Market Commentary

PORTLAND INVESTMENT COUNSEL™

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Global Bank Regulations – updated Basle 3

At yesterday's meeting of the G-10 Governors and Heads of Supervision (GHOS), the oversight body of the Basel Committee on Banking Supervision, new capital requirements and levels were agreed upon. These capital reforms, together with the introduction of a global liquidity standard, will be presented to the Seoul G-20 Leaders summit on November 11-12. The clear goal – stated by regulators – is that the revised capital requirements will increase the quality, quantity, and international consistency of capital; will strengthen liquidity standards; will discourage excessive leverage and risk taking; and will reduce pro-cyclicality of regulatory requirements.

The required capital levels are:

Common Tier 1 Capital:	(previously 2%) 3.5% (by 1/1/2013) 4.0% (by 1/1/21014) 4.5% (by 1/1/2015 and thereafter)
Tier 1 ratio :	(previously 4%) 4.5% (by 1/1/2013) 5.5% (by 1/1/2014) 6.0% (by 1/1/2015 and thereafter)
Total Capital ratio :	(previously 8%) 8.0%

In addition

1. A new capital conservation buffer of 2.5%, intended to ensure that banks are better able to withstand periods of economic and financial stress, so that, effectively the new ratios by 2015 will equate to 7%, 8.5% and 10.5% respectively. While banks will be allowed to draw on the buffer during such periods of stress, the closer their regulatory capital ratios approach the minimum requirement, the greater the constraints on earnings distributions. The conservation buffer will be phased in from 2016 to 2019 in increments of 0.625%
2. A new countercyclical buffer exists to combat asset bubbles, equating to a range of 0-2.5% of tier 1 common equity or other fully loss absorbing capital will be implemented, according to national circumstances, with the goal of protecting the broader banking sector from periods of excess aggregate credit growth. For any given country, this buffer will only be in effect when there is excess credit growth that is resulting in a system-wide build-up of risk. This new countercyclical buffer would be introduced as an extension of the conservation buffer range when in effect. " The additional buffer is designed to protect against "periods of excess aggregate credit growth." According to the BIS' July consultative document, "this focus on excess aggregate credit growth means that jurisdictions are likely to only need to deploy the buffer on an infrequent basis, perhaps as infrequently as once every 10 to 20 years."

Extended phase-in period beginning on 1/1/2013 with transition required by 1/1/2019.

By 1/1/2013, member countries must translate the new rules into national laws and regulations and will be required to meet tier 1 common ratio, tier 1 capital ratio and total risk-based capital minimums of 3.5%, 4.5% and 8%, respectively. Thereafter from 2015 to 1/1/2019 the minimum conservation buffer rises from 0% to 2.5% in increments of 0.625%

Proposal to test a Leverage Ratio

The GHOS agreed to test a minimum tier 1 leverage ratio of 3%. Importantly, the new leverage requirement will be a non-risk-based measure designed to act as a supplement to the risk-based requirements stated above, and it will likely include derivatives and other off-balance sheet items in the calculation.

There will be a supervisory monitoring of this ratio over the period from 1/1/11 to 1/1/13 and then a parallel run period from 1/1/13 to 1/1/17. Disclosure of the leverage ratio and its components will start on 1/1/15, and based on the results of the parallel run period, any final adjustments will occur in the first half of 2017. Systemically important banks should have loss absorbing capacity beyond the new metrics discussed above, according to the Basel Committee on Banking Supervision. This is relevant for most of the banks in which we invest but the majority of those already have exceeded the minimum levels even with the conservation and countercyclical buffers included. Nonetheless, there could be some additional capital raising (witness Deutsche Bank) on the back of supporting additional acquisitions and replenishing capital.

In summary

The new rules do reduce existing capital levels by phasing out / setting limits on some measures of quasi capital (deferred tax assets, mortgage service rights and some capital instruments). However, the overall impact and extended period of implementation effectively result in the larger better managed banks already having excess capital. Current industry averages for larger global banks exceeds the highest minimum levels even with the conservation and countercyclical buffer included. We can now therefore expect these better managed banks to increase their capital management activities via a return to progressive dividend policies, share buy-backs and opportunistic acquisitions. The new capital metrics were widely anticipated, and the clarity provided by the Basel Committee should prove to be a positive catalyst now that the rules have been set. Indeed, knowing the “rules of the game” has generally boded well for the sector, as evidenced by the results of the stress tests and the passage of regulatory reform.

