



## News Highlights on Current Holdings

### Financial Services Companies

**Manulife, Canada's biggest life insurer**, would be interested in buying American International Group Inc.'s (AIG) AIA Group Ltd. to expand its insurance business in Asia, at the right price, a company spokesman said last week.

**Standard Chartered:** Trading Statement issued last week. Income was up in both businesses, the commentary says only slightly on 1H09 but double-digit over 2nd half 2009. In our view the overall tone is slightly weaker than in May. The quality of the income was better with less own account income. The company pointed to a weaker activity in recent weeks in Wholesale Banking due to increased economic uncertainty, nevertheless, client income has grown by around 20 per cent in the first five months of 2010. Costs were ahead of 1H09, driving 'significantly negative' cost:income jaws, which is disappointing but has to be taken in context as the company is investing for future growth and seems well positioned for future business uplift. Comments around asset quality were better than we expected - Consumer Banking impairment around 2/3 of level seen in 2H09, Wholesale Banking impairment is expected to be 'noticeably less than half' seen in 1H09. Asset to deposit ratio is broadly stable on the year end position so that our view remains that the group is tracking towards a strong performance in the first half of 2010.

**Royal Bank of Scotland** - CEO Stephen Hester said in Welt am Sonntag that he expects the British Government to start selling their stake in the bank next year. Hester said "the government's exit wont all come at once but I would be disappointed if the first steps to privatisation won't be taken next year, also The Sunday Telegraph reports that analysts believe RBS is preparing to sell £15bn of property assets a year as part of its unwinding of distressed debt.

**Barclays** announces the signing of a Joint Venture Agreement with Sumitomo Mitsui Banking Corporation ("SMBC") and Nikko Cordial Securities Inc. ("Nikko"), a wholly-owned subsidiary of SMBC, to provide wealth management services to high net worth individuals in Japan.

Barclays hosted an investor seminar today focused on the Global Retail Banking Division (41% of group loans). Barclays is targeting mid single digit revenue growth and 2-3% cost growth to drive a low 50's cost /income ratio and a cross cycle RoNAV of 20%.

Barclays aims to achieve this growth despite "lacklustre" GDP, using mainly organic plans. In Western Europe it aims to be a top 5 retail bank in Spain, Portugal and in the 10 most affluent cities in Italy. To achieve this it will consider small in-fill deals and could be a consolidator of distressed assets in Spain. Its targeted Return on Equity is 13-15%.

Barclays also updated on current trading. Investment banking conditions softer in May and June reflecting lower levels of capital markets and M&A activity.

Impairment trends in Barclays corporate in Spain have worsened in 2Q10, reflecting continued downward movement in real estate prices. Overall group impairment guidance for 2010 unchanged at 15-20% lower than 2009 levels. Credit spreads have widened Q2 hence not unsubstantial credit gain expected for the quarter. Barclays Global Retail Banking Guiding a return on equity of 13-15%

At 0.8x tangible book for a >15% Group Return on Net Asset Value the stock looks too cheap in our view.

Barclays – According to a London City article Barclays is this week set to announce plans for faster expansion in Spain, Portugal and Italy, taking advantage of local competitors weak position. Separately, CEO John Varley said that banks are ready to embrace G20 reforms but said that the wrong decisions could weaken banks and the Global economy according to the Telegraph.

**Santander** is considering a partial stock market listing of its UK business as a way of raising cash. The bank has already made a similar move with its Brazilian operations, which was widely seen as a success.

G20 calls for banks to hold significantly higher capital buffers, but has backed down on the timing from a hard target down to an "aim" of 2012, and the phase in period will vary across individual countries. The G20 also agreed a compromise pledge to halve fiscal deficits by 2013, presuming this will be growth neutral.

EU lawmakers and member states last week backed the toughest restrictions on bankers bonuses seen so far. Under rules expected to pass the European parliament next week, 40% to 60% of a bonus payment would be deferred for three to five years and half the upfront bonus would be paid in securities linked to the bank's performance.



## Dividend Paying Companies

**Siemens AG**, Europe's largest engineering company, predicted "continued strong profitability" in its third quarter as demand rebounds for factory automation gear, health-care products and light bulbs.

Siemens plans to set up its own bank in a move that underscores how large industrial groups are seeking to reduce their reliance on bank financing after the credit crisis. The engineering group said it would use a banking licence primarily to expand its sales finance business but also to be able to deposit some of its current €bn (\$11bn) cash pile at the Bundesbank and to broaden its sources of financing.

**Seven&i** – The Japanese convenience store giant reported a 10.6% drop in its first quarter operating profit to 52.4 billion JPY or 592.9 million USD, yet stuck to its full year guidance of moderate operating profit growth, based mainly on an ambitious cost cutting program. While a modest recovery in personal consumption has been helping retail operators, a persistent deflationary trend is offsetting the beneficial effects.

