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MONTHLY UPDATE

Trident Investment Management, LLC
Opportunities Funds Commentary

April 30, 2010

Performance Discussion

The month of April may have marked the end of the euphoric run that markets have had since late February. The S&P 500 was still up 1.5% on the month, but reversed from its highs made during the month. However, the MSCI Europe Index and the Nikkei finished down 1.4% and 0.3% respectively. The commodity markets benefited with gold up 5.9% to end at $1,179 and ounce and oil up 2.9% to end at $86.15 a barrel. The bond markets rallied with yields on the U.S. 10-year Treasury falling 17 basis points to end at 3.655%. The credit markets were virtually unchanged also, though they widened from the tight levels hit mid-month (all figures in U.S. dollars).

Our funds suffered during the first few weeks of April, but reversed in the last few days as our positions began to pay off. Our long gold position contributed the bulk of our performance. Our curve steepeners hurt our returns and our credit and Australian fixed-income returns were flat. We have added to several of our core positions over the month and believe that we are well positioned to benefit from the turn in market psychology that may have already started

Extreme views and investing

For a while now, we have been concerned about conditions that prevail in the world. We have raised concerns regarding the macro imbalances we observe globally, and the lack of effective policy measures so far to arrest what we perceive to be an unavoidable slide into a new crisis. Those familiar with our views could rightly question whether we are being too pessimistic and whether the consequences we expect are in fact "tail" events that might never come to pass. Many concede that we might be correct on our fundamental views but question the timing and believe that the current investment paradigm could remain operational for years. We will address these issues in greater detail below.

Our investment discipline fundamentally requires that we focus on facts. We believe that our edge comes from being able to analyze the macro forces that shape global markets and being able to consider them in conjunction, rather than in isolation, and with a proper historic context.

Most observers analyze policies across countries only in terms of their effectiveness on their respective economies without considering how they might interact on a cross-border basis. Consider thus that China in an effort to boost domestic growth in 2009 added considerable production and export capacity even though the world was very short of demand. While this might have been a rational domestic policy, it could well prove totally inappropriate from a global context. Also, numerous analysts look at conditions within a given country's market and opine about them with reference to the history in that market alone, with little attention being paid to how similar countries may have performed in equivalent circumstances. Thus, for example, many observers acknowledge the similarities between the U.S. today and Japan in 1991. However, they are dismissive of the Japanese response and uniformly praise the recent U.S. policy measures, even though the Japanese experience would suggest that many of the U.S. policies are almost certain to fail.

Translating our facts and analyses into fund performance requires that we contend with market psychology and hope, which can often conspire to keep prices totally divorced from reality. The efficient markets hypothesis that has served as the cornerstone for most of the academic thinking in finance over the last several decades says that market prices discount all available information, with the stronger version of this theory arguing that even hidden or insider information is appropriately discounted. The efficient markets view does not opine about the process of price adjustment since it represents a static snapshot of market pricing. That is, markets are assumed to be in an equilibrium that reflects all available information and the process by which prices move in response to information is outside the scope of the theory. There is no role for market psychology or herd behavior in this view at all. That is, market prices are always "right" in that they fully reflect fundamentals. Unfortunately, significant economic research, of which most financial practitioners are unaware, suggests that market prices may often not track fundamentals at all.

Does human nature encourage speculation?

The field of experimental economics conducts tests under controlled conditions to study the validity of various economic theories and market mechanisms. This field is not considered part of mainstream economics and is rarely discussed at length in most academic programs. Of late however, this area has gained in credibility. The 2002 Nobel Prize in Economics was shared by Daniel Kahnemann and Vernon Smith. The former is well known for his work on the psychology of decision making and behavioral economics. The latter pioneered the field of experimental economics largely with a view to studying the performance of various economic institutions. Smith conducted a sequence of experiments related to financial markets with their results being summarized in a classic 1988 paper called appropriately *Bubbles, Crashes and Endogenous Expectations in Experimental Spot Asset Markets*. A number of additional experiments in the same vein were performed by others as well and the results were instructive to say the least. We discuss these findings below at greater length.

A number of market trials were conducted with a very simple financial asset that participants could understand easily. The asset had a finite lifespan of ten periods. In each period, it paid an uncertain dividend of either 0 or 20 cents with equal probability. Trading occurred in each period before dividends were determined. The stream of future dividend payments determines the theoretical value of the asset. Given that the expected dividend in each period is 10 cents (50% of 0 + 50% of 20), the value of the asset in period 1, assuming no time value for money, before dividends were paid should be $1.00 (or 10 periods times 10 cents). After the first dividend period, this value declines to $0.90 since only 9 more dividends are receivable and so on. At the end of the experiment the terminal value of the asset is 0 since all dividends have been paid. Clearly, this asset has a theoretical value which is a declining straight line starting at $1 at ending at $0.

In the efficient market world, the asset above should trade exactly at its theoretical value for all periods. The goal of the experiments was to determine how the asset would be priced in a variety of market environments where the nature of the participants involved was well understood. In one environment (call it Market A), the market participants were all novices who had never traded the instrument before. In another (Market B), there was a mix of experienced (meaning actual traders) and novice participants. A number of trials were run with these market structures with some involving repeated participation by the same subjects.

