Market Commentary

PORTLAND INVESTMENT COUNSEL™

April 16, 2012

News Highlights on Current Holdings

Financial Services Companies

Australia & New Zealand Bank: The withdrawal of European lenders from Asia and new regulatory rules that require banks to hold more capital have caused a fundamental restructure of banks' business models in the region, stated ANZ MD of global markets, Steve Bellotti last week. Global competitors have cut their lending in Asia, just as ANZ builds a larger presence there in line with its "super regional" strategy.

Aviva would consider offers for U.S. life insurance unit according to the Financial Times, CEO Andrew Moss, told a group of investment managers recently that it could consider offers for Aviva USA, people present at the meeting told the newspaper. The unit could fetch as much as £1bln according to the article although from earlier estimates we would expect it could sell for ~£2bn.

Credit Suisse may have to cut 3,000 to 5,000 investment banking jobs as it employs too many workers in the unit considering revenue potential, former UBS CEO Oswald Gruebel told Finanz & Wirtschaft in an interview. Seperately Der Sontagg, citing a high ranking executive, said that the bank would have to cut 5,000 IB jobs.

Deutsche Bank, Barclays and Credit Suisse are preparing bids for US$7.49bln of real estate debt from the Federal Reserve Bank of New York, according to Bloomberg. Separately, the Financial Times says that Deutsche Bank's incoming co-CEO is planning an overhaul of its operations, aiming to make its wealth and asset management operations work more closely with its investment banking arm in bid to emulate the business model of Swiss rivals Credit Suisse and UBS.

Goldman Sachs sold $2.5bn (3.55bn shares or 4%) of chines bank, ICBC to Temasek at HK$5.05 a 3% discount to the opening share price. This is the fourth time Goldman Sachs has reduced its stake in ICBC recently as it is concerned about the capital required to back this investment due to the Volcker rule. Goldman Sachs still has 5.23bn share worth about $3.75bn.

HSBC have sold their 11 Korean Branches to KDB Financial of South Korea, no financial details were disclosed. Also, HSBC is in talks to sell up in Pakistan and offload all retail banking in Korea, part of its withdrawal from countries where it lacks scale or struggles to make a profit. HSBC said it was discussing the sale of its Korean retail and wealth management business to Korea Development Bank (KDB), but would keep its investment banking and corporate banking businesses in the country. It is also in talks with several unnamed companies to sell its Pakistan business, it said in a separate statement (Source : Reuters).

ING - sent out financial details of Asian insurance business to a "string of bidders" on Friday evening, according to Financial Times, with a price speculated at about $6bn. The bidders mentioned in the article include AIA, Metlife, Prudential (US) and Manulife. With ING Group trading at about on 0.4x 2012 tangible book value, we continue to believe that this sale will highlight the inherent value in the franchise. The sale of businesses in Korea, Malyasia & Japan is said to be the last opportunity for any group underrepresented in the world's most promising life assurance markets.

