



News Highlights on Current Holdings

Financial Services Companies

Barclays' COO Rich Ricci appeared before parliamentary select committee last week. He indicated that Barclays may exit areas such as commodity trading, not because of the return profile but reputational risks which he described as the "primary lens" for the strategy review. This position is similar to the stance taken by Chris Lucas – Group Finance Director – who we met in Toronto last week ... expecting the strategic review to be 'evolutionary' with the likelihood the group will increasingly fund each business separately across geographic lines (as HSBC already does) in order to be sure all businesses meet both local and global capital requirements. In pressing towards a 11.5%-12% ROE (rather than earlier 13% target) further cost savings will need to be found and so can expect smaller sub-scale businesses/ business lines to continue to be closed....but not to expect any significant change in the direction or scope of its investment bank BarCap – with Chris Lucas highlighting a key differentiator of Barclays is that it is now one of only 3 European banks with a global investment bank platform.

BBVA has announced the sale of its Mexican pension fund business to Afore XXI Banorte for \$1.6-1.73bn (depending on final capital adjustments) and focus on its consumer-banking operation. Company guides this is c.14.5x expected 2012 earnings. The deal, which is expected to close in 1Q13, is expected will generate a capital gain of c.€800m (net of taxes). This sale was expected as BBVA puts its entire LatAm pension business up for review in May. The slight positive is the sale price, which looks to be decent (BBVAs listed Chilean pension business trading on c.13.6x 2012 estimates. Nevertheless, this is another example of a Spanish bank selling off assets to strengthen group capital (albeit we would suggest that unlike Santander, BBVAs announcement is not one in a long line of disposals). Capital gain c.0.24% core capital for BBVA, useful in the context of a fully-loaded Basel III ratio of 8.7% in 2014 estimate. Sale will shave c.2% off Group profits going forwards. Valuation read-across suggests the sale of BBVA's remaining LatAm pension fund businesses (Chile,

Colombia & Peru) could be sold for an additional €1.8bn, which would create another meaningful capital gain (although knocking a further c.3% off earnings).

Credit Suisse - Bloomberg reported last week Credit Suisse will cut 100 jobs in investment banking in the UK, this the Financial Times reports, is part of the plan to reduce costs by CHF4bn by 2015. The losses will mainly be in equities, fixed income and advisory businesses and occur over the next 90 days. Credit Suisse declined to comment on the move. In January Credit Suisse said they were targeting savings of CHF2bn by the end of 2013, but in July it added another CHF1bn to that target. Last month, it added a further CHF1bn, and is now targeting savings of CHF4bn by the end of 2015, half of which it has already achieved.

HSBC may end a 14-year quest to build retail banking operations in South Korea by closing or selling branches in Asia's fourth-largest economy. Europe's biggest lender by market value is reviewing options for the local retail unit, Hyonjin Suh, a Seoul-based spokeswoman, said in an e-mail last week. London-based HSBC is considering shuttering the operations, the Yonhap news agency reported, citing officials and regulators . (Source : Bloomberg)

Morgan Stanley's CEO wants to use the bank's excess capital to boost returns for the company's "long suffering" shareholders. In the strongest signal yet that Morgan Stanley is preparing to hand back more than token sums to shareholders since the financial crisis, James Gorman told a securities industry conference that the investment bank was now "capital flush". (Source : Financial Times)

National Australia Bank : announced the issuance of 21mn NAB ordinary shares to Deutsche Bank upon the conversion of \$500mn of Tier 1 Stapled Securities, with the number of shares provided on conversion determined based on a volume weighted average share price of \$23.5852, to which a 0.2% discount was applied.

