



News Highlights on Current Holdings

Financial Services Companies

Australia and New Zealand Bank CEO Mike Smith believes that the bank's perennially underperforming wealth division can become a more serious player beyond Australia under new leadership, having previously been treated like an "orphan" at the bank. Defending the decision to postpone ANZ Wealth's strategy update until November 28, Mr Smith said the regulatory environment for superannuation and financial advice was now becoming clearer, which would inform the bank's plans.

Bank of Montreal : The Wall Street Journal reported yesterday that several members of the one-time convertible bonds desk at Bear Stearns, who left when the troubled investment bank was sold to J.P. Morgan in 2008, have gotten back together to form a U.S. converts desk at BMO Capital Markets after four years working apart. The move comes as issuance in convertibles has dropped to a record low. Converts are securities that act like bonds but can be converted into equity. Thus, companies can generally issue them for relatively good rates. But with straight bond rates near historic lows, issuers have seen little need to turn to convertibles. But BMO's team says they are hoping to succeed by building a team at what they believe is the market's bottom. "As easy monetary policy abates, [issuers will] find the convertible product more appealing, and that's the cyclical upswing we're looking to take advantage of," said Paul Rosica, the unit's head. BMO, like other Canadian banks, has been trying to take advantage of smaller U.S. firms' pullback across Wall Street in the past couple years by hiring aggressively.

Barclays has reorganised its investment banking structure to create a devolved geographic management hierarchy and combine its fixed-income and equities businesses into a single markets unit. Rich Ricci, head of the group's corporate and investment bank, told the Financial Times, Barclays' former fixed-income boss Eric Bommensath would head the markets business, with equities boss Jerry Donini appointed COO. The management revamp is said to likely calm fears among the former Lehman bankers in the US, as Skip McGee, the most senior ex Lehman

banker, was elevated to CEO of the Americas. A move to combine the fixed income and equities businesses into a single markets unit is accompanied by the creation of a 14 member executive committee that business. Barclays Group CEO Anthony Jenkins has promised a strategic review of the whole group in Q1 next year, however believes that he would retrench from Bob Diamond's investment banking ambitions appear to be unfounded so far as he has sought to stabilize the franchise and signaled his support for Mr. Ricci and the IB business.

Barclays : announced the acquisition of the ING Direct business in the UK. Acquires £5.6 mortgages (average Loan-to-value 50% and at c3% discount) and £10.9bn of deposits. No price indication but expected to be accretive to ROE immediately and have an immaterial impact on Core tier 1. Looks to be a sensible transaction a useful way of improving funding dynamics.

ING - are understood to be close to selecting preferred bidders for its Malaysian, Thai and Korean units. ING is negotiating final terms to sell Malaysia and Thailand to AIA for about €1.4bn and Korea to KB Financial for about €1.8b. A deal could be announced by mid-October.

JP Morgan : was last week sued by New York attorney-general for defrauding investors who lost more than \$20bn on mortgage backed securities written by Bear Stearns. Threatening similar action against other banks he stated that that Bear Stearns had committed "multiple fraudulent and deceptive acts" in promoting and selling MBS. New York AG Eric Schneiderman filed a civil complaint against JPMorgan in New York state court Monday. The case is the first brought under the aegis of a law enforcement group that was formed by President Obama in January to pursue alleged wrongdoing related to the financial crisis. It said more cases from the group are expected to follow. "We intend to follow up with similar actions against other sponsors and underwriters of RMBS" stated the AG's office. The allegations relate to billions of dollars of subprime securities issued by Bear Stearns before it was acquired by JPMorgan. The suit alleges that losses on RMBS issued by BSC in 2006 and 2007 alone were 'astounding,' totaling \$22.5bn, or more than a quarter of the original principal



balance. The action asks that the company be made to pay an undisclosed amount of damages 'caused, directly or indirectly, by the fraudulent and deceptive acts.' JPMorgan spokesman Joe Evangelisti said the bank intends to contest the allegations, and that it is 'disappointed' the NY AG 'decided to pursue its civil action without ever offering us an opportunity to rebut the claims.' JPM is employing an unusual argument in its new legal fight with New York Attorney General Eric Schneiderman: The prosecutor didn't do his own work. A JPM spokesman said the case relied on 'recycled claims already made by private plaintiffs.' The comment was a reference to similarities with a previous lawsuit brought against JPM and a former Bear Stearns mortgage unit by bond insurer Ambac Financial. Both cases quote from emails and messages sent within Bear Stearns that prosecutors say show the bank was aware it was selling poor-quality investments. The two cases also use some of the same statistics to illustrate how large Bear Stearns had become as a packager and seller of mortgages in the run-up to the financial crisis. JPM also raised concerns with the New York Attorney General's office about a staff member, Karla Sanchez, who worked on the Ambac case while with law firm Patterson Belknap Webb & Tyler. Sanchez joined Schneiderman's staff in Jan. 2011 as executive deputy AG of economic justice. After JPM pointed out the connection in a meeting, Sanchez was recused/abstained from further involvement.