The results of the above experiments were eye-opening. Most of the experiments resulted in prices for the asset being *far* above theoretical values, even when participants were told what the theoretical values were before the start of the period. Since the terminal value of the asset was always zero, a crash to fundamentals with large capital losses inevitably occurred. Thus, even with perfect information, bubbles were created. In fact, they were created even when the participants were all experienced and trained in the valuation fundamentals before the experiment. It was not until the same participant had played the game with the above trivial asset about three times did the prices start tracking fundamentals. The key point to note in these experiments is that even with common, widely known information on a relatively trivial asset, participants do not have common initial expectations regarding the value of the asset. Hope, faith, optimism and whatever else condition the participants to be overly optimistic and to behave in herd fashion. So, bubbles were created even with no real preconditions for the same.

A real market is considerably more complex than the experimental one above. Most financial assets have uncertain payoffs, the time value of money varies across market participants and the investor mix is unclear though it certainly includes both novice and expert investors. The above experiments suggest that the tendency to form bubbles might already exist in our psyche even without external help. Any attempt by policymakers to urge the markets upwards only adds to what is already a natural human impulse. In fact, the greater the participation of novices in markets be it due to online trading, CNBC mania, or the need to deal with unemployment, the more certain it is that repeated bubbles will occur.

From market views to investment opportunity

These experiments raise an important question for professional investors such as ourselves. That question, which is surprisingly difficult to answer, is exactly what one should base investing on. Should one invest based on the fundamentals? Or should one focus on the psychology that drives market thinking which in turn is highly influenced not just by policy but also by the current mix of investors? The only approach that we are comfortable with is one that focuses on the fundamentals – after all, most would agree that pricing at some point has to revert to fundamentals be it with a whimper or a crash. But this leads to one inescapable conclusion: **we have to base investing on the likelihood of the various fundamental scenarios and not on the market's presumptions of the same. It is in fact the divergence between market perception and reality that creates investment opportunity.**

From this vantage point, it is much easier to respond to both the questions we started with. We believe strongly that we are lurching into a new market crisis. We have rather simple reasons for thinking this way. Every developed country in the world today, with minor exceptions, is creaking under the weight of too much debt. The US, UK, Japan and the Eurozone as a whole all have debt that cannot be serviced in the long-term barring substantial adjustments to the standard of living. The policies that have been adopted in the U.S. and the U.K. have so far involved explicit monetization of the debt, with the U.S. in particular dramatically increasing its overall expenditure to contend with a weak economy. Japan has yet to make any significant fiscal adjustment but has also resisted the pressure to expand spending. While the country's debt is already perhaps at crisis levels, it has resulted from both chronic deflation and an aging population and has accumulated gradually over the last two decades. The European Union is the only region of the world that has actually tried

to make the fiscal adjustments necessary to live within its means thanks to the Maastricht treaty that governed the EU's formation. However the adjustment, especially in the Southern European countries of Greece, Spain, and Portugal could well be so significant that it might become politically impossible. This in turn has prompted markets to demand higher interest rates which in themselves push these countries closer to the brink of default. Overall, though, the developed world appears to be close to hitting a debt wall.

The problem in dealing with the accumulated debt is that much of the developed world faces a problem of solvency. Most of the countries with too much debt lack any real assets that can be sold to reduce it. Moreover, their fiscal deficits are increasingly becoming permanent as entitlement spending has ballooned even as tax receipts have declined. While increased taxes are a virtual certainty, the tax net covers a relatively small percentage of the population, especially in the U.S. As such, any dramatic increase in tax rates and coverage could tip the developed world into a deep recession where the ultimate repayment of the debt would be even more in question. The only hope is a dramatic improvement in global growth coming from strong performance by the developing countries. The previous global locomotive, the U.S. consumer, simply does not have the wherewithal to continue with the torrid pace of consumption of previous years.

While the developing countries are in much better shape than the developed world on the macroeconomic issues, they are simply not large enough to serve as a locomotive for global growth in the near term. China, which has had one of the strongest economies of 2009, generated the bulk of its recent growth with an investment and infrastructure boom, coupled with a massive real estate bubble. In 2009, the country added substantially to its excess production capacity. Even worse, since housing is one the largest single expenditures for most Chinese households, the rise in home prices and virtually zero bank interest rates have actually prompted families to save even more to be able to make their first home purchase. This has meant that an economy where consumption already represents a paltry 36.4% of GDP is becoming even less consumption oriented – hardly a healthy outcome for the rest of the world. An urgent requirement for China is to tighten policy to quell rising home prices. While this might create some near term problems with a possible hard landing for housing, this is an adjustment that the country has to make for longer-term stability. Of late, the government has become increasingly vocal in its desire to rein in the housing market. A number of administrative measures have been put in place to halt speculation in real estate and the market for second and third homes has virtually ground to a halt. Anecdotally, it appears that home prices have started falling in many of the secondary Chinese cities in the last few weeks. China is in the process of having a post-boom landing – the jury is out on whether the landing will be a soft or extremely hard one. Any Chinese slowdown is sure to have knock on effects on other large developing economies, such as Brazil, that are huge exporters of commodities to China. If this is coupled with a liquidity crunch that might arise from a developed world debt problem, a transition to the developing world for growth leadership could be questionable.

