

Trident Investment Management, LLC Opportunities Funds Commentary

February 28, 2007

Performance Summary

February was a month of turmoil in markets. Most equity markets fell with the S&P 500 index down 1.96%, and the MSCI Europe Index down 2.12%. The Nikkei bucked the trend being up 1.30%. Emerging markets suffered a sell off as well with the MSCI Emerging Market Index down 0.48%. The U.S. dollar was down 1.76% against the yen to 118.56 and down 1.97% against the Swiss Franc. Bond markets, especially in the short end rallied with the 2-year U.S. treasury falling in yield by 0.28% to end the month at 4.64%. Commodities fell with gold in particular dropping 2.22% to end the month at \$672 an ounce. The decline in markets this month was the worst since May 2006. Importantly, the credit markets also suffered in February with lower-quality credit spreads widening out to multi-year highs. (All returns in U.S. dollars)

Market Outlook & Portfolio Strategy

Conditions in the credit markets started to deteriorate in mid January 2007, with the sub-prime arena coming under severe pressure. The weakening in home prices over the last two quarters coupled with the steady rise in interest rates over the last few years have finally begun to take a toll on the weakest borrowers. These individuals entered into adjustable rate loans which typically had fixed teaser rates for a period of one to two years. The loans were taken out with little to no money down and the borrowers hoped to profit by a quick resale of the property purchased within the low rate period. For such a resale to be profitable rapid real-estate price appreciation was essential since leveraged housing magnates had to pay out both hefty brokerage commissions as well as prepayment penalties on their loans. The slowing down, if not outright decline in home prices over the last few months coupled with the higher short rates represent a toxic cocktail. Many of these sub-prime loans are resetting at dramatically higher interest rate levels making the monthly payments unaffordable. Moreover, the properties purchased have often declined substantially in value making a devastating capital loss inevitable. Thus, the default rates especially in lower-grade home loans have picked up dramatically, as have the losses experienced in every default.

The sub-prime problems are occurring despite the fact that the U.S. economy has been growing with low unemployment and steady if not improving wages. Home prices have risen considerably over the last few years and prices even for the last year seem to be almost flat or perhaps even slightly up on a national level despite some serious local problems. The deteriorating conditions are symptomatic of a financial system that has run totally amok.

The sub-prime lenders such as New Century Financial, Accredited Lenders and Novastar Financial all of which have gone in short order from being the darlings of Wall Street to potential entrants into bankruptcy court can be viewed as canaries in the coal mine of global structured finance. What is particularly worrisome is that the reasons for these companies' problems are all too apparent and their lending practices have been replicated to a significant degree even by the so-called "prime" lenders. However, most policymakers including Fed chairman Bernanke, parrot the view that the problems in the sub-prime market will be "contained" whatever that might mean. It would be instructive however, to consider the lending practices that have led to the sub-prime problems and why we believe that they represent a major problem that is only going to get worse over the next several weeks.

Mortgage originators such as New Century Financial are not banks. They function by identifying potential borrowers and determining how much they could be lent against properties that they wish to purchase. The borrowers targeted were typically those with poor credit scores or those who wanted to purchase houses with little to no money down so that the loan would have been inherently more risky. Once the firm qualified such a borrower for a loan amount, it would make the loan much like a bank, except that the funding for such a loan would come from "warehouse" credit lines from banks or others set up by the firm in advance to permit it to lend to its borrowers. Pools of loans thus made would then be securitized and sold to the capital markets through one of the many exotic structures that proliferate today such as mortgage-backed securities (MBS), credit default obligations (CDOs) etc. with varying degrees of recourse to New Century itself. Of course, in that process, the firm would take a handsome cut of closing costs and other fees, not to mention that Wall Street receives huge fees for executing these exotic structured financings.

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The issue of how the risk of these loans is shared is especially important since the losses on the underlying loans will be felt ultimately by those who carry the actual risk. An originator pools these loans and sells them to the capital markets but the structure used for securitization is dictated by the nature of the loans in question and the willingness of the originator to keep some residual exposure to them. To raise funds most efficiently from securitization of loans, the lender can resort to two main techniques. First, he could capitalize on differing risk preferences among buyers of the securitized deals by creating a senior/subordinated structure where purchasers of the subordinated securities are allocated more of the overall pool losses. This would mean that the subordinated bonds sold would have higher yields as well relative to the senior bonds. Depending on the level of risk exposure involved, the subordinated securities could be either bonds or alternatively “residuals” or equity participations in the pool. All these investment alternatives are similar, differing only in the degree of risk borne by the instrument. Under certain market conditions, it may be possible to arbitrage these risk preferences to completely sell a pool of mortgage loans with no recourse to the originator at all, and do so at a profit. That is the originator gets to profit from his ability to initiate and package these loans and leaves the risk to the capital markets entirely. However, such an outcome is often not optimal for the originator since he does have superior information in that he understands the borrowers and their properties best. By retaining some of the exposure to the loan pool either by retaining the subordinated tranche or equity piece himself or by being willing to take the risk on defaults for the loans for a stated period such as a year, he may be able to capitalize on his superior information and earn huge returns if he is correct on his risk assessment. Most securitizations involve one or both of the above techniques, sometimes with additional wrinkles such as a guarantee by yet another outsider party for the payments on the bonds.

