Market Commentary

PORTLAND INVESTMENT COUNSEL™

March 25, 2013

News Highlights on Current Holdings

Financial Services Companies

AXA : issued a press release after the close on Friday saying Axa received an irrevocable offer to sell part of its stake in Axa Private Equity to several acquiring investors. Axa currently owns 95.8% through 100% owned Axa Investment Managers. After the transaction, it will retain a stake of 26.86%. 40% will be owned by Axa Private Equity's current management and employees, and the remaining 33.14% by external investors. Transaction would value all of Axa Private Equity at €510mn. Axa said it would receive up to €488mn consisting of €348mn upfront payment and up to €140mn in deferred consideration. The net effect on Axa will be €0.2bn realised capital gains, to be accounted in net attributable income and €0.2bn cash to be remitted to the holding.

BBVA last week joined a wave of optimism surrounding Mexico's growth prospects as it announced the biggest investment by its Latin American subsidiary to date. The bank, which has been hit by recession in its home market, said that it would funnel $3.5bn into its BBVA Bancomer Mexico arm over the next three years – $1.3bn to upgrade bank branches, $1.5bn in new technology and the remaining $700m on its corporate headquarters in Mexico City.

Deutsche Bank last week announced a €0.6 bn increase in its 2012 litigation charge. The extra charge reflects new developments on US mortgage related litigation as well as "unrelated regulatory investigations," which we assume is LIBOR related. The bank has now taken €3.1 bn of litigation / regulatory related charges in the last 18 months. We expect litigation charges to continue in 2013.

Santander – Confirmed last Friday it had successfully placed 5.2% of its Polish business (alongside KBC selling its 16.2%). Brings Santander's holding below 70% as agreed with local regulators. Immaterial impact on Group capital.

UBS has become the latest big name European bank to stop contributing to money market benchmark Euribor, dealing the credibility of the scandal-tainted lending rate a fresh blow. UBS, which was fined €1.5bn in December for manipulating bank lending rates, said it was pulling out of Euribor as of March 28 as part of plans to focus on its Swiss franc and dollar funding markets. (Source : Reuters)

Dividend Payers

Bayer – The European Medicines Agency (EMA), the European pharma industry regulator, recommended for approval Bayer's blood thinning drug Xarelto for treating acute coronary syndrome (ACS). The decision was in contrast to the position adopted by the FDA, which denied approval to expand use of Xarelto to reduce the risk of heart attacks and strokes in ACS patients earlier this month. EMA applications are normally endorsed by the European Commission within a couple of months. In a separate announcement, Bayer said that the Ministry of Health, Labour and Welfare (MHLW) in Japan had approved Stivarga for treatment of patients with immovable, advanced/recurrent colorectal cancer.

Nestle – is recalling some special chunky varieties of its KitKat chocolate brand, mainly in Britain but also, to a lesser extent, in Germany, Switzerland, Malta, Austria, Singapore, Philippines and Canada. The company is recalling 48g bars of the chunky version of KitKat in four flavours – peanut butter, hazelnut, chocolate fudge and caramel, as well as giant eggs from the chunky collection. The recall was due to pieces of plastic found in KitKat in the UK. No other KitKat products are affected. The group, which is the world's biggest food company, said the recall should not have a material impact.

Siemens – Osram, the group's lighting division, has obtained €1.25Bn of syndicated loans to ensure it has sufficient funding after its planned spin-off from Siemens. Siemens had planned to spin off Osram this spring, but has had to delay the listing because of legal action by a handful of investors challenging the move. The credit facilities comprise a €300mm loan and a €950 multi-currency revolving credit facility, with the loan element to be used partly to repay existing financial liabilities owed to Siemens. The underwriters, mandated lead arrangers and bookrunners of the transaction were Commerzbank, Deutsche Bank, Goldman Sachs, UBS and UniCredit.