JP Morgan reported earnings per share of $1.31, vs. consensus $1.17. Results were impacted by four unusual and/or volatile items, including a net negative debit valuation adjustment (DVA- an economically meaningless notional loss) of $907 million pretax ($0.14 per share), a $1.8 billion pretax ($0.28 per share) benefit from reduced loan loss reserves, a $1.1 billion pretax ($0.17 per share) gain related to a Washington Mutual (WaMu) bankruptcy settlement, and $2.5 billion pretax ($0.08 per share) in additional litigation expense. The positive surprise was driven by "core beats" in both the Investment Banking and Consumer (principally Mortgage) totaling +$0.22, evenly divided between IB and Consumer. Loan Loss Reserve releases across Card and Mortgage added +$.21 to EPS, but were exactly offset by a -$.21 "miss" in Corporate/Other which was driven by an arguably aggressive sizeable addition to Litigation reserves, mainly for future mortgage-related fallout, with management saying that it expects no further addition here in 2012. Fixed Income Currency and Commodities (FICC) revenues (ex DVA) were down -2% year-on-year and Equity (ex DVA), down -4%; further evidencing that JPM appears to be at the end of a multi-year "re-basing" process. About 70% of the $442 MM revenue in the Investment Bank came from FICC and Equity trading fairly evenly split between the two, with Investment Banking better in debt underwriting (the key area of Q1 strength in the market broadly). Most of the core beat in Consumer appears to be in Mortgage origination, despite origination volumes flattish vs. Q4, indicating much of strength was from much better origination spreads. Mortgage applications rose in Q1 though, up about +13% QoQ; this appears to be HARP-1 related (see below) in which case there may be more in the 2nd quarter re HARP II and depending on the rate of improvement in the economy and employment levels. Net Interest Margin contracted 9bps to 2.61%, in line with management guidance and with the fact that consumer loan balances continue to contract, driving the deposit/ loan ratio higher once again. The press last week questioned the group's CIO office results being driven by proprietary trading but given the reported revenue trends in Corporate, it is difficult to validate such a concern. $449 MM in securities gains in the unit compare to FICC revenues in the Investment Bank of $5 billion. The group's 'fortress' balance sheet continues with a Basel 1 tier 1 ratio of 10.4% and Basel III tier 1 of 8.4. It has increased its quarterly dividend by 20% to $0.30 and has authorized a new $15bn share repurchase program (circa 8% of outstanding shares) of which up to $12 billion has been approved for 2012.

Lloyds Bank and Royal Bank of Scotland : Senior executives at the UK's partially nationalised banks say their distressed loan books are showing signs of improvement despite a dismal economic backdrop and government austerity measures. RBS and Lloyds, which were bailed out by the British government in the wake of losses in the financial crisis of 2008, saw their loan books sour in the following recession. Both now say they see light at the end of the tunnel (Source: Financial Times)

It's also understood that NBNK has made a sweetened offer for Lloyds Banking Group's 632 branches, as the investment vehicle ups the ante on its bid to create a challenger bank in the U.K.

The Times reported last week that Scottish Widows Investment Partners is closing a string of its regional investment desks with 'active' fund managers being replaced by a single "global" team built around a 'black box' quantitative equities trading strategy. The result will be the 38 strong investment team being cut to 15. A potential management buyout of the unit had been explored but was vetoed by Lloyds. Sources say Lloyds were looking to offload Scottish Widows entirely, so adopting a lower cost investment approach to managing assets would make the portfolio perhaps easier to sell.

SANTANDER has withdrawn its filing for an IPO of its Argentinian unit (which it had filed for in May last year), saying it will not pursue the offering at this time. The Argentinian unit is relatively small in the context of Santander, contributing approximately 2% revenues. The bank has c.EUR2.5bn loans and EUR0.55bn equity. We would imagine that, as with the UK IPO, the reason for the withdrawal/delay would be the lower level of valuation the bank could achieve in the current environment.

Wells Fargo : Excluding Wachovia-related merger charges ($218mn), WFC reported $0.75 diluted earnings per share, ahead of consensus and up 11% from prior quarter with return on equity of 12.14%. We view this as another strong quarter from Wells Fargo and consensus estimates are likely to move higher notwithstanding management's revised 4Q12 expense guidance of $11.25bn, at the higher end of its previous guidance of $10.75-$11.25bn – a 'good' expense due to increased revenues.. Also, this is more than offset by a much better than expected lending margin, which came in at 3.91% as asset yields came in better than expected, particularly in C&I. Mortgage banking revenues were better than already high expectations, ($2.9bn vs $2.4bn), with gain on sale up 47bp QoQ from already high levels and this could translate into a considerable revenue tailwind at WFC for the next several quarters. WFC continues to ratchet down its best in class cost of deposits (to 20bp from 22bp). Wells' capital strength continues to improve, its Tier 1 common equity ratio is 9.95% and its Basel III tier 1 ratio is at 7.81% - enabling it to increase its quarterly common stock dividend rate by 83% to $0.22 per share. It also has the ability to repurchase shares as a result of the Federal Reserve's non-objection to its 2012 Comprehensive Capital Analysis and Review capital plan.

