

Trident Investment Management, LLC Opportunities Funds Commentary

January 31, 2007

Performance Summary

The U.S. dollar continued its strength from December into the New Year with the dollar appreciating 1.14%. The yen was among the biggest losers in this move, falling to a multi-year low. Oil plummeted during the month due to warm temperatures in many parts of the U.S., falling 6.8% per barrel to end the month at \$58.14 US a barrel. Credit suffered despite the energy price declines with sub-prime spreads in particular widening out a massive 3.0%. Despite these issues, equities rallied in January with the S&P Index up 1.51%, the MSCI Europe index up 1.93% and the Nikkei also up 0.92% (all in U.S. dollars).

Market Outlook & Portfolio Strategy

The economic data for the fourth quarter proved remarkably strong thanks to exceptionally warm weather that prompted consumers to spend at a robust pace. Employment levels remain high as do incomes and consumers were undaunted by the continued softness in real estate. Thanks to a one month uptick in various home sales measures, the consensus view is that the real estate market has stabilized. With overall new and existing home sales still at close to 2003 levels (which for then represented a boom only to be eclipsed by 2004 and 2005) virtually everyone believes that we are going back to the heady days of 2005 in housing, albeit at a more dignified pace. The substantial decline in oil prices in January has served to further fuel bullish sentiment because the expectation now is that inflation should decline even as growth picks up – a perfect scenario for equity markets.

There is ample reason to not share in the equity markets' rosy view of the world. The U.S. continues to be at war in Iraq and the costs continue to escalate even though we were informed that we had "won" years ago. The yield curve remains flat and banks, thrifts and other lenders continue to post anemic results with both a compression in interest spreads as well as a pickup in credit default rates. This is of particular import to most global equity markets since many of them now are driven almost entirely by financial earnings – in fact, about 50% of all S&P earnings are generated by the financial activities of companies, and the sector itself makes up almost 25% of the market. There is little at present in the economic data that would suggest that a Fed rate cut and a steeper yield curve are imminent. The bond and money markets do not anticipate any easing for much of 2006 with some arguing even that the Fed may be forced to raise rates again.

The parabolic increase in credit globally has been the main reason why markets over the last few months have been so unafraid of reality. The flat yield curve has done little to diminish credit appetite and there has been an explosion of risk-taking with the most risky investments being financed at rates which a few years ago would have been unthinkable. In the last two weeks of January we have started to see the first chinks in this credit edifice. There has been a substantial widening in credit spreads, especially for lower grade housing-related debt. For example, BBB- housing-loan-backed securities which, since issuance just over two years ago have traded at an unbelievably tight spread of about 2.5% over Treasuries or LIBOR, widened in a three day period to trade at over a 5.5% spread. This 3.0% widening represents a new low in prices for holders of these instruments and wipes out most, if not all of their gains since inception. The spread widening was triggered by credit deterioration in the assets backing these bonds. In fact, sub-prime default rates by some measures have now approached or surpassed 2001 levels, a worrisome fact considering that we are still in what can only be described as a boom.

Despite the problems with sub-prime issues in January, the overall credit markets seem extremely sanguine. In particular, cheap credit continues to fuel takeover and merger activity in the stock market with transactions taking place at valuations that suggest that the purchaser has little chance of ever recovering his purchase price, let alone earn a return superior to cash. Equally perverse are the moves by numerous companies in shaky, highly leveraged businesses, to issue more debt for the purpose of buying back their own stock at wildly inflated prices.

The rationale for takeover activity in the public markets differs depending on the nature of the purchaser. A number of takeovers have been led by private equity funds which expect to generate attractive, longer-term returns by astute financial engineering and also perhaps management changes. While the longer-term track records of such activity, in general, have been mixed, there is no doubt that there are periods when such strategies have paid handsomely. Unfortunately, these approaches work best at times of overall bearishness when longer-term investors can purchase illiquid assets cheaply. At the current time, it is unlikely that such private equity investors as a group will profit based on the valuations at which some of the transactions are being consummated.

The mergers/takeovers that occur when the purchaser is publicly traded have a much more odious rationale. They allow companies to financially engineer "earnings growth" even though there might be no improvement at all in their underlying businesses. Such legerdemain has fundamentally changed the landscape of corporate America if not the world.

