



News Highlights on Current Holdings

Financial Services Companies

Barclays/RBS/Lloyds – the Financial Times highlights the UK FLS (Funding for Lending scheme), unveiled last summer to lend to small businesses, saw a £2.4bn dip in lending during the fourth quarter of 2012. Only Barclays & Nationwide lent more to UK businesses. Lloyds, RBS & Santander tapped the Bank of England for the cheap funding but all cut their lending to SMEs. Lloyds has drawn down £3bn & shrunk lending by £3bn in the final quarter. RBS has drawn down £750m and shrunk lending by £1.7bn, while Santander has drawn £1bn and shrunk by £2.8bn. Barclays has drawn £6bn and managed a cumulative £5.7bn in additional lending since the FLS was introduced at the end of June last year. I believe, that means that Barclays benefit from cheap funding at 0.25%, whilst for the others the cost will be somewhere between 0.25% and 1.5% given the decline in overall lending...the government 'incentive' for banks to increase lending has yet to show results in those banks which still wish to boost their capital reserve ratios.

BNP - Euromoney ran an article highlighting the company's growth ambitions in Asia, company is targeting €bn increase in AsiaPac revenues by 2016. It follows a article earlier in the week highlighting the company's plans in Africa. This is consistent with the message delivered to analysts in a recent sales briefing - that capital surplus will be deployed predominantly to fund growth although there is also a commitment to grow the dividend in a progressive manner. Questions likely to remain as to whether simply buying back stock at 0.7x Price /TangibleNAV wouldn't be a more value-enhancing strategy.

BNS reported Q1/13 cash earnings of \$1.27 per share, which was above consensus expectations of \$1.25 per share. Canadian Banking reported solid earnings of \$574 million in Q1/13 due to the ING DIRECT acquisition and strong organic growth. Net interest margin fell 7 bps to 2.08% reflecting the impact of ING's lower spread portfolio. Excluding ING, the margin was up slightly due to favorable changes in product mix. International Banking had a strong quarter due to solid loan growth in Latin

America, strong contribution from Thailand, and good fee and commission revenue. Global Wealth Management earnings of \$301 million benefitted from strong net sales and improved market conditions coupled with strong global insurance revenues. Global Banking and Markets reported better-than-expected earnings of \$399 million due to strong trading revenues of \$424 million (particularly fixed income and cash commodities). Asset quality was good with provisions for credit losses declining to \$310 million in Q1/2013 from \$321 million in Q4/2012. Capital remains solid with a Core Equity Tier 1 ratio of 8.2%. The dividend was increased by 5% to \$0.60 per share.

Citigroup is considering pulling back from 21 countries as the most global of US banks trades cost-cutting for international footprint. Mike Corbat, Citi's new CEO, said "we have to be extremely disciplined" with capital distribution and highlighted "unsustainable" performance in countries, which he did not name, that had "a very low" return on assets of less than 0.4% and high costs as a proportion of revenues. (Source : Financial Times)

HSBC agreed to sell a portfolio of US consumer loans for \$3.2bn in cash as it scales back its operations in the country. The sale to a subprime lender backed by Fortress Investment Group LLC and a mortgage investor managed by the private-equity firm is slated to be completed in the second quarter, HSBC said in a statement last week. The book value of the assets being sold was about \$3.4bn at the end of 2012, HSBC said. "These agreements accelerate the run-off of the legacy consumer mortgage and lending business and are a continuation of HSBC's strategy to reposition its U.S. operations," HSBC Finance Corp. CEO Patrick Burke said in the statement.

HSBC reported clean revenue growth ex HFC of 5.5% in 2013. Allowing for a normalization of balance sheet management revenues to US\$2.5bn (US\$3.7bn in 2012) consensus has revenue growth increasing to 9% in 2013. HSBC reported a 2013 Basel 3 core tier 1 ratio (post mgt actions already completed) of 9.8%. Allowing for a 10% dividend rise it's expected this capital ratio will growing to 10.8% in 2013. HSBC were clear that investors shouldn't expect a material rise in the dividend payout ratio, but



instead a focus on organic growth. In our view, HSBC has made good progress in reshaping its business achieving US\$2bn of cost saves (US\$3.5bn annualised). Despite these improvements, costs in 4Q are still higher than 1Q 2011 and so we believe its targeted 12-15% RoE range remains challenging.

Standard Chartered : Profit before tax of US\$6.9bn versus estimate of US\$6.8bn. Estimated normalized EPS (i.e. ex impact of value of own debt etc) was up +14% to US\$ 2.252 and the dividend has been increased by 11% to US\$0.84. Non Performing Loans slowed materially in 2H v 1H and revenue has started 2013 very strong. Total income of US\$19.1bn. Income growth was +8% or +10% constant currency. Loan growth was +6% in dollar terms versus +4% at 1st Half 2012. Management comment that StanChart has had a very strong start to 2013 and is reiterating the double digit target. Consumer Banking revenue is “well ahead” of 2012 and Wholesale Banking is also “ahead”. Wholesale revenues were US\$11.8bn in line with expectations. Consumer revenues were US\$7.2bn and total costs were US\$10.9bn as expected. Included within 2012 costs is the US\$667mn AML charge and a US\$86mn other legal provision. Bad debts of US\$1.4bn – as expected. The rise in 1st Half 2012 Wholesale Non Performing Loans were of concern and so the 2nd Half 2012 Wholesale NPL balance of US\$4.3bn vs. 1H12 of US\$4.1bn (up +6%) is very reassuring and marks a significant reduction in the increase seen in 1H12 (+32%). Management comment that asset quality remains good, albeit they are monitoring closely given the uncertain macro environment.

