

Trident Investment Management, LLC Opportunities Funds Commentary

August 31, 2008

Fund Performance

The sell-off in oil that started in July continued in August with the commodity falling \$8.62 to \$115.46 a barrel. This improved sentiment in the equity markets with the S&P500 Index up 1.45% and the MSCI Europe Index up 2.01%, but the Nikkei was still down 2.24%. Gold suffered with oil, falling \$87.50 to end at \$835.2 and ounce. Bonds rallied with yields on the two and 10-year U.S. Treasury notes both down 0.14%. The U.S. dollar continued its ascent from the previous month with the U.S. dollar index appreciating a whopping 5.67%. The credit markets remained in the doldrums with credit spreads approaching the wide levels last seen in early April (all figures in U.S. dollars).

We had a volatile month in August and finished fractionally down. Our equity and gold positions hurt us substantially, especially since the fall in oil prices caused a rally in consumer sensitive stocks which make up a large part of our short exposure. Our losses were mitigated by our positions in short-dated fixed income in Australia and the U.K., both of which benefited from declines in short rates. Our credit positions also helped performance during the month. We expect continued declines in gold and other commodities for some part of September and are hoping to get good entry points for building up our existing positions.

Market Outlook & Portfolio Strategy

A phenomenon observed in the foreign exchange markets is that exchange rates may often deviate from what fundamentals might suggest, and may do so for extended periods of time. In particular, the futures market for the Mexican peso in the years leading up to the 1977 devaluation valued the currency at a consistent discount to what was the ultimate spot price which in turn was relatively stable. The reason for this constant mispricing in the futures market was that participants understood that there was a chance of a large devaluation in the currency and as such, any position in the currency had to compensate holders for the probability of such an action. Therefore, any analysis of the peso's pricing in the period prior to the 1977 devaluation would have concluded that the market was inefficient unless explicit attempts were made to factor in the probability of devaluation. Put differently, the risk of a significant external event made the peso's price deviate from what an analysis of its pricing history would have suggested. This variation between analysis and reality that arises from outside factors is typically referred to as the peso problem in the international economics literature.

In looking at the financial markets today, I am struck at the degree to which prices, earnings and accounting forecasts all seem to be divorced from reality. We appear worldwide to be operating with a gigantic peso problem. Most market pundits, rather than trying to clarify these unusual dynamics, are instead justifying observed price action by inventing fanciful explanations after the fact. We feel it might be instructive to look at the current reality, and then to identify the external risk factors that we feel are precluding prices from moving to the levels suggested by the facts. Our analysis is of necessity rather simple, but nevertheless will highlight some of the factors of most concern to market participants.

A number of things stand out immediately in the global economy. The U.S. remains the largest single borrower in the world with its trade deficit still in excess of 5% of GDP. The U.S. consumer is exceptionally leveraged and has been using debt over the last several years to fund consumption. The U.S.' trading partners have relied on their exports to the U.S. to power their domestic growth and as such have kept their exchange rates effectively pegged to the U.S. dollar with the Asian countries being the worst offenders in this regard. Because of these policies, there has been no discipline exerted on the U.S. by its lenders overseas – the country has been able to amass huge external debts, albeit denominated in U.S. dollars, while keeping dollar interest rates relatively low. U.S. monetary authorities compensated for the inflow of imports and the

corresponding destruction in the country's export sector by keeping real interest rates low to negative. This resulted in a domestic boom especially in real-estate that by the start of 2007 had become a gigantic bubble. In fact, so easy was U.S. monetary policy, that most of its trading partners who pegged their currencies also started running domestic real estate bubbles. With strong growth through much of 2007, limited resources such as oil, industrial metals and food were in short supply so that the world paradoxically faces a problem of significant commodity inflation today.