Explaining how this earnings scam works is easiest if we liken a company to bond. Consider a bond with a 10-year maturity that pays a principal amount of \$100 at maturity as well as an annual coupon of 6%. If market yields are 6% as well, the present value of the bond would be \$100. Of this amount, \$56 is the present value of the interest payments with the remaining \$44 being that of the principal payment at maturity. An initial offering of this bond to the market would allow the issuer to raise exactly \$100 ignoring transactions costs.

Assume now that the payment terms and risk of our bond do not change at all but that we view it as stock that is issued by a boring company. The company generates earnings of \$6 per year which it pays out entirely as dividends and liquidates its assets at maturity of year 10 and pays out their value which at that time is guaranteed to be \$100. If our company were to issue its stock with such a payment stream to the market, it would raise exactly \$100 since it would be no different in economic terms from a bond. As such, once the issuance is completed, the company would have a book value of \$100, which is the cash it raised and its stock would trade at \$100 just like the bond would. Obviously, the stock would be trading then at a Price/Book ratio of 1X, and a Price/Earnings ratio of 16.7X (100/6). Note also, that if our company did not pay any dividends at all until maturity, and simply reinvested the dividends at its internal growth rate of 6%, on maturity it should pay out \$179 - \$100 of our originally promised principal, as well as \$79 of retained earnings.

Wall Street would find the stock of our company very boring indeed. The company has no earnings growth nor does it need any more debt or equity to be issued. The fact that the company may be in a mature business with tough competition and that generating a 6% steady return requires real management skill is not a point for consideration. Managements such as ours here would be deemed of poor quality, and their stock would be cited as being "expensive" since we are paying a 16.7X P/E multiple for a stock with no growth. The investment bankers and their cohorts in the buy side would have to work their financial magic to transform this company.

Assume that our company above, after raising its \$100, decides to do a "restructuring". It tells you that rather than receiving \$100 at maturity, you will receive just \$50 with the remaining \$50 to be paid out to the CEO Benevolent Fund. This immediate \$50 reduction would mean loss in present value terms to you of \$27.92 today. However, in return for this restructuring charge the company promises to pay you a coupon of \$8 in the first year and \$16 in the second with the coupons after that guaranteed to be a minimum of \$6 (the old level). In present value terms, the additional payments would be worth \$10.79 assuming that payments from year three remain at just \$6 and do not rise. Then, the net cost of this restructuring to you would be \$17.13 (\$27.92 - \$10.79) which is to say that the company's book value drops immediately by that amount from \$100 to \$82.87. However, the company's earnings did go up to \$8 and \$16 in the first two years.

The important question now is what the market price of this restructured stock should be given that the company's tangible book is just \$82.87. The realist would argue that the stock should be priced at just \$82.87. After all, if this were a bond that would be the present value of the earnings stream and that was our rationale in purchasing the instrument originally at \$100 anyway. Sadly, the bond market is filled with boring realists.

The stock market however, sees the above transaction quite differently since it is a domain of optimists. Most analysts would be excited about this transformation since the company has now "increased" its earnings in year one from \$6 earlier to \$8, not to mention that in year two, its earnings are at \$16 - 100% earnings growth! Since two years is an eternity, projecting doubling ad infinitum is hardly a stretch. The last dividend payment (which for us is 10 years away) would be \$4096 so much so that our \$50 terminal payment becomes largely irrelevant. With these optimistic assumptions, the present value of the dividend payments alone goes from \$54.95 to a staggering \$4885.76. And if we were stupid enough to pay such an optimistic price for this stock, we would be buying it at a Price/Book ratio of 59X (gasp). Analysts should probably refer to this today as doing a google of a transaction!

The problem is that if one were even mildly optimistic about the company and believed that there was some real improvement in the company based on the observed earnings growth, the prices get completely out of kilter. Thus, if we were to assume that from year three, the dividends paid would not keep doubling but would stabilize at \$16 which is the second year's payments, you would still get a present value for such a stream of \$138. In fact, this company at \$100 today would be trading at a P/E 12.5X (100/8) on year one's earnings and 6.25X (100/16) on year two's earnings - a hyper-low valuation for 100% earnings growth. Our company with some simple financial machination has managed to make management better off by \$17.13, enrich Wall Street by the transactions that all the analysts would surely generate in the stock and amazingly, at face value, even provide a profit for the stockholder whose \$100 purchase is now worth \$138. And all this accomplished with nothing at all changing in either the company's business or its profitability. The alchemists of yore had nothing on today's financial engineers!