The same store sales at the Japanese Seven-Eleven stores retreated by 2.5% in Q1 on year on year basis, while its Japanese Ito-Yokado supermarkets lost 5.3% worth of sales on the same basis. The group level sales were 0.3% higher in Q1, with the sales trends improving overall in its convenience stores over the last couple of months. Profitability in the supermarket business improved by 10.9% year on year in the first quarter, largely due to the implementation of cost cutting measures. On the merchandising front, the company entered an agreement with Li&Fung of Hong-Kong to supply its supermarkets with budget fashion articles. Structural reforms at the general merchandise stores and the department stores are aimed at improving overall profitability, despite a likely pull-back in the same store sales levels.

**BHP Billiton, Wesfarmers** – The newly appointed Australian Prime Minister, Julia Gillard, showed a lot more determination in dealing with the issue of the mineral resource tax reform than its predecessor, Kevin Rudd who fell victim of the tax proposal which divided the country for over two months. Within less than a week from her appointment, Gillard managed to reach an agreement with the mining industry, thus eliminating the uncertainty that threatened a significant number of projects as well as undermined Australia's status as an investment friendly environment.

**The Australian Government** decided to replace the proposed

Resource Super Profits Tax (RSPT) with a Mineral Resource Rent Tax (MRRT) which is restricted to the mined iron ore and coal and would only affect 320 companies instead of 2500 under the initial proposal. The other minerals are left outside of the scope of the current tax reform, while the on-shore oil and gas projects would fall under the scope of the current Petroleum Resource Rent Tax which covers offshore projects.

A number of significant concessions make the new proposal a winning deal for the large mining companies, and some, like Xstrata, immediately resumed work on projects previously on hold due to uncertainty. The planned tax got cut from 40% to 30% and would only kick in once a roughly 12% profitability threshold (10 year Australian Treasuries plus a 7% adjustment) is reached, compared to a previous threshold of 5% to 6%. There is also a 25% allowance for the extraction activity such that only the resource profit is taxed. Another important amendment allows existing projects to enter the mineral resource rent tax regime at their market value, which greatly improves their profitability compared to the initial proposal. Some estimates put the new effective marginal tax rate at 45% which compares favorably with the 56.8% rate under the initial proposal and BHP's current 43.5% effective tax rate.

A decision made by the Australian Competition Tribunal opened access for the smaller miners to the Goldsworthy and Robe River railway lines, privately owned and operated by BHP and Rio Tinto respectively. Both railways are located in Australia's Pilbara region, the largest iron ore deposit in the world and are of secondary importance for both companies, the perception being that the two lines are being underutilized by the two major miners. The same Tribunal restricted juniors' access to the more important and fully utilized Newman and Tom Price lines. Nonetheless, BHP expressed their dissatisfaction at the opening of the Goldsworthy mine and is likely to appeal the decision on the grounds of increased inefficiencies which would be induced in the system by allowing several miners to operate on the same line. Wesfarmers – Approximately 75% of Curragh's contracted coal production has moved to the quarterly pricing mechanism and for the September quarter the hard coking coal prices have been set at 225 USD/ton.

**ABB** – Following Emerson's counter-bid for the UK uninterruptible power sources (UPS) maker Chloride, which effectively raised the price of the acquisition by 15%, to 375 pence per share, ABB decided to step aside and not continue a bidding war. The company's CEO, Joe Hogan said that the company must take a disciplined approach when assessing potential acquisitions.



Emerson's latest bid is 36% higher than its own original offer of 275 pence per share.

Siemens – Siemens guided for strong profitability in its third quarter, to end on June 30th, during its Capital Markets Day in Munich last week. The positive results are driven by strong demand in the emerging countries, a successful cost cutting program and significant currency tailwinds. It is thus quite likely that the sectors (core businesses) operating profit will exceed the original guidance for the year. The company is not unique in its encouraging performance, as manufacturing activity rebounded strongly in Germany driven by a competitive euro. The energy divisions at Siemens are seeing encouraging signs of a rebound in activity with demand recovering in renewable, power distribution and service.

**Siemens** has applied for a banking license to the German financial regulator BaFin, in order to be better able to manage its own risk and expand the product portfolio of its financial services unit. The German engineering group said they have no ambitions of expanding into retail banking operation, but would rather use the license to improve its sales finance area, add flexibility to group financing and optimize its risk management.

Siemens paid 115 million EUR for a 49% stake in a unit of the Danish energy company Dong Energy, A2SEA A/S, a supplier of installation services for the construction of offshore wind farms. With this investment the company is showing a clear commitment to the offshore wind power industry. Siemens stated ambition is to become one of top three suppliers of offshore and onshore wind solutions by 2012. The company currently ranks seventh in term of installed capacity.

