

## Trident Investment Management, LLC Opportunities Funds Commentary

June 30, 2007

### Performance Summary

Equity markets paused in June after their strong performance over the last two months. The S&P Index was down 1.66% and the MSCI Europe Index was down 0.23%. The Nikkei however, bucked the trend being up 1.51%. Bonds continued their sell-off with the 10-Year U.S. Treasury rising in yield 0.14% to end the month at 5.03%. Oil rose with WTI crude finishing at \$70.68 US a barrel, a gain of almost 9%. The U.S. dollar was down slightly with the dollar depreciating 0.46%. The big moves in the month were in asset-backed credit where the lowest rated credits suffered with their spreads widening to multi-year highs (all returns in U.S. dollars).

### Market Outlook & Portfolio Strategy

The asset-backed credit meltdown in June was precipitated by problems in two credit-focused hedge funds managed by Bear Stearns. These funds were heavily leveraged and long speculative credits and credit derivatives. Both funds had extensive holdings of Collateralized Debt Obligations (CDOs) which are bonds that are backed in turn by other bonds or credit derivatives. Some of these CDOs suffered sufficient losses that required a markdown of their values. However, with the significant leverage in these funds, these write-downs led to severe losses that resulted in investor redemptions which in turn triggered further asset sales and losses in the asset backed credit markets. The problems with the Bear Stearns funds deserve attention because they are symptomatic of the larger issues facing the entire credit industry.

A simple analogy would help us understand the credit situation today. Consider the idea of building a house in the flood plain of a river. The area would provide a terrific view and ready access to water sports, but with a substantial risk of catastrophic flooding. Few people, if any, would be willing to live in such an area however despite its attractions. However, a few years with no floods might convince an intrepid few to put up houses there. Such houses might be strongly constructed with a deep foundation and raised flooring given the flood concerns, but are unlikely to be particularly luxurious given the undesirable nature of the overall area. And of course, these inhabitants fully understand that a major flood would destroy their houses requiring them to move or rebuild.

This can be likened to the situation in the sub-prime lending arena as late as the year 2000. There were a few brave lenders who ventured into this territory for the higher returns it provided, but like the houses in our analogy, the loans in question were structured very carefully to avoid the problems obvious with operating in this space. And all lenders here knew that a recession or other distress event for their less-than-creditworthy borrowers would mean significant losses that they needed to control in the context of their overall portfolios.

A few years of low rainfall and no river flooding would make the public much less concerned about the risks in the flood plain. Many could be convinced then that buying houses in the flood zone might be a good idea given their low prices. Numerous brokers and middlemen would, no doubt, commission studies showing that major floods would not occur going forward using both the recent history and a variety of self-serving facts such as increased deforestation to explain the recent lack of rainfall and how it was going to persist. Several "experts" would be co-opted into providing these analyses so that even the more concerned groups would be convinced of the logic of building in the region. Thus, it is likely that insurance companies, which previously would not have considered

insuring in that zone would start insuring the houses there albeit at higher premiums and lenders who believed that lending against houses there would be a high risk venture would slowly relax their lending guidelines. These factors could contribute to a land rush into the area a period of sustained building in the area.

This situation is analogous to what transpired from 2002 to 2003 in the credit markets. After the U.S. “recession” of 2001 and the publicized problems with telecom debt in 2001 and 2002, most of the bad news had been factored into credit prices. We entered then a period of improving fundamentals an improving global economy, low interest rates and declining default rates. Not surprisingly, credit spreads narrowed as did credit insurance costs, so much so that we had a steady increase in the amount and availability of credit – the building boom of our analogy was in full swing.

Now in our flood world, consider what happens when there is a year of reasonable rainfall and there is a minor flood. The authorities, well tuned to the risks, react promptly building emergency levees and making sure that rising waters of the river are kept from the flood plain. The unfortunate part about these actions is that they encourage the public to believe that the area is forever safe. Anyone who is still concerned about floods is deemed a doomsayer because recent history with a real flood has proved that the damage will be limited and that it can be controlled. Now is when the real mania begins. The previously worried building inspectors and others who ensured construction safety now accept much more shoddy construction because it was proved that even poorly built houses were not damaged in the recent crisis. Insurers flock to insure houses there since these are now very low risk. Lenders believe they have a golden opportunity to lend to undervalued properties with significant appreciation potential.

In the credit world, this was the situation from mid 2004 to early 2007. A few recession and default worries of 2005 and 2006 were proved unfounded, especially since the Federal Reserve could be relied upon to cut rates to save the system. Rampant problems with credit excess and fraud such as with Fannie Mae were all but irrelevant since lawmakers could be relied upon to provide government bailouts. Hedge fund failures such as Amaranth were minor casualties given that the deep pockets of the banking system could salvage if not profit from the situation. Problems with individual loans at the borrower level were easily refinanced into lower rate loans with more cash taken out. All the prompt actions by policymakers and major players served to convince investors at large that there was no more risk in credit.