The stockholder who fancies himself smarter than the village idiot however, has figured out that his stock at \$138 is trading at 1.7X book and is thus overvalued. Accordingly he sells his holdings and even worse, probably expresses his negative views to others. However, this is where our magicians work the next trick. If our initial stock offering at \$100 were held by 100 people who each owned 1% bought at \$1 apiece, it is likely that the realistic group is in the minority. If now say 2% of the stockholders wanted to sell their stock, to do so post-restructuring they would need to receive \$2.76 (\$1.38 x 2). The company however, still generates cash of at least \$6 per year. Instead of paying it out to existing stockholders, it can forestall any perception that its stock is overvalued by simply buying back its own stock. Thus, if \$2.76 were spent to buy out all of the naysayers, the unwashed masses are even more convinced that their stock is worth much more. In fact, one can easily work the mathematics to show that such a buy back would actually "boost" earnings per share and that this transaction would be "accretive" to earnings. There is no doubt that the most realistic and intelligent of the stockholders are the company managements themselves. Even as the company coffers are emptied to buy back stock at wildly inflated prices, the managements are typically first in line to sell their individual holdings of stock.

The above example seems contrived but, unfortunately, it is all too true. Virtually all companies in the U.S., and to a lesser extent overseas, engage in totally non-economic mergers/acquisitions expressly for the purpose of taking charges to be released later as earnings, not to mention allowing managements to profit unreasonably at the expense of the stockholders as a group. Not surprisingly, the biggest champions for such deals are the managements themselves and their investment bankers who see in these transactions just a continuous stream of huge fees.

The value destruction caused by these transactions can be seen by looking at the tangible book values of companies over time. Virtually all major U.S. companies have seen substantial reductions in book value thanks to such charges and poorly executed mergers. Unfortunately however, the enthusiastic reaction accorded to these transactions just encourages our brave corporate chieftains to engage in even more such behavior. Amazingly, the prevailing mantra now is that book value does not matter – it is something even seasoned CEOs of mature businesses are willing to spout. This message is ably broadcast by our stock salesmen and analysts, not to mention even our policymakers who continuously talk of “new paradigms” or “strong productivity growth” to explain what is just a very old-fashioned confidence trick being worked on the investing public of the world.

The one clear message from all this though, is that the lifeblood of the global equity scam is the credit bubble. Without easy credit and gullible investors, such schemes are doomed. Companies cannot issue debt to buy back stock when their businesses are deteriorating and management is actively selling their stock, unless we have a truly naïve class of credit investors. The credit problems in the sub-prime arena that started in January put us on a very slippery slope. With so much excess in this arena, a marked, real deterioration in credit conditions could result in rapid reduction of risk and trigger a correction of crisis proportions. Such a crisis began in May 2006 but miraculously ended thanks to oil price declines as well as the mythical “stabilization” in housing. Both these supports are being eroded again and we feel that a much greater market adjustment is imminent.

Our largest single bet in the funds remains our short position in credit. We believe that the correction of January has much further to go and expect to be boosting our exposure at every opportunity. Also, as overall risk appetite declines, as it will with credit difficulties, we expect a major correction in the U.S. dollar led especially by the yen and the Swiss franc. Finally, the financial sector in the U.S., and some emerging equity markets are at life highs despite an overall environment that has become extremely challenging to say the least. We have significant short positions in financials already, but expect to be boosting them as well as participate in some of the more extended emerging markets as well on the short side.

2007 promises to be an exciting year for us. The cracks in the market façade have already started to appear in January – the whole edifice is now at risk and in that we smell opportunity and profit.

Performance Summary

Trident Global Opportunities Fund

Performance as at January 31, 2007

1 Mth.	3 Mth.	6 Mth.	1 Yr.	2 Yr.	3 Yr.	5 Yr.	YTD	Since Inception (Feb. '01)
0.0%	2.5%	-3.8%	-6.2%	2.4%	2.4%	2.2	0.0%	2.8%

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