Lloyds - Nationwide announced last week that they are pulling out of the UK interest only mortgage market. Back in 2007 interest only mortgages represented one in three loans sold in the market. We suspect that the Nationwide move is front running new regulatory rules that are due to be published this year, which are expected to severely limit the terms on which such products are offered. With over £330bn of UK mortgage loans, 23% of which are >90% LTV Lloyds is most at risk from this dynamic.

Lloyds are thought to be in extended discussions with the Financial Services Authority over plans to restart dividend payouts to shareholders. CEO, Horta-Osario, wants to pay a small dividend next year but the FSA is understood to have threatened to block the move because it wants Lloyds to preserve cash to protect itself from a potential

eurozone break-up or other future financial shocks.

Morgan Stanley is in talks to sell as much as a majority stake of its commodities unit to the Qatar Investment Authority. The US investment bank has for months been discussing the sale of a minority stake in the business, which specialises in trading oil, gas and electricity. Talks have now moved to include a majority sale to Qatar's sovereign wealth fund. (Source : Financial Times)

National Australia Bank has been rated the best of the big four banks for customer satisfaction despite being beaten by some smaller rivals. A survey by online comparison website Mozo found Australia's largest banks recorded improved customer satisfaction levels over the past 12 months, with the Commonwealth Bank of Australia moving up from fourth to second place followed by Wespac and Australia & New Zealand.

Standard Chartered – Wall Street Journal reported last week that the Singaporean sovereign wealth fund shareholder Temasek (owns 18%) is pressuring for the appointment of more independent directors, after abstaining from voting for the re-election of the non-executive board in May. Temasek reportedly have no immediate plans to sell shares but are unhappy with the banks governance. The WSJ says that although Standard Chartered were recently embroiled in the Iran dispute, the issue of the composition of the board dates back several years. Standard Chartered have released a statement suggesting that the abstention relates to a "misinterpretation of UK corporate governance requirements concerning the credentials of non-executive directors to sit on specific Board committees."

Dividend Payers

BHP – announced today it had priced a five year A\$1Bn note issue under its Australian Medium Term Note Program. The note will pay interest at 3.75% and mature in October 2017. The proceeds will be used for general corporate purposes.

BHP revealed it plans to cut an undisclosed number of jobs in its iron ore business, which currently employs some 6,000. The company had reviewed the iron ore division and was letting employees know about a



reorganisation plan, which would result in some job cuts. The announcement follows the closure of two of BHP's coal mines, where some 800 miners were let go. Other miners, such as Rio Tinto and Xstrata, have announced job cuts at their Australian operations.

Schindler – announced a new share buy-back programme under which, after acceptance by the regulatory authorities, a maximum of 9.5% of the nominal capital can be purchased via separate trading lines on the SIX Swiss Exchange starting January 3, 2013, until December 31, 2015. The purpose of the buy-back is the reduction of capital through cancellation of the shares purchased under the program.

Tesco – provided a second quarter and first half of its fiscal year trading update which showcased prominently a 0.1% underlying sales growth in the UK home market, the first such improvement in 18 months. The improvement in the UK sales performance is partly credited to the company's comprehensive restructuring programme, budgeted at around £1Bn. Despite losing market share recently, to rivals such as J Sainsbury, Morrisons and discounters such as Aldi and Lidl, Tesco still accounts for more than one in every £10 pounds spent in British shops. The company's CEO reported that customer perception of service, quality and availability had "begun to show some early signs of improvement". In the first few months of the new programme, Tesco recruited 8,000 more staff to give customers better service at its 3,000 UK stores.

Partly as a result of the new costs, the first half group trading profit fell 10.5% to £1.6Bn, while UK trading profit fell 12.4% to £1.1Bn, in line with expectations. Tesco currently earns almost 40% of its revenue outside Britain. Outlook abroad was not encouraging as the US Fresh&Easy stores failed to narrow trading losses, while in South Korea, Tesco's biggest overseas market, legislation allowing local government to impose shorter trading hours is negatively impacting its sales. Elsewhere, in Central Europe, the firm's trading profit suffered due to euro zone's instability.