The economic conditions have been made more precarious by the credit dynamics that accompanied the real-estate bubble. The financial system in the U.S., and to a lesser degree in much of the developed world, saw tremendous growth in lending thanks to inflated bubble valuations of real estate and other assets. Most financial institutions expected asset prices to increase indefinitely, and therefore speculated with abandon using significant leverage. In fact, whole new classes of derivatives were created for the express purpose of channeling funds to fatuous projects typically in real estate. These toxic instruments could reasonably be expected to have little to no value in the event of a real-estate or credit market decline, but such was the optimism that prevailed over the last few years that most institutions were willing to take on these opaque and risky positions with leverage having done little to no analysis.

With the bursting of the real-estate bubble that occurred in late 2006, the situation in the global economy has become precarious. To the extent that strong growth and inflation were induced by bubble dynamics in the real-estate and credit markets, they could both reverse quickly as the bubble deflates. This in turn is going to be very painful since it carries the risk of a synchronized global slowdown that could turn into a global depression. The phenomenon of over-consumption with leverage obtained from bubble wealth is most pronounced in the U.S., the U.K. and Australia, and one can expect that these economies should suffer the most when the bubble deflates. The rest of the world will suffer too, but indirectly through the trade channel. The collapse in asset values due to the deflating real-estate bubble has also meant that the credit bubble that occurred in funding these projects has started to come apart as well. Much of the financial system that had engaged in aggressive consumer and asset-based lending is now in trouble. In particular, the U.S. Government Sponsored Enterprises (GSEs), Fannie Mae and Freddie Mac, are technically insolvent already. Many large U.S. and European banks are in distress with some most likely insolvent as well. The U.S. brokerage houses which operate with even greater leverage than the banks, are indubitably in even more trouble. The important thing to note is that there is no simple fix for this situation. The only painless solution is to go back to the bubble world which would mean restoring asset values to their bubble levels but that is virtually impossible once rationality returns as has happened already.

The problems faced by the world today would not be as challenging assuming policymakers have both the understanding and the wherewithal to deal with them. Unfortunately, most policymakers globally have spent the last several months denying that a problem even existed. And even worse, it is not clear that many of them have the resources to do much. Almost every government in the world is running a fiscal deficit, with only a few being exceptions, most notably Canada and Russia. Deficits are counter-cyclical – they increase when growth is weak and vice versa. However, over the last few years, many countries have continued to run big fiscal deficits despite very strong growth. In particular, the U.S. has moved from a fiscal surplus to deficit over the last few years despite robust growth, even without factoring in the costs of the war on terror, the Medicare prescription drug reimbursement plan and other quasi balance sheet items.

In a nutshell then, the global imbalances are huge with the U.S. trade deficit and its global indebtedness being the largest problems. The global real estate bubble is collapsing and conditions currently approximate those last seen during the Great Depression of the 1930s. The financial system is in a mess in the countries that are in the most trouble. And while the governments have some capability to intervene, the scale of the problem is much bigger than their resources.

With this context, let us consider what should be happening in the markets were we to have true laissez faire economics at work. The real estate market collapse should trigger the failures of Fannie Mae and Freddie Mac, as well as a host of U.S. banks, mortgage insurers and credit insurers not to mention investment funds. This should intensify the nascent recession in the U.S. (and very likely also in the U.K. and Australia) forcing massive depreciations of their currencies in short order against all of their trading partners. A consequence of that would be a dramatic decline in consumption spending in these areas with an improvement in the terms of trade. Assuming the rest of the world does not remain slavishly pegged to the U.S. dollar, one could hope for a reorientation of global growth away from the U.S. consumer to the non-U.S. spender with the U.S. becoming more of an exporter and reducing its trade deficit. With this scenario equities of domestically oriented companies in the U.S. should be decimated as should the financials. Well capitalized exporters and multi-nationals would survive and should thrive ultimately. This outlook carries significant risk. In particular, if the U.S.' trading partners continue to rely on the U.S. for growth, we could enter a global recession with even more bank failures and problems – a vicious cycle that could last a generation.

