Market Commentary

PORTLAND INVESTMENT COUNSEL™

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News Highlights on Current Holdings

Financial Services Companies

HSBC - HSBC settled a lawsuit over a liability for losses of $1.1bn incurred by Thema International Fund PLC, through Bernard Madoff's Ponzi scheme. The settlement for an undisclosed amount, doesn't include an "admission of liability on the part of any party". Thema shareholders meet in July to agree the settlement.

ING has received bids from Tongyang Life, Kyobo Life, MBK Partners and Hanwha Life for its Korea Life Insurance unit, according to Maeil Business. The newspaper said the bid deadline was May 24.

Lloyds Banking Group plc announced last week the proposed sale of its International Private Banking business to Union Bancaire Privée. The Transaction will include the business of the Group's Geneva-based Private Bank, its branches based in Geneva, Zurich, Monaco and Gibraltar, and its representative office in Montevideo. The Group will also be closing the Dubai International Finance Centre based private banking business. As of 31 March 2013 the assets under management of the Business were approximately £7.2 billion and the total balance sheet assets were approximately £729 million. The Business reported a loss of approximately £50 million in 2012. The total consideration, payable in cash, for the Transaction is up to approximately £100 million, of which we expect to receive approximately £65 million at closing, with the rest deferred and payable in the two year period following completion of the Transaction, contingent upon the performance of the Business in that period. The transaction is expected to result in an overall gain on sale and be capital accretive, although not material from a group perspective. The sale provides further evidence of the significant progress being made in simplifying the Group. In addition to this transaction, and in line with its stated objective to reduce its international footprint, the Group has decided, in principle, to withdraw its presence in South Africa.

Sabadell/Lloyds - Sabadell has agreed to buy Lloyds' private banking business in Miami that includes $1.2bn AuM (€926mn) and $60mn loans (€46mn) for a price of $6mn (€4.6mn) plus a variable of up to 0.5% of the Assets under Management that remains in one year from the closing of the transaction with a maximum of $12mn. The size of the deal is very small and follows the agreement to buy the Lloyds business in Spain achieved a month ago. Sabadell will integrate the acquired business in its private banking operations in Miami.

Lloyds Banking Group plc (the Group) announced last Friday that it has agreed the sale of a portfolio of US RMBS (residential mortgage backed securities) to a number of different institutions for a cash consideration of £3.3 billion. The transaction is part of the Group's continued capital accretive non-core asset reduction. The assets subject to the transaction have a book value of approximately £2.7 billion and as a result of the transaction the Group will realise a pre tax gain on sale of approximately £540 million. The sale proceeds will be used for general corporate purposes. As part of the same transaction the Lloyds TSB Group Pension Trust (No. 1) Limited also sold its share of the portfolio of US RMBS with a book value of £805 million, realising a pre tax gain on sale of £360 million, which will reduce the deficit in the scheme. Taking into account the gain on sale, the reduction in risk weighted assets and the benefit from the pension deficit reduction the sale is expected to increase the Group's common equity tier 1 capital ratio, on a pro forma fully loaded CRD IV basis, by approximately 0.47% (i.e. £1,400 million capital equivalent) and increase the Group's core tier 1 capital ratio, under current capital rules, by approximately 0.33% (£950 million capital equivalent).

The transaction is expected to complete in the first week of June.

Royal Bank of Canada : RBC reported adjusted Q2/13 cash earnings of $1.9 billion, or $1.31 per share, just below consensus expectations of $1.32 per share. Canadian P&C had a good quarter with $1.1 billion of earnings due to strong loan growth, the acquisition of Ally Financial, positive operating leverage and lower provisions, partly offset by Net Interest Margin compression. Capital Markets earnings of $386 million came in below our expectations due primarily to lower trading revenue (namely fixed income trading in Europe and U.S.). The other business segments performed relatively in line with our expectations. Asset quality was strong in the quarter with loan loss provisions down $60 million compared to the year-ago period due to lower Provisions for Credit Losses in Canadian Banking personal loan and credit card portfolios. As expected, capital declined in the quarter as a result of the Ally Financial acquisition but remained strong with a Core Equity Tier 1 ratio of 9.1%. The bank repurchased 2.1 million shares of the 30.0 million authorized. We expect the amount of share repurchases to increase in the third and fourth quarter given the Q2 amount was initiated late in quarter. The company announced it will repurchase its series AH preferred shares early at a $1 premium.

