a bid for portfolio assets that Italian insurers Unipol and Fondiaria will have to sell to secure regulatory clearance for their planned merger. Axa has "finalized in recent days a formal double mandate" for the operation with UniCredit and Credit Suisse, the Italian paper said on Sunday. Allianz, Zurich Insurance Group, Italy's Cattolica and U.S. Liberty International are also interested according to the article.

Barclays has sold its 60% share of the UK's student-housing operator to a Dutch pension fund manager in a deal valued at £840mn. Although PGGM of the Netherlands did not disclose what it paid for the stake in UPP, it did say the company is worth £1.4bn. (Source : The Independent)

Deutsche Bank announced last week that it has reached an agreement to sell BHF Bank to RHJ International for a price of €384 million. Its estimated that at that price Deutsche will be taking a roughly €150 million loss on the disposal. However given its estimated that BHF Bank carries roughly €4 billion of risk weighted assets the disposal should be roughly 0.05% capital accretive. In December 2010 Deutsche Bank announced that it had reached an agreement to sell BHF Bank to LGT Group. By April 2011 it became clear that the regulator would not grant approval for that transaction. Since then, Deutsche Bank has focused on streamlining BHF's operations while continuing to look for a buyer. Assuming the disposal happens we would view it positively as it is both capital accretive and frees up management time to focus on additional disposals and running the core business. We think the potentially lost income (if any) from BHF Bank is irrelevant in the context of Deutsche Bank.

Lloyds Banking Group became the latest UK lender to offer to buy back a large portfolio of its own debt as it looks to use excess cash on its balance sheet to eliminate expensive funding. The part-nationalised bank is trying to repurchase up to almost £10bn of senior bonds denominated in a number of different currencies. The move follows a similar attempt by RBS, which embarked on a debt buyback of up to £16bn two weeks ago, also as a way to drive down borrowing costs.

Nordea - CEO Christian Clausen told Finnish business daily Kauppalehti he believed the Swedish government will continue to reduce its ownership in Nordea "when the price is right". Swedish state is the second biggest owner of Nordea with 13.5% stake after Sampo that has 21.4%. When asked if the time of bank mergers in the Nordic countries was over, Clausen said: "No, why would it be. The grounds are however different. Banks' in general have enough capital and the situation is not alarming."

Nordea raised $1 billion of subordinated debt in its first offering of dollar-denominated 10-year bonds in more than 16 months. The bank sold the 4.25 percent notes to yield 250 basis points more than similar-maturity Treasuries, according to data compiled by Bloomberg.

Prudential - the Financial Times reported last week that Prudential are stepping up their Asian expansion, emerging as preferred bidder for the non life arm of Thailand's Thanachart Bank. Thanachart is 49% owned by Scotiabank. An agreement is yet to be reached and a deal is not imminent, sources say. The business is said to be valued at around $500mn.

Royal Bank of Scotland has confirmed the IPO of its Direct Line unit, in a flotation expected to value the UK personal lines insurer at around £3bn. The bank is obliged sell off its insurance operation before the end of 2014 by European Union regulators, after it received UK taxpayer aid worth £45.5bn during a 2008 bailout.

UBS – Bloomberg reported last week that UBS plans to cut about 80 to 90 jobs in its European investment-banking division as part of a global revamp. The cutbacks, which are likely to take place before year-end, would amount to about 17 percent of staff within the region's investment-banking division and include junior and senior bankers. The division includes merger advisory and equity and debt capital markets.

Dividend Paying Companies

Novartis has released headline Phase III data from the

Relaxin-AHF (acute heart failure) trial which. The data shows a statistically significant reduction in the secondary endpoint of all-cause mortality but only one out of two measurements of the primary endpoint (different scales of measuring breathlessness) was met. Given the mixed data Novartis will discuss with regulatory authorities (we assume to determine whether another study or what additional data is needed).

Detailed data will be presented at American Heart Association, November 3rd-7th, which will likely answer additional questions surrounding the data and primary endpoints. Novartis is "discussing data with authorities" rather than proceeding straight to filing which in our opinion suggests that additional trials/data may be needed. We note that this was only a single Phase II/III trial in 1160 patients and more convincing data on the mortality benefit might be needed for approval.

Syngenta AG acquired Pasteuria Bioscience for $113 million to expand in biological controls for plant-damaging parasites. The two companies have been working together to develop a naturally occurring soil bacteria to control plant-parasitic nematodes since 2011, Basel-based Syngenta said in a release last week. The transaction is expected to close in the fourth quarter.