Core Tier 1 was 11.7% and the dividend was increased by 11%. Normalised Return On Equity was 12.8% versus 12.2% in 2011. Overall we believe these are a solid set of results, with a strong and reassuring outlook.

Dividend Payers

ABB – has signed a \$260mm service contract with A/S Norske Shell in Norway.

BHP – the world’s third-largest iron ore miner, said it had produced iron ore at full capacity between July and December 2012 and sold all of the material, responding

to the National Development and Reform Commission (NDRC) of China’s accusations that the world’s top three miners and some traders had delayed shipments and held back stocks ‘to send a fake market signal that there was a supply shortage’. BHP was the only major iron ore producer to respond to the NDRC’s statement. BHP said it was very normal for steel mills, traders and producers ‘to both buy and sell cargo to balance their books’. NDRC’s comments came at a time when steelmakers in China, the world’s largest iron ore importer, are booking losses as steel demand has fallen and raw material costs have surged.

GEA Group AG – said CEO Jurg Oleas will continue to steer the company until December 31, 2016, as it granted a three year extension to the original contract.

Roche Holding AG – Roche’s influential chairman Franz Humer said he will not stand for re-election next year when he will have served 16 years at the top of the company, which could be seen as a shift of emphasis towards the company’s US operations. A top candidate to replace Humer is the chairman of Genentech and Apple, Arthur Levinson, who is likely to continue Humer’s focus on innovation, but might increase the weight of the company’s US operations. The company said it would nominate a successor in the autumn and said it would keep the offices of chairman and chief executive separate in the future. Since passing-on the job of chief executive to Severin Schwan in 2008, Humer has remained a hands-on chairman and was heavily involved in the last year’s bid to buy the gene-sequencing company Illumina. His departure also increases the chances that Roche might consider developing bio-similars (generic biotech drugs), to which Humer is said to have been opposed, but which CEO Schwan has reportedly raised as a possibility.

Roche received European approval for its breast cancer drug Perjeta, which the company hopes will become the standard of care for an aggressive, incurable form of the disease. The company aims to combine Perjeta with its older drug Herceptin, the company’s second biggest seller, for women with a form of cancer known as HER2-positive, which makes up about a quarter of all breast cancers and has no cure.



Toyota – announced significant changes at its top level as it is trying to put the lower ranked workers in a day-to-day command as it seeks faster responses to market changes. Executive vice-presidents will take charge of three new business teams covering developed markets, emerging markets, engines and transmissions, while Toyoda will personally oversee the luxury Lexus brand, which sells around 500,000 vehicles per year. Toyota named Takeshi Uchiyamada, who in the 1990s spearheaded the development of its bestselling Prius hybrid car, as chairman, replacing Fujio Cho. The firm, which employs 320,000 people worldwide, also brought in board members from outside Toyota for the first time, including Mark Hogan, a former vice president of General Motors.

Toyota expects to turn a profit in its European automotive business during the current fiscal year for the first time since 2007, the company declared at the Geneva auto-show. The division's profitability was boosted by cost cuts, which included a 40% reduction in headcount at Toyota's headquarters in Brussels. Toyota's car sales in Europe, defined as 27 countries by trade association ACEA, fell 3% in 2012, better than the 8.2% decline that the entire auto industry faced in Europe. Didier Leroy, the head of Toyota's European operations, reiterated that the company is aiming to sell 1 million vehicles in Europe by 2015, including Lexus brand cars. To support this goal, the company aims to build in Europe 75% of the vehicles it sells in the region, which compares to 63% at the present.

Veolia – announced it is selling its Moroccan water, wastewater and electricity services. The company expects the deal to contribute around €70mm to its divestment program, which aims to cut debt by €8mm in 2013. The services, which are operated by concession companies Redal and Amendis, will be acquired by the investment fund Actis. The company added that it had signed a three-year technical support contract with Actis for the business.

Vodafone : Bloomberg News (5 March) reported that Vodafone and Verizon held merger discussions as recently as Dec 2012. According to the very detailed

article, these discussions did not result in a merger agreement - largely due to soft issues (choice of CEO, location of HQ, sale of fringe Vodafone assets). We believe that such soft issues could, over time, be resolved and that a merger would make sense for both parties. First, Vodafone could receive a premium into a merger (as its P/E multiple of c10x is considerably lower than that of Verizon Comm at c16.5x). Second, Verizon shareholders would see improvement in both its P/E multiple and Verizon W ownership. Essentially, the P/E would fall from c16.5x (Verizon Comm) to c14x (MergeCo), while its Verizon W ownership would increase, from 55% (Verizon Comm) to 100% (MergeCo). Third, a merger of market caps would not trigger a leverage rise, or tax leakage (CGT on Verizon W stake).