Unfortunately, in our flood plain, things have been getting a little less rosy. Rainfall has been very heavy of late and the river has risen to worrisome levels already. The local officials have reinforced the levees but realize that for a real flood their defenses are woefully inadequate. They also have to contend with a blithely oblivious public which, even seeing the rising river waters, believes that things are satisfactory. Moreover, since the authorities were supposed to regulate building standards and risk guidelines for insurers and lenders, they recognize that if the flood does occur with its attendant damage they would face at least figuratively a lynch mob.

This is the situation in credit today. The sub-prime defaults in the mortgage arena are already ominously high and the national decline in home prices which is the first we have seen in the U.S. since the Great Depression is another terrifying sign. Banks, thrifts, credit and mortgage insurers are simply not in any position to weather a real credit contraction and an attendant recession. And the public is entirely clueless about the risks of this credit accident were it to happen.

The important question in our example is just what should the policymakers do given the increasing risks of a catastrophic flood? Do they raise the alarm and cause general panic? Do they move their own families quietly to higher ground and then wait for the flood to hit and claim later that it was totally unanticipated? Do they do nothing in the hope that the river waters subside? In fact, this problem becomes more and more urgent as a few members of the public start raising concerns about the rising river – how can the authorities deny this reality? The sad part is that no course of action is entirely satisfactory. The sobering truth is that nothing can be done to save the houses in the flood plain although raising the alarm quickly might at least save lives at the expense of some unpopularity if the river does subside without generating too much damage. The policy mistake which was the uncontrolled growth of housing in a dangerous area has already been made – one can only live with the painful consequences.

The unfortunate thing is that an environment of danger also engenders some of the biggest conflicts and frauds. Consider what could happen if the river has already started to overflow its banks in a few areas, flooding several houses. The large property investor groups in the region will probably pay off these homeowners to remain silent about the flooding of their houses even as they rush to sell their own property holdings to the public. The cost of buying silence is still very low compared to the losses that they might suffer based on their large holdings not to mention the lawsuits that may arise from the shoddy construction and fraud on the houses they have already sold. The policymakers here have to choose between this “free-market” outcome and the ethical choice of making the public aware of the facts. Unfortunately, serving the public interest could result in a significant loss of personal prestige and future job opportunities. Selling out to the property groups, builders and other large players from whose cadres the governing board themselves hail, however, is a far more palatable alternative.

Policymakers, especially in the US, are faced with the same dilemma of the flood plain leadership. The mistakes have already been made in credit. The question is how to deal with them. The debacle in the Bear Stearns credit hedge funds shows just how willing both the authorities and the large intermediaries are to hide these mistakes from the public.

The Bear funds which had large positions in CDOs carried most of them (even the riskiest) at cost. A small markdown in a few of these triggered large losses in the funds prompting a few alarmed investors to redeem. The logical outcome in such a situation would have been a forced sale of these assets with investors and lenders to the funds being forced to accept the losses that would have occurred. Such a forced sale of these illiquid CDO securities was in fact considered but was abandoned after it was realized that many assets held at cost on the funds’ books might be worth as little as 50 cents on the dollar. Also, such a sale of these assets would have meant that everyone else who held these assets might well have been forced to mark them down given the low market values they commanded. This in turn could have wiped out the earnings of many of the large banks, brokerage houses and fund managers if not put them into outright bankruptcy. That is an unpalatable outcome that most financial institutions and regulators would like to avoid or at least postpone, even if the facts are undeniable. In fact, given the large pipeline of LBO and private equity debt deals in the investment banking pipeline, a gullible investor who is taken in by the lipstick on the pig is a virtual requirement.

Our example may seem contrived but it does fit the facts. The credit sell-off that started in late January of this year miraculously reversed in March and April only to resume in May. In June, it has become clear that we in the middle of a full-fledged debacle that is sure to have enormous consequences for global markets.

Our largest holdings in our funds remain our massive shorts in credit, and especially in sub-prime related credit and in the lenders focused on the same. We have recently added to both holdings. We continue to believe that the authorities in the U.S. are going to fight the consequences of the credit problems that have already started. Accordingly, we have boosted our long positions in gold and gold stocks, our shorts in the U.S. dollar against a basket of its trading partners as well as our long position in short-duration, risk-free, sovereign bond instruments. June was a very profitable month for us because our bets, especially in credit, started to work again after a two month hiatus. If the credit trends of June continue and spill over into the other markets, we would expect our strong performance to continue.

Performance Summary

**Trident Global Opportunities Fund**

Performance as at June 30, 2007

1 Mth.	3 Mth.	6 Mth.	1 Yr.	2 Yr.	3 Yr.	5 Yr.	YTD	Since Inception (Feb. '01)
4.2%	-4.6%	1.9%	-2.8%	4.0%	2.0%	2.5%	1.9%	2.9%

**CI Global Opportunities Fund**

Performance as at June 30, 2007

1 Mth.	3 Mth.	6 Mth.	1 Yr.	2 Yr.	3 Yr.	5 Yr.	YTD	Since Inception (Feb. '01)
6.1%	-0.2%	8.8%	0.9%	5.4%	0.9%	1.3%	8.8%	15.6%

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