**Novartis – Afinitor**, one of the company's products tested for extensions in oncology applications, including pancreatic neuroendocrine tumors (NET) and advanced carcinoid syndrome, exhibited promising results during its Phase III trial in pancreatic NET. Potential revenues additions are estimated as high as 1 billion EUR.

Novartis provided a progress up-date on achieving 77% majority ownership of Alcon, expecting to close the deal in late third quarter or the fourth quarter of 2010, pending regulatory approvals. The company announced at the same time the nomination of five individuals to replace the five Nestle nominated directors on the Alcon board.

**Tesco – Tesco** issued roughly 960 million GBP of CMBs, backed by rents generated by a portfolio of its supermarkets. The deal covers 41 supermarkets and the mortgages term is 30 year. The bond yielded 5.744 at issuance or 165 bps over the UK Treasuries. The sale and leaseback agreement was managed by HSBC and Goldman Sachs and is the third one by Tesco in about 18 months, with the total amount being raised at around 2 billion GBP. The issue was rated 'A-' by the S&P credit rating agency. Tesco survived an investor protest over executive during its Annual General Meeting, with 47% of the investors either voting against or abstaining in a poll over remuneration. The revolt was aimed mainly at what it is perceived an oversized compensation package for Tim Mason, head of the group's US loss making unit, which effectively made Mason the second best paid executive of the group.

## Economic Activity, Consumer and Business Conditions

**Germany** – German unemployment fell for a 12th month in June as business confidence improved, putting Germany's export-led economic recovery on a broader footing.

**US** – Most of the economic indicators coming out of the US over the past week pointed towards a marked slowdown in the economic recovery and the markets definitely took notice. As far as manufacturing is concerned, the series got kicked-off by the Chicago PMI, which for June came in, as expected, marginally lower than the May reading, 59.1 versus 59.7, yet nevertheless indicating expansion in the manufacturing sector. The broader and more impactful Institute for Supply Management's (ISM) Purchasing Managers Index (PMI) for manufacturing came in significantly lower than expected at 56.2 in June versus 59.7 in May and 59.0 consensus. Announced Friday, the factory orders for May declined by 1.4% month on month versus the expected 0.5% correction expected. While demand for durable goods, part of an earlier report, decreased by 0.6% in May, orders for non-durable goods decreased by 2.1%.

The all important employment situation report depicted a grayish picture with 125,000 jobs being lost in June, compared to the expected 110,000 jobs correction, while the unemployment rate unexpectedly retreated to 9.5%. The fall in the payroll numbers was primarily caused by the loss of 208,000 government jobs as the Census work tapered down. On the bright side, the private payrolls added 83,000 jobs, which was about equal to the



expected level, and in line with the last months' trend. The drop in the unemployment rate was due to a further drop in the labor force, as discouraged workers stopped looking for jobs. All in, over the last two months some 1 million people stopped looking for jobs as the average duration of the unemployment reached further higher record levels at 35.2 weeks. Other components of the employment report were the average weekly hours dropping to 33.4 from 33.5 and compared to 34.2 expected and the average hourly earnings which closed the month virtually flat.

On the housing front, the pending home sales index for the month of May fell significantly, over 30% and reached its lowest level yet, boding badly for the existing home sales reports to come. The mood in the sector was hardly being improved by the 3.8% year on year improvement of the housing pricing in 20 US metropolitan areas as determined by the S&P/Case-Shiller House Pricing Index. In such an environment it should come as no surprise that the US Consumer Confidence dropped a staggering 10.4 points from 63.3 to 52.9 for June.

**China** – The headline Chinese Purchasing Managers Index fell 1.8 points to 52.1, still signaling expansion, but representing the third consecutive decline. There are concerns that the Chinese powerful manufacturing sector is cooling down rapidly as export orders are softening and inventory rebuilding has been completed. While we believe that a cooling down of the Chinese economy is desirable to avoid the dramatic effects of high inflation and asset bubbles, we're equally concerned with weakness apparent in what's been the engine of global growth over the last two years.

## Financial Conditions

Policymakers continue to accommodate a recovery in bank profits. The U.S. 2 year/10 year treasury spread is 2.34% and the U.K.'s 2 year/10 year treasury spread is 2.57% - enabling financial services companies' assets booked at these levels, to be very 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 regional banks – rather than larger more diversified global financial services companies. The number of small U.S. banks failing continues to grow (86 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 4.58% - (the record low is 4.69%) as the Government and Fed continue to encourage new home owners. Existing U.S. housing inventory has reduced to 8.4 months supply of existing houses – but that is still 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 30.12, 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. Financial services companies that have breached client trust will keep losing business to those reputations that have been enhanced by the crisis. 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.



July 12, 2010

## 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](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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