So, to list the potential issues the world faces today:

1) The debt levels in the U.S., U.K., Japan, Greece, Spain, Portugal and Ireland are all out of control.
2) The Euro zone is under severe distress because reining in deficits to ensure that debt is repayable is proving hard to put into practice given the already serious recessions in the countries involved.
3) The Chinese economy needs urgently to rein in its real estate bubble. This appears to be happening

already, but it is unclear how painful the accompanying economic correction will be.

4) Global growth has largely been driven by inventory restocking and hopes of future demand over the last year. Any perceived slowdown in future growth and we could easily be back in a double dip recession. In fact, given the state of the U.S., Chinese and European consumers, it is unclear who, outside the already indebted governments can dramatically increase consumption.

With all these issues to wrestle with, few could argue that things are anything like normal in the world today. A benign resolution, even in theoretical terms ignoring global political realities, is hard to envision in this environment. The most likely outcome is a crisis (or crises) that might force dramatic global changes. Observers could legitimately argue about where such a crisis might start. A Goldilocks world where everything is pleasant is highly unlikely and represents a "tail" outcome. Put differently, accepting the global situation and positioning for what could ensue does not make us part of the lunatic fringe. In a market that is actually efficient, we should represent the consensus view.

Most markets today are pricing in the Goldilocks tail outcomes. In terms of payoffs, these outcomes currently provide meager profits with potentially huge losses if one is wrong. We see compelling payoffs with little risk in betting against the current consensus. As such, the question of how long the current environment might last is almost moot. Adopting the market's thinking today is tantamount to moving into the first floor of a house whose upper storey is burning, secure in the fact the ceiling will not collapse. Will the collapsing ceiling telegraph enough signs to ensure painless escape? And if you ignore the early warning signs of impending doom, how do you leave when the collapse has started? The economic experiments above suggest in general that the collapse, when it does happen, occurs very quickly. This is simply because most participants recognize that when the buying slows or stops, they all need to exit at the same time. In our house analogy, if the house exits are jammed with fleeing folk when the ceiling collapses, the chances of a safe exit decline precipitously.

Timing the potential payoff

The signs today that a market crisis might be imminent are legion:

1) The U.S. Federal Reserve stopped its program of quantitative easing at the end of March 2010. The massive debt issuance of the U.S. government now has to be absorbed by market participants with a corresponding decline in liquidity available to other markets.
2) Most housing tax credits (in the U.S., Australia and China in particular) should expire within the next few weeks. The artificial support to housing so provided and the pulling forward of demand could well result in a second leg down in housing.
3) A rate hike by the Chinese appears imminent. Even a serious attempt by the Chinese to rein in runaway housing prices through administrative measures, which is already happening, will mean a reduction in Chinese credit availability.
4) Europe does not seem ready to engage in quantitative easing. Germany given its Weimar hyperinflation history, seems against such a move. Any shift in European policy without Germany's assent might result in a fracture of the political union itself.

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5) The U.S. legislature seems intent on passing a financial regulatory bill that will make some attempt to separate the banks' trading activities from their traditional payments and lending functions. Such a move could well result in significant uncertainties and market disruption.

Conclusion

We have added to several of our positions over the last few weeks. We have significantly increased our long positions in Australian fixed-income believing that a market crisis and a global growth scare are both imminent. The options which we use to express this view became considerably cheaper over the last few weeks thanks to a collapse in volatility, providing us with excellent potential payoffs. We have also added to our short positions in credit. The Euro sovereign debt concerns have not translated into an equivalent blow-out of corporate credit spreads either in Europe or in the U.S. Markets are now afraid of government risk, but, remarkably, not about the companies in the countries whose governments they worry about. A period of credit revulsion seems likely and we are positioned to profit in such an event.

With numerous macro imbalances and huge uncertainty about their ultimate resolution, the world today seems exceptionally risky. Markets, despite recent selloffs, still expect a relatively benign set of outcomes which are also the least likely in our view. The chasm between perception and reality suggests that exciting, and hopefully very profitable times, are ahead for our portfolios.

Performance Summary at April 30, 2010

Trident Global Opportunities Fund

1 Mth.	3 Mth.	6 Mth.	1 Yr.	2 Yr.	3 Yr.	5 Yr.	10 Yr.	YTD	Since Inception (Feb. '01)
0.0%	-3.0%	-4.9%	-5.8%	12.7%	35.5%	21.1%	N/A	-3.0%	12.6%

CI Global Opportunities Fund

1 Mth.	3 Mth.	6 Mth.	1 Yr.	2 Yr.	3 Yr.	5 Yr.	10 Yr.	YTD	Since Inception (Mar. '95)
0.0%	-2.8%	-4.5%	-5.4%	15.0%	38.8%	22.3%	6.7%	-2.8%	19.8%

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