Toyota – reported September US auto sales which were the highest since March 2008 and represented a gain of

41.5% in year on year terms. Previous year comparative sales had been affected by inventory issues stemming from the Japanese natural disasters earlier in the year. Toyota currently is third largest carmaker in US, behind General Motors and Ford. On the flip side, Toyota's Chinese sales fell about 40% in September from the year before as a result of the recent territorial disputes between Japan and China. In response, both Toyota and Honda announced plans to cut China production to about half the normal levels by shortening working hours and slowing down the speed of production lines, as reported by Nikkei. However, sales showed signs of recovery towards the end of last month, especially over the final weekend, providing hope for an early comeback.

Vivendi – is exploring the sale of its 53% stake in Maroc Telecom, its second biggest profit earner after French telecom operator SFR. Credit Agricole and Lazard have been asked to gauge potential buyer's appetite for the offer, which is expected to raise about €4.2Bn. The Moroccan government, which controls a 30% stake in the operator, wants strong guarantees in terms of investment in the country. Interested parties include the Qatari operator QTel and the United Arab Emirates based Etisalat, as well as Telefonica and France Telecom. Vivendi has been reviewing its portfolio of businesses and strategy as it is trying to reduce its €14Bn debt position and generate more value for its shareholders. The Financial Times cited industry sources as saying Vivendi had received "highly preliminary" interest in its French telecoms business SFR.

Economic Activity, Consumer and Business Conditions

US – The highlight of macro-economic releases in the US last week was the employment report for September, which revealed 114,000 positions growth in non-farm payrolls, much as expected, yet it surprised everyone with a three tenths drop in the rate of unemployment, to 7.8% significantly below the consensus expectations, which were calling for an up-tick to 8.2%. Revisions to the previous two months job reports boosted the non-farm payrolls by 86,000 positions. A key job contributor over the last three months was an increase



in government positions, which accounted for a net 73,000 positions, a departure from the cuts experienced in the past few years. Otherwise, a large contribution to September's job additions was a significant increase in part-time positions. At the sector level, manufacturing lost jobs for the second month in a row. Part of the same report, the average duration of unemployment rose to 39.8 weeks, while the average earnings grew by 0.3% month on month, ahead of the expected 0.2% improvement.

The non-manufacturing purchasing managers index (NMI), as aggregated by the Institute for Supply Management (ISM) for September, improved to a higher than expected 55.1 level, ahead of the expected 53.2 level and higher than August's 53.7 index level read, which seems to point to a pick-up in activity in the important service sector.

At the consumer level, the consumer credit unexpectedly expanded by \$18.12Bn in August, more than reversing July's revised \$2.45Bn reduction and significantly ahead of the expected \$6.50Bn increase.

Canada – The employment report for September surprised everyone with much stronger than expected job creation, adding 52,100 positions to the payroll, on top of the 34,300 positions added in August. Unlike the US, the report revealed that much of the additions were full time positions, mostly in construction and trade, albeit many self-employed. Although the unemployment rate moved higher, to 7.4%, it is likely this is because more Canadians returned to the labour force, attracted by the better employment prospects.

On the Canadian housing front, the housing starts for September managed to hold up at a relatively elevated 220,200 annualized rate, dropping just a notch from August's 225,300 annualized level. The reduction was led by a 3.9% drop in multi-unit starts, which maintain a close to historically high pace. Earlier in the week, the building permits for August also surprised on the up-side, more than reversing a July pull-back.

Australia - Concerns about weaker growth led the Reserve Bank of Australia to cut interest rates by 25 basis points in a surprise move last week.

China : The World Bank has lowered its growth forecast for China citing weak demand for its exports and lower

investment growth. The bank said it expects China's economy to grow by 7.7% this year, down from its projection of 8.2% in May. The International Monetary Fund cut its forecast for Chinese growth, a key driver of demand for iron ore, this year to 7.8% from 8.0%.

Europe: with the European Stability Mechanism now declared operational by EU Finance Ministers, the promise of ECB intervention (with implicit Bundesbank backing) and Germany wanting to keep the eurozone together, herebelow are some comments on peripheral Europe. Under the terms of the ECB's Open Market Transaction operations, the ECB will provide assistance to those eurozone countries who have market access – albeit it will not be surprising if Draghi takes a very liberal interpretation in 2013 in order to help Portugal and Ireland maintain market access.

(1) Rating Agencies Outlook

Country	Moody's / S&P Rating
Portugal	Ba3, negative / BB, negative
Ireland	Ba1, negative / BBB+, negative
Italy	Baa2, negative / BBB+, negative
Greece	C / SD
Spain	Baa3, negative / BBB+, negative
Cyprus	B3, negative / BB, negative

(Portugal (78bn bailout package; March 2014 maturity; 40% GDP)

IGCP (bond agency) has completed a bond swap whereby holders of 3.76bn one-year Treasury Bills at 3.1% yield (due September 2013) agreed to rollover into three-year maturities (5.125 yield due October 2015). This marks the first time Portugal has issued bonds since the April 2011 bailout and the 38% tender rate exceeded the 30% expectation.