US HARP : The Home Affordable Refinance Program (I and II) for refinancing underwater Fannie Mae and Freddie Mac mortgages has accelerated sharply in the first quarter of 2012, according to a new analysis and ranking by Inside Mortgage Finance. Based on loan-level data on mortgage-backed securities issued by the two government-sponsored enterprises during the first quarter, HARP activity surged to a record 180,572 loans in the first three months of the year. That was up 93.8 percent from the fourth quarter of 2011, and it featured a huge 56.3 percent jump in activity from February to March. An estimated $38.60 billion of HARP loans were securitized by Fannie and Freddie during the first quarter, which represented 16.8% of their total refinance activity for the period. The program made up a somewhat larger share, 19.9%, of Freddie's refinance business and accounted for 13.6% of Fannie's refinance activity. For all of 2011, HARP represented just 12.4% of GSE refinance activity. Fannie generated more HARP business overall, with an estimated $21.20 billion, compared to Freddie's $17.40 billion. Two lenders dominated the HARP market in the first quarter. Wells Fargo delivered an estimated $12.00 billion in HARP loans to the GSEs in the first three months of the year, representing 31.1% of total activity in the program. JP Morgan's Chase Home Finance ranked second with a 19.9% of HARP loan securitizations, and the program accounted for a strong 28.5% of its refinance loan sales. What's encouraging, is that Wells Fargo commented in its quarterly conference call that the mortgage production was mostly driven by HARP I which means the pipeline for 2Q should be relatively solid under HARP II as well.

Financial Infrastructure

Hong Kong Exchange: On Friday, various media sources reported that HKEx was looking to raise as much as US$3 billion in bank financing to support its bid for the London Metal Exchange (LME). While no official statements have been released by HKEx, an acquisition of LME would suggest a clear shift in focus from its current strategy.

Dividend Paying Companies

Bayer – agreed to pay around $110mm for the settlement of the first 500 lawsuits involving its Yasmin brand of birth control pills. The claimants contend that the drugs caused blood clots. The company had announced in February that 170 Yasmin related cases had been settled out of court. Bayer is likely to continue to consider out of court settlements, while the US health regulators said that information about an elevated risk of blood clots will be added to the label of the widely used class of birth control pills which includes Bayer's Yasmin and Yaz brands.

Carnival – Salvage of the Costa Concordia cruise vessel, capsized off the coast of the Italian island of Giglio on January 13, is set to begin next month. An Italian civil protection officer announced that contracts are expected to be signed by the end of April, with operations to begin in mid-May. The front-runners to win the contracts are two consortia, comprised of (1) Smit Salvage of Netherlands and Neri of Italy and (2) Titan Salvage of US and Micoperi of Greece. The operation to pump more than 2,300 tonnes of fuel out of the vessel was completed last month.

Siemens – Nokia Siemens Networks, a joint venture of Siemens and Nokia, has reportedly won an order from Softbank Corp of Japan to build a new LTE network as well as to expand its existing 3G network. The financial details of the deal have not been disclosed, but the contract is said to include both network implementation and system implementation for the LTE services.

Vivendi – the European Commission announced it would open an inquiry into the termination rates (i.e. wholesale tariffs for cross-network calls charged to other operators) awarded to the French new entrant Iliad, arguing that they were too high and favourable to the company. The entrance of Iliad had a disruptive effect on the businesses of the incumbents, including France Telecom and Vivendi's SFR. The European Commissioner stated that "imposing higher mobile termination rates for new entrants only make sense if this reflects real higher costs" adding that the French regulator had not provided sufficient evidence that Iliad really faced higher costs than established players. A period of negotiation between European and French regulators, which could last as much as three months, will follow and could have as a result a lowering of Iliad's termination rates if the European Commission wins or could have the rates stay the same if the French regulator wins.

Tesco : Shareholders have increased pressure on Tesco to scrap its US ventures and pull out of banking with renewed calls for it to focus on rejuvenating its flagging UK retail business.

(Source : The Guardian)

Economic Activity, Consumer and Business Conditions

US – A mixed bag of macro-economic news over the last week and this morning is likely to leave the market undecided until the next major economic announcements, which include the industrial production and the existing home sales report later in the week.