News Highlights on Current Holdings

Financial Services Companies

Deutsche Bank announced on Sunday, as expected, a €9.8bn rights issue to boost its 29.9% stake in Deutsche Postbank, stating: “The capital increase is primarily intended to cover capital consumption from the planned Postbank consolidation, but will also support the existing capital base to accommodate regulatory changes and business growth”. Deutsche also issued a tender offer of €24-€25 a share for the shares in Postbank that it does not already own (though that was below the €27.04 price that the post office bank shares closed at on Friday). Deutsche currently owns just under 30% of Postbank.

Deutsche shareholders will be able to purchase one new share for every two shares they own - leading to the issuance of 308.6 million new shares. Based on the minimum amount of capital being raised - €9.8 billion - the minimum subscription price will be €31.8 per share. This represents a 25% discount to the TERP (theoretical ex-rights price) of €42.4 per share.

Deutsche Bank indicated it must “recognize a prospective charge of around EUR 2.4 billion” in relation to a revaluation of its current stake in Postbank. As a result, Deutsche now discloses an expected pro-forma Core Tier 1 ratio of ~8%. Under Basel III, we estimate Deutsche’s Core Tier 1 ratio could be around 6.5%. And Deutsche has chosen to offer Postbank shareholders the minimum price required under German law - 3 month Volume weighted average price. We think the acquisition (and additional capital increase) is between 25-30% dilutive. Following the transaction we expect roughly 60% of Deutsche’s earnings to come from Corporate Banking and Securities (the investment bank).

Santander reached an agreement with Allied Irish Banks to buy its 70.36% stake in Bank Zachodni (Zachodni Bank – Poland) for €2938mn (PLN227 vs. closing of 195, 16% premium) and will launch a tender offer for 100% that would value the whole bank at €4175mn. Santander is also buying 50% of the asset management company that BZW doesn’t own for €150mn so total disbursement is €3088mn. We believe Santander is paying 2.6x 10E Price / Book Value and 17x 10E PE and after factoring consensus estimates for BZW and adding 2% revenue synergies and 15% cost synergies we understand the deal to be accretive by 2013 with approximate 11% return on equity in year three. Santander says impact in capital at closing of the deal in 2011 will be ~40bps with ~€2.0bn goodwill generation. If the bank ends up buying 100% of BZW, then impact will be nearer to 60bps core T1. Santander already operates a small network network in Poland, mainly focussed in consumer finance, and has said in the past that it would look for an opportunity to enter what they consider to be one of the most attractive banking markets in Europe. The addition of Polish BZW will add ~3% to group earnings (thereby diluting further the current ~25% earnings contribution from Spain). Santander’s preferred alternative to raising capital right now to absorb its acquisitions is the IPO of 27% of Santander UK. We initially estimate a value of £17-20bn meaning £4.6-5.4bn deal or €5.5-6.5bn that could generate ~90-105bps of CT1 if done.

National Australia Bank’s bid for Axa Asia Pacific has been blocked for a second time by the regulator. This means that Axa will have to work again to try and simplify the structure of its Asian business. The likelihood is that National Australia Bank will walk away and concentrate on its existing dominant retail franchises. This leaves the way clear for AMP to come back with another bid but AMP say there is no urgency from their side. The key question is what does AXA-SA want? They will be frustrated by the turn of events and yet still keen for the Asian assets and so presumably will either engage the alternate bidder (AMP) or structure a break up or alternate transaction.

Credit Agricole insurance unit has agreed to buy Axeria Vie and April Patrimoine from April Group. Axeria Vie is small life insurance company with reported at end-2009 Eur187mln in new inflows, Eur251mln in underwriting reserves and 27 employees. The deal is subject to regulatory approval and no financials were disclosed.

UK banks - the Financial Times reported last week that UK banks may avoid being split up along “crude” lines, despite fears about their combination of investment and retail banking. The article says that Vince Cable, the country’s Business Secretary, told the BBC, Britain’s “universal” banks had to be made safe, but conceded: “Splitting the banks can mean different things” that more “subtle” methods - rather that a “crude” separation of investment and retail banking - could work, such as placing “firewalls” between the two arms.

Lloyds Bank has confirmed it is to sell its interest in housebuilder Crest Nicholson according to the Financial Times, the sale is part of the restructuring of the tattered portfolio of loans it inherited when it bought HBOS. The bank’s interest consists of a 25% of Crest’s debt and 30% of its equity, which would have a combined nominal value of about £150m according to the article, Lloyds refused to confirm the price. The unit will be bought by US investment fund Varde.