Royal Bank of Canada, the first Canadian lender to report 4Q results, said profit rose 22% on higher trading and investment-banking fees, beating analysts' estimates. Net



income for the Q4 period ended Oct. 31 was C\$1.91bn, or C\$1.25 a share, up from C\$1.57bn, or C\$1.02, a year earlier. Revenue rose 12% to C\$7.52bn. Overall, it was a clean quarter. Canadian Banking generated another quarter of \$1 billion of earnings due to positive operating leverage, strong volume growth, and flat Net Interest Margin (q/q). Insurance results were strong due to lower claim costs. Wealth Management benefitted from higher average fee-based assets and increased transaction volume. Capital Markets results were good but down 4% sequentially due to lower trading activity and higher Provision for Credit Losses. Capital was in line with expectations with a Tier 1 ratio of 13.1% under Basel II and Core Equity Tier 1 ratio of 8.2% under Basel III (assuming no phase-in benefit for IFRS). Management reaffirmed its mid-term financial objectives of 7% EPS growth, Return on Equity of at least 18%, and a pay-out ratio between 40% and 50%.

Standard Chartered WSJ reports that SC is near a settlement with US Federal authorities over the transactions with Iran. The final fine will be around \$300m (on the top of the \$340m already paid to the NY state regulator), according to WSJ. A final fine of about \$300m would be a positive since it would remove a significant uncertainty and is very manageable for Standard Chartered with \$42bn equity capital.

UBS: A UK's Financial Services Authority has fined UBS £29.7mn for "significant control breakdowns" that allowed a rogue trader to lose \$2.3bn at the Swiss bank in 2011. In the third-largest fine in its history, the FSA criticised the bank for having ineffective computer risk controls and "poorly executed and ineffective supervision" that allowed Kwaku Adoboli repeatedly to breach risk limits and book fictitious trades. Mr Adoboli was convicted of fraud last week and sentenced to seven years in jail. Also, The New York Times reports that UBS are close to a \$450m settlement with US authorities over interest rate rigging allegations, citing unidentified officials briefed on the matter. U.S. authorities want to seal a deal by the end of the month, though the discussions could continue into next year. The article also highlights RBS as being in advanced settlement talks though did not mention the size of settlement.

UK Banks - The Financial Stability Report (FSR) last week again highlighted the view that UK bank capital ratios may be overstated. This is based on three assertions: (1) provisions + capital deductions < expected losses, (2) past conduct costs (PPI, LIBOR, etc) have been under-provided, and (3) there is widespread disparity in internal Risk Weighted Asset models. The Financial Services Authority has now been charged to take action and, where necessary, ensure banks 'strengthen resilience'. This could happen via (1) equity issuance, (2) LMEs, (3) continued distribution/compensation constraint, (4) high-trigger contingent capital issuance, or (5) disposal of non-core assets/businesses. The FSA is to report back on actions in advance of the FPC's March meeting. Of course, none of these issues are new, but they at least inch the debate forward in the sense that the FSA now has a framework to discuss with the banks. While some uncertainty will persist, the positive is that there is no express requirement for external equity.

Dividend Payers

Chemring – issued a trading update last week as the company's operating results tallied in for the end of its fiscal year at October 31. The statement followed a couple of profit warnings issued at short intervals over the prior few weeks as well as the scrapping of a highly preliminary deal with Carlyle and a shake-up at the executive level. The company admitted that for its fiscal 2012, the 'operational performance has been weak, and management of investors' expectations over the past year has also been poor'. Chemring, which makes flares, equipment to detect improvised explosive devices (IED), ammunition and mechanisms used in ejection seats, ended the year with £760mm of orders in its back-log, down by 13% compared to a year earlier and roughly on par with its projected revenue line for the just ended fiscal 2012 at £740mm. The company also said it expects defence spending in the United States, the United Kingdom and Europe would remain under pressure as governments struggle to rein in budget deficits. We are concerned with the recent set-backs and we'll continue to monitor the situation carefully, yet we continue to believe that, at 8.3x 2013 earnings and 6.5% dividend yield, the company is valued attractively and also believe that



the relatively lower cost of its products, compared to the value of equipment and human lives they help protect, should provide it with a more solid footing even in a lower defence spending scenario.

Siemens – In a move which surprised many industry observers, Siemens announced the acquisition of Invensys' rail business for £1.74bn as the company is trying to boost profitability at its Infrastructure and Cities (I&C) division in an otherwise tough economy. Part of the plan in acquiring Invensys' rail business is selling its baggage handling and postal sorting operations. The deal is expected to lift I&C division's operating profit margin by more than one percentage point in fiscal 2014, from 7.5% last year, in the opinion of Roland Bush, the I&C division head. The acquisition is also boosting Siemens' market share in the rail signaling business, to 17%, almost double the closest rivals Alstom and Ansaldo. Given the price tag for the acquisition, at 14.5x the 2013 estimated operating earnings, we expect Siemens to manage to improve the deal's economics as the company mentioned plenty of scope for cost savings, as well as a boost from cross-selling.