Syngenta also announced last week its €403 bid for the Belgian company Devgen, a global leader in hybrid rice and RNAi technology. Completion of the transaction would enable Syngenta to combine its leading crop protection portfolio with Devgen's best-in-class rice hybrids and broad germplasm diversity. Devgen also brings proven expertise in RNAi-based insect control, for which the two companies signed a global license and research agreement to develop spray applications in May. The bid has been recommended by the Board of Directors of Devgen and is supported by a number of major shareholders holding approximately 48% of all shares. Davor Pisk, COO, said: "This acquisition will significantly reinforce our leading global position in rice, enabling us further to expand our integrated offers by incorporating the next generation of hybrid rice.." Sandro Aruffo, Head of R&D, said: "There is immense potential in combining Devgen's pioneering research in both GM and sprayable RNAi-based crop applications with Syngenta's broad crop protection portfolio. By building complementary biological insect control solutions into our offer we can increase the options and capabilities we provide to our customers." Devgen only generated EUR25.5m in sales last year. So, obviously the deal looks super expensive. However, it remains to be seen how sales will develop when on Syngenta's platform. Syngenta had already started a research partnership with Devgen back in May, so its assumed they know what they are buying. Rice is an area of relative weakness for Syngenta with only about E 600m of sales.

Syngenta today announced that it expects sales for its eight key strategic crops to reach $25 billion by the end of the decade, compared with a previous target of over $22 billion. This increase is being driven by the accelerating rate of innovation and strategy delivery across the company.

In May, the company upgraded its sales expectations for Corn and Cereals. This week, at a meeting for the investment community in Pune, India, senior Syngenta executives will outline the potential for Rice and Vegetables, whose combined sales are now expected to reach $5 billion.

Mike Mack, Chief Executive Officer, commented "Since we announced our new strategy in February 2011 we have focused on the rapid integration of our commercial teams and on broad-based innovation. I am pleased to say that success in both these areas has enabled us to increase our expectations for future growth across our eight strategic crops. We shall this week be sharing the details of our progress and potential in both Rice and Vegetables, reflecting our unique ability to integrate technologies and to meet the needs of smallholder farmers in Asia."

Vivendi: European and American regulatory approval for acquisition of EMI by Universal Music. Vivendi and Universal Music Group announced last Friday of their pleasure with the announcements from the European Commission and the Federal Trade Commission in the United States approving the acquisition of EMI Recorded Music. Vivendi states that " With EMI, Universal Music

Group will strengthen its presence in countries such as Japan, the world's second largest music market, increase its market share and develop its presence on all the digital platforms. With a broad array of EMI artists from Katy Perry, Emeli Sandé, Robbie Williams, Herbert Grönemeyer, Lady Antebellum and Norah Jones, to icons like The Beatles, the Beach Boys, Genesis and Bob Seger, Universal Music Group remains true to its vision: to invest in talent and grow the company to offer consumers more music and more choice. This acquisition will also enable Vivendi to significantly strengthen its ownership of exclusive content."

Economic Activity, Consumer and Business Conditions

The U.S. current account deficit shrank more than expected to $117.4 billion in Q2 from a three-year high of $133.6 billion in Q1 (revised down). The gap is down moderately from a year ago and in line with the two-year average. Most of the surprise stemmed from an upward spike in the investment income surplus. The goods and services trade deficit shrank largely as expected. Despite a weak global backdrop, export volumes ran nearly twice as fast as imports in the quarter. A sharp slide in oil prices also helped. As a percentage of GDP, the current account gap narrowed to 3.0% from 3.5%, in line with the norm of the past two years and less than half the 6.5% peak in late 2005. At an annual rate, the current account shortfall was $470 billion in Q2. It is expected to decline gradually in the year ahead in response to the recent weakening of the US$, a modest pickup in global demand, and steadier oil prices. The trade sector should provide modest support to the U.S. economy in 2013. U.S. net foreign liabilities topped $4 trillion in 2011, or a record 27% of GDP. If the current account deficit ratio trends below 3%, the net foreign debt should stabilize at manageable levels in the long run.

U.S. housing starts rose to a slightly lower-than-expected 750,000 annualized units in August, though after revisions (July is now 733k versus 746k previously), the 2.3% advance in August was about in-line with the consensus call. Aside from the 754,000 tally recorded in June, that marks the highest level of starts in almost 4 years as the U.S. housing recovery continues. Regionally, the Midwest was strong (up 20.7%), while the Northeast was weak (down 12.6%). Single unit starts jumped 5.5% in August, but the volatile multi-unit segment slipped 4.9%. Still, despite the latest dip, the broader trend remains one of more momentum in the multi-unit segment, prodded by strong rental demand—multi-unit starts are up a sizzling 35% y/y, but singles are quickly catching up at +27% y/y—they've risen in 5 of the past 6 months. Meantime, building permits dipped 1.0% in August, a slightly more mild-than-expected decline. At a solid level of 803,000 annualized units, or an 807,000 average in the latest 2 months, recent permit activity points to more upside momentum in housing starts ahead.