HSBC confirmed that Chairman Stephen Green will step down to become UK trade minister. The group intends to appoint a successor by the end of 2010. Reportedly (via the UK ‘Times’) HSBC’s Chief Executive Michael Geoghegan is a serious candidate; other candidates John Thornton (currently a non-executive director), Lord Turner (Chairman of the Financial Services Authority) and Lord Davies (former chairman of Standard Chartered).

Goldman Sachs has agreed to pay a fine of nearly £20million to the Financial Services Authority for failing to tell the FSA that it was under investigation for fraud by the US and conceding that the company made a mistake in regulatory disclosures about trader Fabrice Tourre. The FSA opened its investigation into the bank in April after the SEC charged Goldman with misleading investors in an Mortgage Backed Security known as Abacus. The SEC claimed that Goldman had failed to disclose that a hedge fund that was betting against the security had selected some of the mortgage loans included in the portfolio, costing investors as much as $1bn. The fine is one of the largest ever handed out by the FSA.

AIA the Asian arm of AIG has struck a bancassurance distribution deal with ICBC in a move to consolidate its leading foreign life position in China ahead of a possible HK listing this November. AIA has 17 other smaller bancassurance agreements across China, giving it access to 1,000 bank branches. The $1.1bn premiums it wrote in 2009 was 21% of foreign market share but only 1% of the total China life market. AIA filed its IPO application last week and hopes to get approval from the HK exchange by Sept 21

Dividend Paying Companies

Vodafone has announced the sale of its 3.2% stake in China Mobile in a move that highlights the group’s willingness to divest its minority stakes. We expect that Vodafone should receive c£4.0bn/ $6.8bn (post tax and transaction costs). The UK-listed operator will continue its co-operation with China Mobile. In terms of cash proceeds, Vodafone is expecting to dedicate c£3bn to a share buyback and the remaining cash will be used for debt reduction, which makes sense given Net Debt / EBITDA is currently c2.3x. In our view, this asset sale highlights value within the portfolio - Vodafone is (finally) proving that it will actively manage its assets. Future sales could be considered (including SFR France, Vodafone Egypt, Polkomtel Poland, and possibly Bharti India).

Vodafone has lost a landmark legal battle against the Indian tax authorities and is being required to pay capital gains tax in India of approximately $2bn for its $11 bn acquisition of a 67% controlling stake in Hutcheson Essar, the domestic mobile phone operator, completed 3 years ago. It is the first time an Indian court has ruled that the country’s tax department can charge a foreign company over a transaction that occurred outside India. Vodafone is expected to appeal.

Posco, BHP – Economic authorities in China have demanded a forced cut of the steel output in order to reduce the steel inventories and reduce the power consumption to more manageable levels. The cuts have initially impacted steel mills in the eastern province of Hebei, where some mills were ordered production cuts of as much as 70% while others were shut down completely for up to a month. Others areas of the country have been or are likely to fall under the same restrictions. Estimates of the impact on the annual Chinese steel production hover around the 4% figure. Despite this seemingly modest adjustment, steelmakers outside China, in particular the South Koreans and the Japanese, have rallied under the expectation of increased steel products pricing. If such measures are to continue for longer periods of time, iron ore and coking coal consumption in the area could be impacted.

BHP – The $45bn financing deal that BHP has put together for the all cash acquisition of Potash Corp had a deadline at the end of the last week and it ended up being significantly oversubscribed with the five underwriters, including Santander, Barclays, BNP Paribas, JP Morgan and RBS each agreeing to an $8.4bn commitment each while a group of other 11 banks committed $2.5bn. Each bank’s participation is expected to be reduced as a result.

Seven&i – 7-Eleven, a subsidiary of Seven&i, turned out to be the counter-bidder in the Alimentation Couche-Tard's pursuit of Casey's General Stores, a US Midwestern chain of convenience stores. 7-Eleven offered roughly $2bn for Casey's more than 1,500 stores and it is looking for growth outside of its core Japanese market. The company operates more than 31,000 stores worldwide, with over 7,000 being located in US and Canada.

BMW – BMW announced its sales results for the first 8 months of the year, showing a 14% improvement on cumulative basis. For the month of August alone sales were up more than 16% and were higher than the 2007 and 2008 levels. The overall figures were greatly enhanced by the performance of the group in China, where sales for the first 8 months of the year exceeded those for the entire 2009. At this pace it looks as though only delays in transportation infrastructure built could slow down growth in the Asian country.