In an unrelated announcement, the company revealed the closure of its Nokia Siemens Networks' (NSN) Bruchsal plant in Germany, as the NSN joint venture is carrying out a cost-cutting plan, which includes laying off a quarter of its staff and selling product lines to focus on mobile broadband. The restructuring should result in €1Bn in cost savings by the end of the year.

Vivendi – Reuters is reporting that the company is examining a number of non-binding offers above €6Bn for its Brazilian broadband company GVT SA. GVT is an alternative provider of fixed telephone, broadband and TV services in 120 Brazilian cities. Preliminary bids were tabled by DirecTV, the satellite provider, America Movil SAB, the Mexican telecom giant, as well as a group of private equity funds. Telecom Italia, which was initially expected to be part of the process, did not bid, yet it might join in later, after its December 6 board meeting. Liberty Global Inc, initially reported to be one of the bidders selected for the second round, denied having submitted a proposal. Vivendi paid roughly €3mm

for GVT in late 2009 and spent about €2mm more in building its high-speed fibre broadband network. Deutsche Bank and Rothschild are advising Vivendi on the deal.

In a separate announcement Vivendi said it had completed a long awaited deal to combine its pay TV operations in Poland with TVN, a Polish broadcaster. The deal, approved by Polish regulators, is part of a wider partnership arrangement that could see Vivendi ultimately take control of TVN.

Economic Activity, Consumer and Business Conditions

US – The Institute for Supply Management's (ISM) Purchasing Managers Index (PMI) reading for November, released earlier today, was 49.5 index points, the lowest reading since July of 2009. This puts back the manufacturing sector into contraction territory, after a couple of months of mildly expansionary readings. The reading came as a surprise, as the consensus expectations were calling for a smaller retreat, to a 51.3 index points from October's 51.7 reading. Early last week, the durable goods orders report, another key indicator of manufacturing activity, while surprising on the upside, were essentially flat for the month of October. When controlling for the volatile transportation orders, the durable goods were 1.5% higher in the month, with many manufacturing industries contributing to the improvement. One notable exception was the automotive orders, down 1.6% over the period, although we expect auto orders will pick up in lieu of replacement vehicles post superstorm Sandy.

The revised reading of the US GDP third quarter growth, at 2.7%, fell just short of a 2.8% expected rate. The consumer sector remained the key contributor in the quarter, accounting for a full percent of the growth rate, followed by inventory expansion and government spending, slightly offset by weakness in business investment. It is difficult to see how the positive trend re government spending can continue in the light of the upcoming budget cuts. The US personal income report, which also includes consumption expenditures, revealed a 0.3% drop in real personal income for the average American in the month of October. In nominal terms,



the personal income was flat in the month. Consumption expenditures surprisingly, though surely influenced by hurricane Sandy, retreated by 0.2% in October. Part of the same report, the core personal consumption expenditures (PCE) price index, Fed's favourite inflation gage, held steady at 1.6% year on year rate of change, providing little reasons for concerns.

On the housing front, following a deluge of positive numbers, last week was more of a mixed bag, as sales of new homes in the US unexpectedly retreated to a 368,000 units annualized, in stark contrast to the consensus expectations calling for a 390,000 units annualized. Earlier in the week, the US housing pricing, as measured by the Case Shiller index for the 20 metropolitan areas, moved higher at a 3.0% year on year rate, much as expected, while the US pending home sales, a lead indicator of US existing home sales, shot up by 5.2% in October, compared to 0.4% in September and expectations of a 0.8% advance.

Canada – Economic releases in Canada over the last week were dominated by a disappointing 0.6% GDP rate of growth for the third quarter, below the expected 0.9% improvement and the 1.6% advance in the second quarter. Not surprisingly, net exports were a key detractor to the economic performance, given the continued poor visible goods trade monthly reports, mentioned in our previous weekly newsletter. Other sectors, such as business investments and the housing sectors, also performed poorly with little respite for the rest of the year.