Existing home sales exceeded expectations in August, rising 7.8% after a 2.3% advance the prior month. At 4.82 million annualized, sales are the highest since May 2010 and up 9.3% from a year ago, though still below the 5 million norm warranted by household formation rates. The gains were in both detached and multiple-unit dwellings and spread across the country. While inventories rose moderately, the months' supply eased to 6.1, down from 8.2 a year ago, and now tilting slightly toward a sellers' market in some regions. As a result, median prices rose 9.5% from a year ago, in line with the prior month's pace (9.7%) which was the fastest since early 2006. An encouraging trend is that the proportion of distressed property sales is shrinking, now at 22% versus 31% a year earlier. However, first-time buyers still account for a low 31% of purchases, down from the prior month and year. Restrictive lending standards and weak job growth are to blame (see below). Great affordability, pent-up demand and strong investor interest in rental units are driving the market, and QE3 can only help by reducing mortgage rates further.

U.S. initial jobless claims fell a less-than-expected 3,000 to 382,000 in the September 15th week. This is up 8,000 from the August payrolls survey period, suggesting no improvement on the modest 96,000 advance that month. The slight decline did not even retrace the prior week's 9,000 boost from Tropical Storm Isaac. There were no special factors influencing the report last week, including the Chicago teachers' strike. The 4-week moving average rose modestly to 377,750, the highest since late-June, and above the norm of earlier this year when the labour market was seeing healthy job growth. The insured unemployment rate stayed at 2.6%, where it's been since March, suggesting no underlying improvement in the unemployment rate. At least continuing claims are trending down, easing to 3.27 million in the prior week, though likely because more claimants are exhausting their benefits rather than finding work. Such data supports why the Federal Reserve kept the QE3 expansion door wide open.

Financial Conditions

Eurozone banking union: France and the UK broadly agreed on the EU plan for the ECB to supervise all eurozone banks, the French finance minister told BBC News last Monday. Pierre Moscovici also said the UK "will be part of the decision-making process" on bank supervision, even though the UK is outside the 17-nation eurozone. He was speaking in London after talks with UK Chancellor George Osborne.

Brazil's central bank reduced reserve requirements to free up 30bn reais in credit as President Dilma Rousseff pushes banks to lower borrowing costs in the world's second-biggest emerging market. The measure came a week after Rousseff criticized Brazilian banks for overcharging for loans. Over the past year, the central bank has cut its benchmark rate by 500bp, more than all G20 nations, though borrowing costs are still among the highest in the world. The average interest rate charged for personal loans stood at 36% in July. (source : Bloomberg).

The Bank of Japan unexpectedly expanded its asset-purchase fund by 10 trillion yen ($126 billion), seeking to counter an increasing danger of contraction in the world's third-largest economy. The BOJ's program, in which it buys mainly government bonds, was enlarged to 55 trillion yen in a unanimous decision by the board, the bank said in a statement in Tokyo last week. A separate fund that extends credit to banks was held at 25 trillion yen.

Australia's banks passed received "full marks" in an IMF stress test considering the possibility of a severe recession hitting the resource-rich country. Under the stress test, the IMF assumed a 5% contraction in GDP and a 35% drop in house prices - circumstances similar to the correction the UK underwent shortly after the outbreak of the global financial crisis. Cheng Hoon Lim, a deputy division chief within the IMF's International Capital Markets Department, said that even if the economy did contract sharply, Australia's low debt levels, strong banks and flexible exchange rate would help cushion the fall. "Even in the most extreme scenario, the banking system fared pretty well," she said. (Source :Dow Jones)

The world's biggest banks significantly boosted their capital ratios in the last six months of 2011 and collectively are on pace to achieve the tougher Basel III bank safety requirements by the middle of next year, global regulators have found. The Basel Committee on Banking Supervision, which writes the international rules, said that a survey of 102 of the largest international banks found that they collectively had core tier one capital equal to 7.7% of their assets, adjusted for risk at the end of December, up from 7.1% in June 2011. (Source : Financial Times)

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 1.46% and the U.K.'s 2 year/10 year treasury spread is 1.60% - 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 3.49% - (3.49% end of July was previously 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 6.1 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 42 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 14.58 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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