Markets clearly are not pricing in the laissez faire outcome even though it can be viewed as inevitable given the fundamentals. The GSEs are still valued as viable entities even with negative net worth, as are many banks, brokerages and insurers which have essentially ceased to function as going concerns. The retailers are among the strongest performers in the U.S. equity market despite a host of problems faced by the consumer. And the U.S. dollar has mounted an astonishing rally against its trading partners due to a belief that conditions in the U.S. are not as bleak as in the latter's economies.

To understand the price action, we need to look for the external factors that are inducing prices to deviate from the facts as was the case in the peso problem. The issue with the GSEs is simple – the US government has already given Treasury Secretary Paulson a blank check to bail out these entities using any approach he sees fit. And this is despite the fact that the U.S. government never explicitly guaranteed these entities to begin with. The cost of a full bailout of these firms could well be in the hundreds of billions of dollars. Unfortunately, saving these entities does restore asset values to bubble levels. We would still be left then with the problems facing the rest of the financial system, notably the banks, the brokers and credit insurers. Not surprisingly, all the financial pundits have started calling for even more bailouts from the government for these entities also, arguing that a tsunami might otherwise engulf the financial sector. And the beleaguered consumer who spent the resources obtained from leveraging real estate and is now bankrupt – a bailout is expected for him as well.

The cost of the bailouts that the equity market participants have started to count on even superficially should exceed a trillion dollars. And these bailouts are expected at a time where tax revenues are already on the decline at the federal, state and local levels due to weaker growth. This combination of massively increased expenditure with lower tax revenues implies much higher deficits and debt issuance. However, yields on U.S. treasuries are near record low levels and with current inflation levels real yields are negative. In fact, the Treasury market in the U.S. is behaving as though a major recession is already under way and expects growth to slow significantly. The bailouts expected by the equity market, which still does not project a recession, are not anticipated by bond market participants. To argue that they are, one would need to introduce yet another external event to explain the price action in bonds which is that foreigners would be slavishly ready to buy the additional huge issuance of Treasuries at the current low yields.

Looking at the currency markets next, the recent dramatic strengthening of the U.S. dollar suggests that the U.S. might be in better shape than its trading partners. A simple review of the facts suggests otherwise – the trade deficit in the U.S. is still out of control and the export sector is hardly likely to improve enough to reduce the trade deficit significantly – the adjustment has to come from reduced imports which should mean sharply lower U.S. growth. Easy monetary policy and sharply lower growth are both recipes for a weak currency. Any sustained rally in the

dollar therefore has to presume that the rest of the world will remain in much worse shape than the U.S., yet another assumption about external factors. Of course, if foreigners are to be purchasing U.S. bonds in this situation, the assumption we need to make also is that they would much rather invest their resources in the U.S. in preference to deploying them to support their much weaker economies. Fortunately, the slow growth suggested by all this for the globe is at least consistent with the recent collapse in commodity prices.

If we summarize all the external factors assumed by the various major markets we have the following:

- *Bailouts are forthcoming for the U.S. GSEs, the financial firms and for the consumer. These should run into the trillions in all likelihood with substantially higher bond issuance.*
- *Foreigners will buy all of the additional bonds issued by the U.S., while continuing to fund its already staggering trade deficit.*
- *The U.S. dollar will remain stable or rally not because of higher rates that the currency promises but because the non-U.S. economies will be in much worse shape. U.S. growth might be slow, but global growth outside the U.S. will be even slower. In fact, foreigners will buy U.S. securities channeling their savings into the country, even though their own economies might be clamoring for help.*

The expectations of market participants regarding the above issues are implausible when taken together. Long term yields in the U.S. are already at generational lows and real yields are negative. Investors are unlikely to lap up substantial new issuance without higher yields as an inducement. Weak foreign growth in turn would mean reduced overseas savings requiring even higher yields. Were higher yields to result, they could hurt the real estate and credit markets further leading to a vicious negative spiral. Even if we accept that the above factors could all prevail, we would be looking at a very bleak world indeed characterized by repeated bailouts or nationalizations and substantially greater debt issuance – hardly a good environment for equities, bonds or even commodities. As such, all of these markets should decline dramatically from current levels.

