Market Commentary

PORTLAND INVESTMENT COUNSEL™

October 4, 2010

News Highlights on Current Holdings

Financial Services Companies

Prudential Financial is, as anticipated, acquiring from AIG the Japanese life insurance businesses Star/Edison for a net purchase price of $4.2 billion, which equates to 10x earnings post anticipated cost savings and closer to 10.5x if we include a present value estimate of one-time integration expenses. Prudential will fund the deal through $1.7 billion of excess capital, a $1.3 billion common equity offering and a $1.2 billion debt offering. At about 95% of Book Value, Prudential remains materially undervalued in our view.

HSBC - Nedbank said yesterday that the process leading up to a potential offer by HSBC is ongoing.

HSBC's departing Chairman Stephen Green said Wednesday ahead of a board meeting in Shanghai that the bank has no plan to move its headquarters to Hong Kong from London, quelling recent market speculation about such a move. Green, who will soon become the U.K.'s trade minister, also said China remains strategically important to HSBC.

Unicredit announced Federico Ghizzoni as their new CEO at the close last Thursday. We think this is positive to have the appointment made quickly, which however, also required an internal candidate and may have limited a broader search for a candidate. Thus, the clean sweep by bringing in someone new didn't happen. Not appointing a GM (if stays this way) is also positive since shows there is still opposition in the organisation to the foundations that called for a general manager and according to the press wanted to make UCI more Italian. The new CEO Mr Ghizzoni stated in a press interview with Il Sole on Saturday that UniCredit will continue to focus on Italy, Germany and some core CEE markets (namely Turkey and Poland); the bank will dispose of some assets in countries where it has limited presence.

Royal Bank of Scotland has begun the process of shedding a further 500 back-office staff in its investment banking unit, as the group continues to cut costs.

VISA & Mastercard are apparently close to a settlement with the JusticDepartment over an antitrust probe regarding credit-card acceptance rules.

Basel 3, Risk Weighted Assets – Since the new Basel 3 minimum ratios were announced banks are slowly coming out with initial estimates on impacts to RWAs. Barclays indicated the total impact of the measures announced could increase RWAs by £150bn which is in line with expectations stemming primarily from market risk and securitisation treatment. Credit Suisse indicated that if it were implemented today then RWAs could be inflated by ~CHF170bn to CHF400bn and UBS guided to CHF400mn RWA (ie double Basel 2) if Basel 3 applied to 2Q10, but expect nearer CHF300bn after mitigating actions, in line with their prior guidance for 2012 RWA.

Switzerland: The Commission of Experts recommends Core Tier 1 of min. 10% by end-2019 (Basel 3 imposes 7%) and Tier 1 of min. 19%. Within that there is a 6% buffer of contingent capital required but Contingent Capital instruments can be included. As expected these requirements are higher than the Basel 3 impositions but arguably less than expected. The leverage ratio requirements remain unchanged at 5% (of total assets), compared to Basel 3 which is likely to impose just 3%.
The right structure and size is up to the banks and the regulator will only step in if the banks fail to comply.
Following the announcement Credit Suisse have said that they will meet the "very stringent measures" by 2019 and that they are prepared for the developments, UBS said that they are well positioned to meet the targets before the deadline and that they have no plans to raise common equity. At first glance, in-line to slightly better than expectations, not too onerous on the banks and plenty of time for implementation.
Dividend Paying Companies

Toyota Motor Corp – Toyota reported September US sales higher by 16.8% compared to September of 2009, while it registered a roughly 1% pullback in sales compared to the month of August. The most impressive US sales progress was reported by Ford. September 2009 was an unusually weak sales month after the conclusion of the 'cash of clunkers' governmental incentive program.

Siemens – Siemens announced the acquisition of Site Controls, a leading energy management solutions provider located in Austin, US. The newly acquired business will be part of the Building Technologies Division, a global leader in building automation and HVAC control solutions. The terms of the acquisition have not been disclosed.

Siemens is the preferred bidder in a process aimed at supplying Eurostar, the Channel Tunnel operator, with a new generation of high-speed trains. The deal is worth several hundred million euros and Siemens would displace Alstom as the preferred Eurostar supplier, should its bid be deemed successful.

Wesfarmers – The home improvement business of Wesfarmers, Bunnings, revealed plans to invest more than AUD 600mm in an expansion of its distribution in New South Wales, Australia's most populous state. The company disclosed it has secured sites for 12 new stores. The move is an attempt to prepare the division for the entrance of Woolworth's, in a venture with Lowe's, in the lucrative Australian home improvement business.

Wesfarmers published its guidance for its coal mining operations, announcing that it expects a weakening in the metallurgical (coking) coal pricing of roughly 11% for its second fiscal quarter. At the same time the company disclosed that the production volumes are likely to be somewhat lower than initially guided for the fiscal 2011, at 6.2-6.7 million tonnes compared to 6.5-7.0 million tonnes. The reduction is mainly due to the unusual wet weather.

Novartis – Novartis announced it will pay $422.5 in fines and civil liabilities as it pleaded guilty to charges of improperly marketing its epilepsy drug Trileptal. An investigation found that Novartis promoted Trileptal (oxacarbozepine) for uses unapproved by FDA, including for pain and psychiatric conditions, such as bi-polar disorder. The announcement helped clear uncertainties around this litigation, the company having provisioned for the outcome of this process earlier in the year. The stock price was virtually unaffected on the announcement as the outcome had already been priced in.

BHP – The province of Saskatchewan is to release a report on Monday, October 4th, on the impact a takeover of Potash Corp would have on the well-being of Canadians. The report would analyze three scenarios, including the current hostile bid by BHP, a competing bid by a Chinese led investor group and a takeover by and investor board or sovereign fund. While the report is only a piece of the puzzle that would lead to regulator's decision on the proposed takeover, it is expected to be influential in the process.