Nestle – Nestle announced the acquisition of the privately held Waggin' Train, a US dog snacks business for an undisclosed amount. The acquisition comes as little surprise given that the pet care business is highly lucrative and Nestle needs to find ways to deploy its substantial cash pile. The new business will be merged into Purina PetCare, a Nestle subsidiary.

Novartis – Novartis received its first worldwide approval for its leading multiple sclerosis oral drug, Gilenia, in Russia, where it will be marketed under the name Gilenya. Approval in US is expected to follow soon, after the drug was unanimously recommended for FDA approval by a panel of experts.

Novartis has presented key data for the company's meningitis B vaccine at an international conference in Banff, Canada. The first set of a Phase 3 study results are encouraging offering improved immunity and good safety profile. Approval of the vaccine is expected in the second part of 2011, should the studies continue to show positive results.

Economic Activity, Consumer and Business Conditions

US – The limited number of economic data points issued last week in US, painted an unexpectedly better picture, with the trade deficit shrinking by more than $7bn in the month of July, while the initial jobless claims surprised on the downside by about 19,000. The US exports were boosted by a significant increase in aircraft deliveries, usually highly volatile, while the imports retreated in most categories, indicating weakness in the consumer sector. The US consumer credit decreased by $3.6bn in July, more or less in line with the expectations.

Canada – The highlight of the economic events in Canada last week was the interest rate hike to 1% announcement by the Bank of Canada as well as the accompanying comments. The central bank emphasised that it considers the level of domestic spending, at both consumer and business levels, to be robust. BOC sees the recent actions as steps towards reducing the size of the stimulus rather than the beginning of a tightening cycle.

The housing sector continues to show signs of cooling off, with the New House Price Index for July down 0.1% month on month, on expectations of a 0.2% improvement, while the housing starts annualized figure for the month of August also decreased more than expected, to the 183,300 level compared to 186,500 units consensus. The building permits for July were 3.3% lower in July, yet better than the expected 4.8% retrenchment.

The Canadian merchandise trade balance for July resulted into a record deficit of $2.7bn, as exports lost speed pretty much across the board, down 0.7% in aggregate, and the imports soared 2% over the same time period. This is another confirmation of the fact that, while the internal consumer sector is robust and has supported the economic recovery, the Canadian exports dependency on the faltering US economy is putting the brakes on growth.

Financial Conditions

Policymakers continue to accommodate a recovery in bank profits, albeit less than 6 months ago. The U.S. 2 year/10 year treasury spread is 2.24% and the U.K.'s 2 year/10 year treasury spread is 2.39% - enabling financial services companies' assets booked at these levels, to be profitable.

Our concerns are mostly focused around the later cycle issues facing financial services companies – particularly commercial real estate and unsecured consumer loans/credit card loans. However, commercial real estate exposure is more acutely held by US, Spanish and German regional banks (as identified in the European stress tests) – rather than larger more diversified global financial services companies. The number of small U.S. banks failing continues to grow (119 to-date in 2010) and we expect will exceed last year's 140 which was the highest annual tally since 1992. This supports our view that 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 FDIC changed the loss share arrangement on assisted deals from absorbing 95% of losses down to absorbing 80% although this is still attractive to acquiring banks it does probably lower the Internal Rate of Return.

The U.S. 30 year mortgage market has remained low and has now fallen back to 4.35% - (the lowest rate since the Federal Reserve began tracking rates in 1971 was in August at 4.32%), as the Federal Reserve effectively continues to seek to incentivise home ownership. Existing U.S. housing inventory has increased to 12.5 months supply of existing houses – much higher than what we believe is a more normal range of 4-6 months. We believe it remains premature to consider a recovery in house prices but a measure of stability from which to build is welcomed…. particularly for those financial services companies holding such assets in their portfolios.

A concern which remains is the extent to which loan modifications are an exercise in loss deferral but 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.

The VIX (volatility index) is 21.99, which is below the levels experienced prior to the ECB bail out and substantially lower than last August/September. While, by its characteristics, the VIX will remain volatile, we believe a VIX level below 25 augurs well for quality equities.

We believe the next few years will highlight the growing polarization between strong and weak institutions. Companies that have capital strength will buy assets from those required to divest. Companies that have a strong presence in emerging markets will likely grow quicker than those that do not. Banks that have strong retail deposit franchises will take market share from those that rely on wholesale markets to fund loan growth at attractive margins. We believe the Funds we manage are extremely well positioned to benefit from the strength of their portfolios of strong, dominant, attractively priced financial services companies.

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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