The factors above are also based on an indefinite continuation of the unipolar U.S.-centric world despite numerous indications that suggest otherwise. The U.S. economy faces some of the most serious imbalances in its history and is highly vulnerable to changes in foreign sentiment. Its trading partners, which collectively have U.S. dollar reserves of over \$7 trillion already, are expected to continue to fund the profligate ways of the world's biggest debtor nation which is also its sole remaining "superpower". The U.S. plays the part of the superpower aggressively in the political arena despite the fact that a debtor nation is hardly in a position to dictate terms to its creditors.

Recent events in the Former Soviet Union republic of Georgia underscore how disconnected from reality the U.S. government has become. Georgia has a pro-Western government that is seeking NATO membership despite the fact that the country borders Russia. It must be remembered that the first NATO secretary general, Lord Ismay said that the organization's goal was "to keep the Russians out, the Americans in, and the Germans down". A Russian satellite that seeks to join NATO represents a threat to the country's vital interests. While the U.S. supported Georgia's move to NATO, the Europeans were quick to argue against it understanding the country's strategic importance to Russia. Moreover, the breakaway regions of South Ossetia and Abkhazia within Georgia contain considerable numbers of ethnic Russians and since 1991 have operated as semi-autonomous states within the country. The recent attempt by the government of Georgia to take control of South Ossetia, aided by U.S. and Israeli advisers and weapons, represented a direct affront to Russia. The provocation produced a ferocious response from Russia which proceeded to enter Georgia to "liberate" these regions. The point of this is not to discuss the questions of who might have been correct in this misadventure. Rather it is to highlight the fact that relations between Russia and the U.S. have cooled at a time where the former already supplies a significant part of global oil production. The U.S. willingness to meddle in Georgia, which is of little strategic value, is surely not lost on the Asian powers. China in particular, has aspirations of being a more significant Asian military power – something that will run counter to U.S. interests in the region. Unfortunately both Russia and China are in much better positions to put economic pressure on the U.S. in the event of a dispute.

In a micro sense, markets are already facing unpleasant conditions where it comes to earnings and solvency. However, they persist in ignoring these factors by relying on macro factors for support. However, on the macro side, the U.S. today is politically vulnerable, its economy is not robust and it is facing increasing needs for foreign capital. Markets may as well pray for manna from Heaven.

The one thing that should be obvious from the discussion so far is that global conditions, both economic and political are a bit of a mess. Markets are unstable and volatile and price moves are being driven to some extent by fundamentals, but much more by unreasonable expectations. We have a depressing shortage of realists among the policymakers and the investment community, but a plethora of quasi communists who believe in bailouts for the crooked super-rich of Wall Street and corporate America.

With markets already in prayer mode, numerous wild swings in prices are likely to be the norm. The impaired capital levels of the market-makers and their unwillingness to take risks has meant that these gyrations have been amplified since any sizeable transaction order requires a price move that is large enough to allow for other market participants to take on the offsetting risk. We operate today in a challenging environment where short-term price movements are even more unpredictable than the norm.

In this rough environment, we have been doing relatively little. The vast majority of our positions in currencies and fixed income have been taken through options and as such our risks are fixed and we have no requirement to trade in these difficult markets. Our gross equity exposure is limited and we are well positioned to stick with our core long positions in gold and short positions in the U.S. consumer and financials despite near-term reverses. Mercifully, the credit markets have not been subject to the wild gyrations we are observing elsewhere. We are being presented with numerous opportunities now that we feel confident will pay off over the next 12 to 18 months. Our current challenge is to assess what the risks to taking positions in these ideas would be over the next few weeks.

Performance Summary at August 31, 2008

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)
-0.2%	11.0%	8.3%	59.5%	48.1%	32.1%	20.3%	N/A	18.8%	13.8%

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)
0.4%	13.3%	8.2%	58.6%	51.2%	33.9%	16.7%	15.3%	14.8%	21.1%

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