Royal Bank of Scotland - Royal Bank of Scotland is grooming Nathan Bostock, the state-backed lender's restructuring boss, for the top job as part of long-term plans to replace chief executive Stephen Hester, says the Daily.Telegraph last week. Sir Philip Hampton, the RBS chairman, earlier this month called a meeting of non-executive directors to discuss that bank's succession planning, where he presented a list of prospective candidates. Mr Bostock, 51, who will be taking over as finance director in October, is believed to be the leading internal candidate. A number of outsiders are also being considered, with Standard Chartered finance director Richard Meddings, 54, reported to be a front-runner. National Australia Bank chief exec Cameron Clyne, 45, is also thought to be on the list.

Santander has agreed to sell 50% of a holding company that integrates Santander asset management companies in Spain, UK and other EU and Latin America to two private equity firms (Warburg Pincus and General Atlantic) and entered into a 10 year distribution agreement. Total consideration for 100% is €2,047mn or €1,775mn ex-preclose dividend and Santander's 2013E net profit for the business is €155mn implying a 2013E PE of 11.4x. The holding company manages €152bn assets as of 1Q13 and Santander expects this to grow to €160bn by end 2013. Santander will book an accounting net capital gain of €700mn of which €350mn cash and €350mn on the revaluation of their remaining 50% stake that will increase goodwill. Impact in capital ratios and future earnings will be very small.

Santander's Polish unit has set its sights on becoming the No. 2 lender in the European Union's largest emerging market, with further acquisitions in its plans over the next two years, its chief executive said in an interview (source: Wall Street Journal).

Scotiabank reported Q2/13 adjusted EPS of $1.24 versus consensus $1.26 with the the modest miss for the quarter attributable to BNS' capital markets operations, with Q2 revenues negatively impacted by market driven challenges in commodities (where the bank has above average exposure). Earnings below expectations in Canadian Banking (higher credit losses) were entirely offset by a beat in wealth. International Banking earnings came in ahead of estimates, however the beat appears to have been driven primarily by securities gains. All-bank core net interest margin (excluding capital markets assets) increased 1bp to 2.31%. Net interest margins were unchanged in Canadian Banking at 2.08%. BNS reported a Basel III Tier 1 Common capital ratio of 8.6% at Q2/13 compared with 8.2% in Q1/13.

UBS is seeking to expand its wealth management in Africa as economic growth rates surpassing 5% boost demand for banking services from the continent's rich. Sean Bennett, the Johannesburg-based managing director of UBS, said in an interview last Wednesday. "We want to increase our physical presence before year-end and then do more in the next few years," he said, declining to give details on expected locations.

Dividend Payers

BHP Billiton - the world's biggest coking (metallurgical) coal exporter, said, during a metallurgical coal investor briefing, it expects the market to be "comfortably supplied" in the near term, with supply swings determined by U.S. mines and demand swings dominated by China. "In the absence of a major supply disruption, near-term metallurgical coal prices will be range bound," the company said in slides prepared for the first analyst briefing by newly appointed coal chief Dean Dalla Valle and his team.

Dalla Valle is pulling together BHP's two coal businesses, combining energy coal, used in power plants, and coking coal, used in steel-making, and looking to strip out costs in the face of a steep decline in coal prices, higher royalties and a high Australian dollar. He said BHP Billiton would look to sell some coal assets as part of the company's wider effort to focus only on its best mines, and would not embark on any new coal projects, the end result of which would be significantly improved free cash flow. The market is expected to remain well supplied as projects, such as BHP's Caval Ridge mine in Australia's Queensland state, are completed and as production that was held back due to weather or industrial disruptions returns, BHP said. BHP said China will dominate demand in the near-term, but India and emerging countries would become increasingly important drivers further out as Chinese demand growth eases.