The problem with the securitization alternatives is that it is very hard to measure and account for their risks. The originators may have substantial risk exposure to these loan pools even after they may have been “sold”. An example will make this clear. Let us assume a \$100 mortgage pool which is expected to sustain capital losses of 5%. If this pool were securitized with a 10% first loss subordinated tranche, it would mean that \$10 of bonds would be sold with the proviso that the first \$10 of losses in the pool would be borne by them. The remaining \$90 of bonds sold would be senior to these bonds in that they would not lose at all until losses exceed \$10 on the overall pool. Thus, if the 5% loss materializes as expected in the pool, the senior bonds would have no losses but the subordinated bonds would lose \$5 or 50% of their principal of \$10. So, even though the senior holders hold more debt, they actually take much lower risk than the junior bond holders – in fact, the entire risk of the pool with a 5% loss expectation is held by the junior bond holders. Of course, the \$90 of lower risk bonds sold against the pool are sold at yields that reflect the lower risk to the holder, even as the \$10 junior bond holder gets paid much better for taking the risk. Thus, if the underlying mortgages in the pool pay 8% interest and the senior bonds are sold to yield 5%, if there are no defaults, the loans will take in \$8 of income each year and pay out \$4.50 (5% on \$90) in interest to bond holders. This leaves the junior bond holder with a handsome \$3.50 in annual income on a \$10 investment which represents a 35% yield, albeit with an expected 50% loss rate. Thus, based on the terms of the securitization, the risk sharing of the actual pool ends up being radically different from a straightforward purchase of the underlying loans.

A number of companies have focused on the business of purchasing high-yielding residuals or junior bonds and have benefited from the exceptionally low loss environment we have observed in the last few years thanks to rising home prices. Most mortgage originators and banks have purchased considerable amounts of such instruments, as have a group of hedge funds, private equity firms and other leveraged investors. The recent successes of these investments has led most of our sycophants on Wall Street to worshipfully tout their excellent “capital discipline” in being able to generate over 20% returns even as their recent historical risk profile suggests that they take no risk. Such a track record begets even more capital flowing into such strategies so much so that yields on these super-high-risk leveraged tranches have actually plummeted of late to less than 15% or lower, though the risks have actually gone up considerably. In fact, even a relatively trivial analysis will reveal that most such transactions today will permit 15% yields in the best case with 100% capital loss under a variety of scenarios. Even when drinking the Kool Aid and believing in Goldilocks, one has to reach to construct an environment where purchasing such deals make any economic sense.

The residual ownership game has claimed many victims (who experienced over 100% losses and a barrage of lawsuits) over the years starting in 1986. Most accounting firms will therefore require at least some discussion of the risks in these instruments. Many of these risks are measurable relatively easily by using standard stress-tests that have long been applied to mortgage pools. But Wall Street has stepped in with creative genius to make identification of such risks virtually impossible. If these loans and/or bonds are packaged into Credit Default Obligations or other

exotics many of which are off balance sheet, the risks become totally opaque. A mortgage pool is already fiendishly complex. If we create a CDO which is an instrument representing a pool of bonds issued with differing risk-sharing metrics against a group of these mortgage pools, the work required to perform a risk analysis of the CDO itself would tax an Einstein. Of course, we could resort to just looking at market pricing of the bonds underlying CDO instruments and measure risk just in terms of these component prices. However, in a stroke of inspired creativity, Wall Street has created these structures so that they do not need to be marked to market. In fact, and I wish I were joking, CDOs are typically expected to be held to maturity since they are so “riskless”. They are carried at cost unless there is an explicit ratings downgrade which from experience we know almost never happens until after the problems have already surfaced. They may also be marked down by holders and/or issuers when there is a substantial deterioration (whatever that means) in a large enough number (whatever that is) of the underlying mortgage pools. This whole methodology is a bit like guaranteeing a decline in lung cancer incidence by no longer requiring early detection testing of at-risk patients – when the problems finally surface, the patient is sure to be near death.