Troika estimating Portuguese debt/GDP to peak



<124% and to begin declining after 2014 (revised upwards from 118.5%) assuming +2% pa GDP growth and 7% 2013 borrowing costs to decline to 5% over ensuing four years (10-year currently ~9%).

Government (estimated) 2012/13 GDP -3% / -1% and -5% / -4.5% deficit targets >15% unemployment

ECB' Draghi commented on the bond swap operation "It's not complete market access, but it is the beginning of complete market access". Draghi's comments appear to be deliberately aimed at supporting peripheral countries receiving bailout assistance and to present additional clarity to Spain/Cyprus (ie. ECB will take a liberal view as to what constitutes "market access")....i.e. ECB will help those who first show desire to help themselves Like Ireland

Ireland (67.5bn bailout package; December 2013 maturity; 42% GDP)

2013 Outlook:

- 3.5bn spending cuts/tax hikes
- Lowering GDP estimate to 1.7% from 1.9%

14.8% unemployment

Bond Market Access:

- Issued 4.19bn 2-year bonds in July which marked Ireland's return to the markets for the first time in ~2 years
- Debt maturity extension via tender involving 1.04bn maturities due in 2013/14 for October 2017 (5.9%) and October 2020 (6.1%) maturities
- Demand was majority from foreign investors and 5.23bn proceeds (5.95% average rate) were 1bn above government expectations
- The bond swaps/new issuances have allowed Ireland to majority cover 8.2bn Jan 2014 bond maturity (eases worries over funding cliff).

There remains much work ahead for Ireland but the willingness of the Irish to push ahead to regain market access is we believe off to a promising start.

Greece (173bn bailout package; 2015 maturity; ~85% GDP)

Angela Merkel visiting Athens this week to offer German solidarity in keeping Greece in the eurozone. Presumably Germany will seek to offer concessions (eg. lower interest rate, extend bailout terms one or two years) to help Greece given the ongoing depression (further -3.8% GDP for 2013) and >25% unemployment rate.

Greece is scheduled to return to private markets for refinancing needs in 2014 but is looking for a bailout extension to end 2016.

Troika. IMF urging the ECB/national central banks to consider taking debt haircuts in order to help place Greece on a sustainable debt level. PM Samaras is facing a difficult task in persuading Greece to move forward with 13.5bn in cuts over next two years in order secure the next release of bailout aid in November (31bn aid tranche due to be released which includes 23bn for bank recapitalization). The proposed plan consists of:

- 10bn spending cuts and 3.5bn tax hikes (Troika has rejected 2.5bn taxes imposed on self-employed as not credible along with government proposal to reduce wages for 2 years for 15,000 public sector workers before re-evaluation vs. Troika wanting layoffs)

Public Sector Holdings (as of March 2012):

- ECB. Spent ~38bn for 50bn par value Greek sovereign debt
- European Investment Bank. ~1bn Greek sovereign debt
- National Central Banks (ex-Greece). ~10bn Greek sovereign debt
- Bilateral Loans (other Eurozone nations). ~53bn
- IMF. 20bn (ranked super senior)

With the ECB indemnified by the EU for up to 35bn sovereign debt losses, a theoretical debt forgiveness of 75% on the public sector's 114bn Greek debt (ex-IMF) exposure would reduce Greece's debt/GDP by 43.50%



to 126%. This would certainly put Greece on a much more sustainable debt level but at the expense of adding +0.91% debt to eurozone debt/GDP. Nevertheless, even with Germany all-in in trying to keep the eurozone together, this remains a question of the willingness to continue by the Greek population (2013 will mark 6th consecutive year of downturn and country is already in a depression)...and the willingness of other Europeans (read Germans) to continue support.

Financial Conditions

Europe : A panel of experts appointed by the European Commission is expected to recommend that European banks introduce barriers between their investment and retail units to prevent consumer accounts from being put at risk by bank trading activities. The expected recommendation from the group led by Bank of Finland governor Erkki Liikanen follows moves well under way in the UK and US aimed at stopping banks which have customer deposits from taking large risks in the financial markets (Source : Wall Street Journal)

The Bank of England's Funding for Lending (FLS) scheme made a "disappointing" start in August as loans to businesses and households dropped by £5bn. The steep fall contrasts with an average monthly £900m rise in lending over the previous six months, according to the Bank's latest lending statistics. (Source : The Independent).

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 through 2015 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 extension 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 until mid to late 2014. The U.S. 2 year/10 year treasury spread is now 1.46% and the U.K.'s 2 year/10 year treasury spread is 1.56% - 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 3.36% - (3.36% early October 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 6.1 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 increase 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.

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 43 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 15.11 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

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Market Commentary



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