On the consumer side, the US retail sales for the month of March unexpectedly advanced by 0.8%, way ahead of the expectations for a 0.3% improvement, driven mostly by better than expected auto sales, though other areas such as building materials and electronics performed well too. The core retail sales, which excludes sales of vehicles and gasoline, were also up by 0.8%, though expectations where somewhat closer, calling for a 0.6% improvement. The consumer sentiment for April, as measured by the University of Michigan, dipped to 75.7 on Friday, driven chiefly by a drop in the consumers' view of the current conditions, with the 'current conditions' component of the index dropping to 80.6 index points from 86.0 and way below the expectations for a 86.1 level. The 'expectations' component actually advanced in the month, to 72.5 index points from 69.8, which bodes well for future retail sales readings.

On the inflation front, the case could be made for very modest inflationary pressures, as the core consumer price index (CPI) moved up to 2.3% year on year in March, ahead of the expected 2.2% rate, helped by categories such as clothing. The headline CPI reading was in line with the expectations at 2.7% year on year, driven by food and energy.

The US goods foreign trade balance unexpectedly improved in February, as a minimal increase in exports was not matched by imports. Imports dropped 2.7% in the month, which is likely to put downward pressure on consumer spending down the road.

The US foreign trade deficit is sitting at $46Bn, $6Bn less than the expected and $6.5Bn lower than January's reading.

News from the housing sector was disappointing this week, with the key reading of the Housing Index by the National Association of Home Builders (NAHB) for the month of April falling to 25 index points, the first retreat in seven months. All of the index's components retreated in the month, including the 'current sales conditions' and the 'next six month conditions', each dropping 3 index points to 26 and 32 respectively, as well as the traffic of prospective buyers, which dropped 4 points to 18. Obviously stability must first be evident before a recovery can gain traction/ credibility.

Canada – the Canadian visible goods trade balance surprisingly dropped to less than $300mm in February, against expectations for a $1.9Bn level, as export of energy products and vehicles sunk in the month. Canadian housing prices continue to improve in February, advancing by 0.3%, ahead of the expectations for a 0.2% and accelerating from the January's 0.1% rate of growth. The day before, the housing starts report for March revealed a higher than expected 215,600 units annualized level, beating expectations for a 200,000 units annualized.

Spain – Focus of the market remains the sovereign crisis in Spain. The country will auction 10 year securities on Thursday and the market is nervous about the demand for this. The 10 year yield broke through 6% this morning for the first time since November and since the Technocratic government of Mariano Rajoy came to power. At the end of this week EU leaders will travel to Washington for the IMF's spring meeting and will seek a bigger war chest to fight the crisis.

Financial Conditions

IMF – IMF Head Christine Lagarde made comments last week hinting that she would ask for an increase in IMF firepower amount lower than the $500bn originally requested at the start of the year. But, with $400bn now rumoured by DJ Newswires, we think it could actually be a net positive: $400bn extra is better than none at all (~$200bn already pledged by eurozone itself, rumoured $60bn from both Japan and China leaving just $80bn to be found from other members) and with only a week to go before the IMF meet, we would assume that the IMF believe this is a realistic level to achieve.

Federal Reserve policymakers appear determined to flatten the yield curve as much as possible, having indicated they expect 'exceptionally low levels' of interest rates "at least through late 2014". which is still an "exceptionally low level" in the grand scheme of things. Fed Reserve Chairman Ben Bernanke has indicated 1% or less would be considered exceptionally low. The advent of the US 'twist' (whereby the Federal Reserve is selling 3 year and less maturities to buy 6 years and longer) means all parts of the yield curve will benefit from a near-zero anchor for essentially the next 3 years. The U.S. 2 year/10 year treasury spread is now 1.72% and the U.K.'s 2 year/10 year treasury spread is 1.65% - 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 3.88% - (3.87% is 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 improved to 6.4 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. While we still believe it remains premature to consider a recovery in house prices prospects of a measure of stability are likely to increases 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 remains 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 have been increased suggesting overall current levels of total provisions should suffice, enabling banks to continue to post increasing earnings per share (as credit improves) over the next 2 years 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.

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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 17 in 2012 (compared to 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. 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 VIX (volatility index) is 19.55 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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