China – A rise in HSBC's China manufacturing PMI (Purchasing Manager's Index), to 50.5 in November is the first time above the 50 point growth threshold in 13 months, suggesting the world's second largest economy may be heading into 2013 with more momentum after struggling this year.

Greece - The Eurogroup issued a positive statement last week agreeing to reduce Greece's debt load. A debt reduction plan should see debt to GDP of 175% by 2016 and 124% by 2020 as European Finance Ministers convince the IMF they have the plans to take further steps to reduce the debt to less than 110% in 2022. Greece will get EUR 34.4bn in December and EUR 9.3bn in 3 tranches during 1st Q 2013. This will be €10.6bn for budgetary financing

and €23.8bn in EFSF (European Financial Stability Fund) bonds earmarked for bank recapitalisation. These measures were drawn up in satisfaction that the "updated programme conditionality includes the adoption by Greece of new instruments to enhance the implementation of the programme", and includes that all privatization revenues will be used for servicing debt as well as primary surpluses (from 2014) and up to 30% of the excess vs. the budget. These initiatives are subject to the above conditionality and Greece's announcement they may buyback debt (though tender prices will not be higher vs. closing prices on Nov 23, 2012). The payment of the 3 tranches is conditional to the implementation of the reforms. Measures include profits from ECB loans to be allocated to Greece, EU bilateral loans have a maturity extension of 15 years to 30 years and a deferral of interest payment of Greece on EFSF loans by 10 yrs (these measures will not affect the creditworthiness of EFSF, which is fully backed by the guarantees from Member States), and a lowering by 10bps of the guarantee fee costs paid by Greece on EFSF loans. Further, EU Finance Ministers pledging to take further steps to reduce the debt load "including inter alia lower co-financing in structural funds and/or further interest rate reduction of the Greek Loan Facility".

The Greek bond back details were released today. Greece says it will spend up to 10 Billion EUR to buy back heavily discounted bonds in hopes of stabilizing its debt. It is hoped that the 10 Billion will buy back anywhere from 25-40 Billion in notional value of debt. Private debt holders such as banks and pension funds have until Friday to register their interests and the entire process is expected to be completed by Dec 17. The IMF will be watching closely as its participation in the plan will be dependent on a successful buyback which it feels is needed to get Greece back on a sustainable path.

Financial Conditions

Norway: In its Financial Stability report the Norwegian Central Bank, Norges Bank, concludes that "the



overall risk in the Norwegian financial system has decreased somewhat since the May Financial Stability". However, as expected the tone suggests higher capital requirements for the banks and that banks should be cautious in their payouts in order to boost the equity capital. Norwegian banks are still forced to use the transition rule Basel 2 rules, which means that the reported risk-weight on residential mortgages is 40%. Should Basel 2 internal rating based (IRB) models be applied the risk weights would drop to 10-16% with SR-Bank the lowest and Nordea the highest. In Sweden, mentioned below, the FSA recently announced a 15% floor for the Basel 2 IRB risk-weights on mortgages. Norges Bank now states that the "transitional floor should continue to apply until a supplemental capital add-on is introduced".

Sweden's financial regulator said last week it intends to force banks to set aside more capital to cover potential mortgage losses, asking them to use a 15% risk-weight floor on such loans. (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 through 2015 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 1.40% and the U.K.'s 2 year/10 year treasury spread is 1.48% - 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 3.32% - (3.31%, end of

November 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 5.4 months supply of existing houses. So the combined effects of record low mortgage rates, near record high affordability, a more promising economic recovery, job creation, and low prices are finally supporting the housing market with housing inventory well off its peak of 9.4 months and we believe now in a more normal range of 4-7 months. While we still believe it remains premature to consider a recovery in house prices prospects of a measure of stability are likely to 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 is easing 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 should suffice, enabling banks to continue to post increasing earnings per share (as credit improves) over the next 18 – 24 months 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 50 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..

The VIX (volatility index) is 15.87 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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Market Commentary



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