POSCO – The South Korean steel maker has bought out its partner in an Australian coal project in a rare deal that could indicate nascent Asian interest in coal assets following a slump in prices for the commodity. Several investment bankers have reportedly said Japanese trading houses, South Korean companies and Indian firms have been looking to snap up bargain coal assets, particularly in metallurgical coal. POSCO will buy Cockatoo Coal's 30% stake in the Hume coal project in New South Wales for about A$16 million ($15.4 million), Cockatoo said. POSCO, the biggest of several Korean shareholders in Cockatoo, agreed to buy the coal project with A$9.7 million in cash and give up its 13.3 percent stake in Cockatoo.

Total – agreed to pay $398.2 million to settle U.S. criminal and civil allegations that it paid bribes to win oil and gas contracts in Iran. France's largest oil producer on Wednesday agreed with the U.S. Department of Justice to enter a deferred prosecution agreement and pay a $245.2 million fine to resolve three charges that it violated the Foreign Corrupt Practices Act (FCPA). Total will also give up $153 million of illegal profit in a related civil settlement with the U.S. Securities and Exchange Commission. The criminal penalty is the fourth-largest under the FCPA, an anti-bribery law, Justice Department spokesman Peter Carr said.

U.S. authorities said that between 1995 and 2004, Total paid about $60 million in bribes to induce an Iranian government official to help the company obtain lucrative development rights in three oil and gas fields. The U.S. criminal case will be dropped after three years if Total complies with the deferred prosecution agreement, which calls for it to retain an independent compliance monitor.

A French prosecutor said Total and its Chief Executive Christophe de Margerie should face trial for allegedly corrupting foreign public officials over contracts with Iran in the 1990s and early 2000s. The prosecutor also said de Margerie should face trial for misuse of company funds. A Total spokesman confirmed that the company had been notified of the Paris prosecutor's recommendation and said the company and de Margerie would demonstrate in any trial that their behavior had been legal.

Wesfarmers – held its 2013 Strategy Briefing Day last week. Of note, the company reported that:

1. Coles', the leading Australian grocery chain, turn-around remained on track;

2. Bunnings, the leading Australian home improvement chain, estimates 90 new Bunnings Warehouses openings in the coming years, with growth being driven by value, experience, brand reach, commercial and merchandising;

3. the resources division is focused on cost reductions;

4. no additional capital management, with main use of funds being paying the dividend and growth capital expenditures.

The company's department store business Target announced plans to refocus the brand, reduce prices, cut queues and resurrect the nickname 'Tar-jay'. The new Target managing director Stuart Machin said overstocking and a confusing marketing message contributed to the 50% drop in earnings this year. Earnings of A$268 million were reported for 2012, up from A$100 million in 2009.

Coles, Wesfarmers' grocery chain and liquor retailer, has been reported to be trialling a larger, warehouse-style format in a bid to gain ground on liquor competitor Dan Murphy's, which has dominated the sector for the last five years. The company's San Souci warehouse in Sydney is up to three times larger than the average Liquorland formats, offering a wider variety of stock.

Syngenta announced last week the launch of CLARIVA™, a proprietary seed treatment nematicide based on the Pasteuria technology acquired in 2012. CLARIVA consists of naturally occurring soil bacteria with a unique, direct mode of action on nematodes: microscopic worm-shaped soil organisms, which cause significant damage to all major agricultural crops. Syngenta Chief Operating Officer, John Atkin, said: "Soybean growers in particular have long been searching for additional tools to manage the widespread cyst nematode problem, which in the USA alone causes more than a billion dollars of annual yield losses. CLARIVA will take nematode control to a new level and reinforce our global leadership in seed treatment innovation." Multi-year field trial data demonstrate that CLARIVA delivers immediate and long-lasting protection of plant root systems resulting in significant yield benefits. CLARIVA will be available in the USA for the 2014 growing season. It will be combined with other leading Syngenta seed care compounds as a complete solution for soybeans. Further registrations across major crops worldwide are planned.