Sinochem of China is reported to have suffered a set-back in its attempt to mount a competing bid for Potash as it could not interest Uralkali, the Russian fertilizer giant, to get involved in the deal. Potash Corp of Saskatchewan's stock in the meantime has proceeded to trend lower, to the point to which there is only roughly a 10% premium to BHP's all cash offer of $130/share.

ABB – The US unit of ABB was charged by US prosecutors with conspiracy involving bribes paid to a Mexican state utility. At the same time, ABB Jordan Ltd was accused of paying hundreds of thousands of dollars to Iraqi officials for contracts worth roughly $6mm. The company pleaded guilty to the charges and identified the US unit's general manager, John O'Shea, as the person responsible for approving the payments. O'Shea was fired in 2004 and the company disclosed the improper payments the US Justice Department and the SEC in 2005. ABB resolved the charges and will pay a total of $58.3mm.

BMW – BMW announced it extended Norbert Reithofer's, its current CEO, term by 5 more years until September 2016 in an attempt to ensure continuity of its operating improvement and market share gain efforts. Reithofer is known for being instrumental to increasing the operating margin by slashing jobs, as well as for concluding key alliances with other industry leaders such as Daimler and PSA Peugeot Citroen.

BMW is voluntarily recalling some 350,000 vehicles worldwide, including 200,000 in US in an effort to deal with a potential braking problem likely to be caused in cars with higher mileage. The vehicles affected include the BMW 5,6 and 7 Series built since 2002, as well as some Rolls-Royce cars.

Economic Activity, Consumer and Business Conditions

US – Mildly encouraging macroeconomic signals continue to trickle out of the US with a key reading, the final estimate of the second quarter GDP moving higher to 1.7% from the previous value of 1.6%, while the Chicago PMI, a leading manufacturing indicator, strengthened to 60.4 in September, higher than the 56.7 figure in August and significantly higher than the expected 55.9 value. Unfortunately, the broader and more impactful Institute for Supply Management's (ISM) PMI was barely in-line with the expectations for September and actually retreated to 54.4 from 56.3 in the month. The pace of firings seems to be improving, with the initial jobless claims retreating 16,000 to 453,000, better than the expected 460,000 figure.

The monthly income and spending report from the Bureau of Economic Analysis of the Department of Commerce revealed that US personal income increased faster than expected in August, by 0.5% compared with 0.3%, mainly helped by an extension of the unemployment insurance, while the personal consumption expenditures also moved higher than expected by 0.4% compared to 0.3%. The personal savings rate is pegged at 5.9% of the disposable income. Noteworthy, the personal consumption expenditure chain weighted price index less food and energy (core), the Fed's preferred inflation gage, remained stuck at 1.4%, helping ease some of the deflationary fears.

U.S. pending home sales continued to bounce off record lows in

August. Signed sales contracts jumped 4.3% in August to the highest level since April, above expectations and on the heels of July's downwardly revised 4.5% increase. With the exception of the Northeast, more contracts were signed elsewhere in the country….the Midwest, the South and the West. It does therefore appear that home sales have stabilized, albeit at very low levels, but at least they have been stable, which should keep confidence steady. And given that mortgage applications for new purchases climbed for two consecutive months (in August and September) after diving for three straight months is also reassuring. This also bodes well for existing home sales.

Canada – The Canadian economy has confirmed its downward moving trend with a decrease of 0.1% in July, largely expected, given previously announced weakness in manufacturing, retail and housing sectors. Last time the Canadian economy contracted was in August of 2009. The net exports, a key contributor to the national GDP growth, have been a drag for most of the time since recession started. With a currency seen by many as overvalued, exports struggle to keep pace with the influx of goods and services. Given that the monetary policy differential between Canada and US is seen as the main culprit in the recent dollar strength, it is likely, in our opinion, that the Bank of Canada will find it difficult to continue to raise interest rates in the near term.

Financial Conditions

A.I.G. – The US Government has moved closer to exiting from AIG by exchanging its preferred shares into a 92.1% stake in AIG which can thereafter be sold down in the market. The New York Federal Reserve which lent AIG $20 billion is also to be repaid by March 2011. The first share offering to start reducing the Govt stake could be the first quarter of next year and will follow the sale of AIG's Alico business to Metlife and the AIA Initial Public Offering in Hong Kong. Under the plan, the US Treasury would need to issue shares at about $29 to break even (discounting accrued interest) … but given shares are currently trading close to $40, the prospects for the Treasury to be able to have undertaken the bail-out, avoided fire sale prices and now make a profit for taxpayers are considerably enhanced.

Spain has lost its last triple-A credit rating with the major rating agencies, following a downgrade from Moody's. The agency downgraded Spanish debt by one level to Aa1, following similar moves by Fitch and Standard & Poor's earlier this year.

European Government measures to tackle debt: In a race to stop speculation about their ability to achieve sustainable fiscal positions and contain the recent increase in bonds yields, European 'peripheral' countries' governments are announcing new measures to reduce the total deficit and stop the growth of public debt. In our view markets deserve credit for imposing fiscal discipline. As "bad" as the status quo can look, governments are implementing positive reforms that will strengthen their economies and so in our view, markets should start considering the positive effects good policies will have.

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 2.09% and the U.K.'s 2 year/10 year treasury spread is 2.29% - 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 (129 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 4.32% - (the lowest rate since the Federal Reserve began tracking rates in 1971), as the Federal Reserve effectively continues to seek to incentivise home ownership. Existing U.S. housing inventory has increased to 11.6 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 23.62, which is below the levels experienced prior to the ECB bailout 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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