Economic Activity, Consumer and Business Conditions

US – The employment report for February, which revealed a 236,000 increase in the size of US non-farm payrolls, stole the headlines in term of macro-economic news. Although well flagged by previous economic announcement, such as the ADP report, the weekly jobless claims updates and the employment components of the manufacturing and services purchasing managers indices (PMI), the actual number managed to take observers by surprise, as the consensus expectations were only counting on a 160,000 job additions. The increase in the US private payrolls was equally strong, at 246,000 positions, ahead of the expectations for 167,000 job gained. The headline unemployment rate retreated two tenths of one percent, to 7.7%, again exceeding the expectations, which were calling for a flat 7.9% reading. Activity seems to have picked-up significantly in construction, manufacturing and business services, which posted the biggest advances in the month.

The update on the non-manufacturing activity, as captured by the non-manufacturing purchasing managers index (NMI) issued by the Institute for Supply Management (ISM), was up-beat, a reading of 56.0 index points for February being ahead of January's 55.2 and exceeding expectations for a flattish 55.0 index points read. Labour productivity took a dive in the fourth quarter



in the US, an un-surprising side-effect of robust employment gains. It retreated 1.9%, more than the expected 1.6% pull-back, partly reversing the 3.1% advance in the third quarter.

On the consumer side, there is increased evidence that the de-leveraging cycle is either done or approaching its end. Consumer credit rose by \$16.15Bn in January, on top of December's \$15.1Bn and ahead of the expectations for a \$14.5Bn increase. The US international trade deficit opened up again in January, to \$44.4Bn, as imports grew by 1.8%, while exports saw a 1.2% drop.

Canada – February employment report was as impressive and likely more surprising than its US counterpart, as the 50,700 jobs added in the month exceeded the 8,000 net new jobs expected by a wider margin. The headline unemployment rate remained flat at 7.0%, contrary to the expectations of a one tenth increase. Details of the report were also strong, with full-time jobs advancing by 33,600, while the private sector added 29,200 net new jobs.

The growth was supported by the professional services, hospitality and trade sectors, but the construction sector also had a nice showing, which was less surprising when the housing starts for February, up to a 180,700 units annualised from 159,000 units annualized in January, are taking into consideration. Building permits advanced in January by 1.7%, albeit less than the 5.3% improvement expected and only partly reversing the 10.4% drop in the prior month.

Canada's merchandise trade balance showed a narrower than expected deficit, of \$0.24Bn, an improvement over December's \$0.33Bn deficit, as exports were up by 2.3%, supported by the energy exports, while imports rose a more muted 1.9%.

Italy – The country problems were likely exacerbated last week with the announcement that Berlusconi has been convicted by a Milan court for wiretapping. The ex-premier and still powerful politician is also fighting accusations of tax fraud and sexual misconduct this month.

On Friday, the credit rating agency Fitch cut Italy's sovereign credit rating, citing a deep recession, rising debt and political instability following last month's inconclusive elections. The country's sovereign bonds suffered a retreat

and are expected to continue to weaken, relative to safer alternative, such as German bonds. Reported this morning, Italy's economy contracted by 0.9% in the fourth quarter of last year, in line with a preliminary estimate. The economic growth was affected by chronically weak domestic demand and a fall in inventories. Exports grew modestly in the quarter.

The Bank of Canada last week left rates unchanged but took a page out of the Fed's book and basically said they are staying lower for longer. The Bank of Canada is an inflation fighting bank and with inflation at the bottom end of the target, the Bank needed to moderate its statement to signal the next rate hike is even further out.

The Bank of England left rates and Quantitative Easing unchanged last week as 29 out of 39 economists had expected (its Asset Purchase Facility remained unchanged at £375 bln). The UK economy remains sluggish and other all possible tools appear to be exhausted so today's move looks only to delay more QE for a couple of months.

The ECB left rates unchanged last week at 0.75%.

Financial Conditions

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 until the unemployment rate falls below 6.5% (January 7.9%) which is likely to be through 2014. Fed Reserve Chairman, Ben Bernanke has indicated 1% or less would be considered exceptionally low. In September 2012, the Fed announced it would buy \$40 bn per month of agency mortgage-backed securities and in December 2012 that it would also buy \$45 bn per month of treasuries (4 year maturity and above) which means all parts of the yield curve will benefit from a near-zero anchor until late 2014. The U.S. 2 year/10 year treasury spread is now 1.80% and the U.K.'s 2 year/10 year treasury spread is 1.79% - 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 3.52% - (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 4.4 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. A recovery in house prices appears increasingly sustainable 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 4 in 2013 (compared to 49 in 2012, 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 11.98 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

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Market Commentary



PORTLAND
INVESTMENT COUNSEL™

March 11, 2013

Source: Thomson Reuters, Bloomberg, Company reports

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PIC13-017-E(03/13)