Economic Activity, Consumer and Business Conditions

United States – The US consumer confidence improved considerably in May, with the US consumer sentiment measurement by the University of Michigan jumping to an 84.5 index points level in May, from a 76.4 reading in April, ahead of the expected 83.7 level. Both the 'expectations' and the 'current conditions' sub-indices contributed to the advance. Earlier in the week, another measurement of the US consumer confidence, by the Conference Board, reached an impressive 76.2 index points level, up from April's 69.0 reading and well beyond the 71.0 level. This is, in all likelihood due to the 'wealth effect' from the recently increased asset prices – home and equity. The equity markets have been posting all time highs, while the Case Schiller home price index for the 20 US metropolitan areas accelerated to a 10.9% year on year rate of improvement in March, from 9.4% in February and faster than the expected 10.2%. The improvement in confidence was despite non-existent personal income growth in April, below the non-demanding expectations for a 0.1% improvement. In the same report, it's been revealed that, at least insofar as April is concerned, personal consumption actually took a step backwards, down 0.2%. Also the core personal consumption expenditures (PCE) price index, the US Fed's favourite inflation gage, clocked-in at a 1.1% year on year rate, down from March's 1.2% rate and continuing to provide ample manoeuvre room to the central bank's unprecedented expansionary policy.

Other noteworthy news came out of the housing sector, with the US pending home sales, a leading indicator of existing home sales, missing the 1.1% expected improvement, as it only grew by 0.3% in April.

Conversely, earlier this morning, the Institute for Supply Management's (ISM) purchasing managers index (PMI) for manufacturing for May dropped to a 49.0 index points, only the second time in two years when it reached a level indicating a contraction in the sector (readings below 50 indicate contraction, while readings over 50 indicate expansion).

Canada – The Canadian economy expanded by 2.5% in the first quarter, ahead of the expected 2.3% improvement, on the back of stronger net exports and inventory build-up. Consumer spending missed the expectations, while residential investment (housing activity) actually and not surprisingly subtracted from growth in the quarter as it pulled-back by 4.7%.

Singapore cemented its ambitions to become an offshore centre for the use of the Chinese currency as HSBC and Standard Chartered became the first banks, last week, to issue bonds denominated in renminbi, creating a new market in what are likely to be known as "Lion City" bonds.

Financial Conditions

Eurozone deficit targets – Financial Times reported last week that Brussels will allow France, Spain and the Netherlands to overshoot the 3% deficit limit, and will also free Italy from intensive fiscal monitoring, in a further move away from austerity response to the crisis. The EC will make these moves on the condition that national governments embark on stalled labour market reforms. Officials stress they are not abandoning fiscal discipline altogether, Spain and France have a 2 year extension to the deadline, as the two still have stringent measures to get their deficits on track. Other countries including France will be criticised over their slow pace of reform.

Moody's has upgraded its outlook of the US banking system for the first time since 2008, citing improving US economic conditions that more than make up for the challenges of low interest rates.

High-frequency traders now account for less than half the trades on American exchanges, down from an estimated 70% at its peak in 2009, because algorithms developed by investment banks have made it harder for super-fast traders to make money, according to the global head of algorithmic products at an investment bank. (Source: Australia Finance Review)

Switzerland : the Swiss government has taken a step forward in the resolution of the US tax issues by creating the legal base for banks to provide data, notably on business relationships and the employees involved, to the US Department of Justice. Information on clients will however not be divulged, unless the US goes through the usual administrative assistance channels.

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% (April 7.5%) 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 1.86% and the U.K.'s 2 year/10 year treasury spread is 1.66 % - 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 3.81% - (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 4.7 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 14 – 20 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 14 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 16.30 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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