So, let us recapitulate the mortgage story – originators of these loans lend money to borrowers who really cannot pay. They do not worry about careful checking or analysis of the borrower because they hope to sell 100% of the loans they originate without any recourse, while earning handsome fees for the same. Wall Street has no incentive to police these loans since they get paid fees to create the arcane structures to disguise the risks in these pools and their responsibility stops with that. The purchasers of these loans through CDOs effectively can hide losses for a considerable period of time while booking superior returns by simply not needing to mark to market. Of course, the geniuses managing these purchases will get paid for their “superior performance”. And the originator, or other financial players such as hedge funds, can participate in this game to further boost returns by purchasing disproportionate amounts of the risk in these loans in the form of residuals or subordinated debt (now euphemistically called Credit Enhancement Securities rather than Structured Highly Innovative Tranches) to profit from buoyant home prices. What an amazing thing financial engineering is! A badly conceived loan is miraculously transformed into something that pays fees to a number of players along the financial food chain when it was totally unprofitable on a risk-adjusted basis even on day one. This is the incredible “productivity” no doubt that Alan Greenspan and now Ben Bernanke continue to cheer – the concept of U.S. ingenuity has come a long way from the Wright brothers.

The main question facing us now is what will cause this whole edifice of lies to collapse. The experience of some of the recently originated loans is instructive in this regard. The recent turmoil at New Century and other sub-prime lenders shows that there has been such a relaxation of credit standards over the last few years that the actual pattern of defaults now is considerably different than in past cycles. In the past, most borrowers could be expected to make their monthly payments for at least a year because even rudimentary qualification of the borrowers’ prospects would permit the lender to weed out the obvious risks. More seasoned mortgages typically defaulted simply because many defaults arose from a change in employment or other conditions which take time to play out. Amazingly today, a large percentage of loans that have just been issued have been defaulting with many borrowers not even being able to make their very first payment

A number of securitizations by the sub-prime originators were done with a 90 day or 1-year loan warranty where the originator is required to buy back the loan at cost if from the securitized pool when payment history suggests that the whole loan might be a virtual fraud. Such put-backs to issuers have risen dramatically in the last year so that anyone who says that these issues were not obvious until the last few weeks could give Rip Van Winkle a run for his money. The put backs coupled with increasing loan defaults overall have virtually wiped out a number of sub-prime issuers – by last count, no less than 33 of such originators have gone bankrupt in the last few weeks.

The mechanics of sub-prime packaging however, are mirrored in virtually all debt markets including the so called prime markets. The sub prime originators were the most exposed by far when reality bit. To argue that the problem here will not spread is not a statement about the quality of loans elsewhere in the economy. Rather it is an opinion that totally extraneous factors such as future Fed rate cuts, global growth or something else (sunspots) can prevent the spread of this financial problem. Witness thus, that most of these opinions are advanced without any discussion about the leverage in the financial system or the possibility of systemic risk based on history, even by Fed Chairman “Helicopter” Ben. This rosy view of the sub-prime morass is similar to taking the position that a disease has been eradicated because the sickest patients have died. That view could certainly be correct were it based on a rigorous examination of the disease. But how

much confidence should one have on such an “examination” as performed, not by a group of degreed doctors but by a group of faith healers? And let us not even dredge the bigger issue that the health crisis started in the first place because these faith healers encouraged irresponsibility in diet because of the existence of all-curing manna that they could magically produce.

The mode of resolution of the credit issues in the U.S. will be critical to forecasting markets in 2007. The existence of and continued appetite for these exotic credit instruments is what allows the “carry” trade of borrowing in low yielding currencies such as the yen to even be considered. Remember that Japanese interest rates have long been close to zero. The yen is being employed in these carry trades to a significant degree now only because the risk of leverage has magically been “reduced” by financial engineering. Anything that calls our financial beavers’ products into question should ultimately result in a painful unwinding of the carry trade which in turn will inflict major damage to most asset classes. We have a bleak prognosis for the global markets for 2007. The carnage has started much as it did in early 2000. It should continue.

We are substantially short sub-prime and other related credit plays. We boosted our exposure to this sector in January and continue to be amazed that despite huge problems at a few players in the area, the continued belief of markets is that the problem will not spread. We also continue to build up our short position in the U.S. dollar against the yen, the Swiss Franc and the Euro – enough credit tension and a dollar problem should surface as the U.S. economy weakens. And were that to happen, we have a smorgasbord of consumer related opportunities on the short side to choose from, even as we have no shortage of defensive ideas such as European short-term bonds, U.S. consumer staples etc. that might come more into vogue. We had a very strong month in February when all indications suggest that we are still in the first inning of this credit game. We expect to score much more as the game continues.

Performance Summary

Trident Global Opportunities Fund

Performance as at February 28, 2007

1 Mth.	3 Mth.	6 Mth.	1 Yr.	2 Yr.	3 Yr.	5 Yr.	YTD	Since Inception (Feb. '01)
3.3%	4.1%	0.9%	1.3%	2.0%	2.5%	2.7%	3.3%	3.3%

CI Global Opportunities Fund

Performance as at February 28, 2007

1 Mth.	3 Mth.	6 Mth.	1 Yr.	2 Yr.	3 Yr.	5 Yr.	YTD	Since Inception (Feb. '01)
7.7%	5.2%	1.4%	1.2%	0.7%	-1.1%	-0.2%	6.6%	15.9%

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