Siemens also sold a bond convertible into shares of Atos, the French company that acquired Siemens' IT services business SIS in 2011, last week. Proceeds are expected to be around €300m. Though Siemens is selling the bond, it said it intends to retain its stake in Atos.

Economic Activity, Consumer and Business Conditions

US – Last week was rich in macro-economic updates from the US housing sector, culminating with the existing home sales report last Thursday, which showed a 4.98mm units annualized sales rate for the month of February, an improvement relative to January's 4.94mm units annualized rate, yet short of the expected 5mm units annualized level. In month on month terms, the 0.8% growth was only a half of the expected 1.6% improvement. The increase was driven by sales of multi-units, as sales of single family homes actually retreated 0.2% in the month. Earlier last week both the US housing starts and the US building permits statistics for February had exceeded expectations. The US building permits reached a 0.946mm level, in annualized terms, a 2.7% jump over January's level, while the US housing starts improved by 0.8% in the same month, reaching a 0.917mm units annualized rate.

The US leading economic indicators (LEI) reading for February was a positive 0.5%, ahead of the expectations calling for a 0.4% improvement and on par with January's rate. Key components driving this composite index higher were building permits, an increase in the average workweek, but also a modest improvement in the consumer goods orders. Financial conditions continue to be extremely supportive, while the consumer expectations were less of a drag compared to January.

Canada – Retail sales rebounded in January in Canada, up 1.0% at the headline level, ahead of the expected 0.9% advance and offsetting some of the holiday season's weakness. Sales of autos and parts were a strong driver, with retail sales excluding sales of autos being up a more muted 0.5%, still ahead of the expectations, which were pencilling in a 0.3% improvement. Improvement was broadly based, with many retail categories contributing to the positive result, including electronics and appliances, clothing, general merchandise and furniture.

Cyprus: - EU ministers this morning approved a deal reached by Cyprus with international bailout negotiators. The agreement sees depositors with accounts worth less than €100,000 protected, however, uninsured deposits and senior bondholders of Cyprus Popular may see 100% writedowns and Bank of Cyprus uninsured deposits/senior bondholders may see up to a 40% haircut.

Deposits up to €100,000 will be protected and transferred to Bank of Cyprus, effectively creating a "good bank". Deposits of more than €100,000 will remain frozen and used to resolve bad debts. If Cyprus Popular assets are insufficient to resolve bad debts, Bank of Cyprus equity and debt holders will be bailed in and equity and uninsured deposits may receive up to 40% haircut, which will hurt Russian-based deposits which are more concentrated in Bank of Cyprus vs. Cyprus Popular. €100 daily withdrawal limit imposed upon Bank of Cyprus and Cyprus Popular accounts and capital controls are in place for Tuesday's expected reopening of banking system. Cyprus Popular Bank, 84% owned by the government, will be wound down & Bank of Cyprus, will take over the viable assets of Cyprus Popular Bank. The deal does not require Cypriot Parliament approval because it has already passed laws on bank restructuring. Parliaments in Germany, Finland and the Netherlands may hold votes to approve loans to Cyprus from the European Stability Mechanism, the €500bn rescue fund. A statement by the ministers said the bank will channel liquidity to the Bank of Cyprus "in line with applicable rules."

The plan gives investors a preview of the future European bank resolution mechanism – needed to break the sovereign-bank feedback loop – which makes insured depositors safe, uninsured depositors senior but bail-inable, and all other non-secured debt available for bail-in.

Rising home values in the US have lifted more borrowers out of the hole of owing more than their properties are worth, an encouraging sign for an economy still closely tied to the health of the housing market. The number of "underwater" homeowners in the fourth quarter of 2012 declined by 1.7mn from a year earlier, meaning 1.7mn US households have regained home equity, according to Corelogic. Overall, the company said 21.5% of households with a mortgage were underwater at the end of 2012, down from 25.2% at the end of 2011. WSJ

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% (February 7.7%) 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 1.70% and the U.K.'s 2 year/10 year treasury spread is 1.64 % - 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 3.54% - (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 13.57 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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