

## Trident Investment Management, LLC Opportunities Funds Commentary

February 29, 2008

### Performance Summary

February 2008 proved as volatile and eventful as January. The credit markets took center stage with spreads on virtually every type of credit instrument widening to multi-year highs. Global equity markets suffered too but much less than the credit rout would have suggested. The S&P500 index was down 3.48%, the MSCI Europe index down 0.75% but the Nikkei up 0.11%. The U.S. dollar resumed its slide against most major currencies moving to new lows against the euro and to multi-year lows against the yen. And gold, oil and other commodities all broke to new highs. Gold was up 5.06% on the month to \$975 and ounce, and oil rallied 11.08% to end at \$101.84 a barrel. Remarkably, U.S. Treasuries rallied on the month with yields on the 10-year note declining 0.08% to end at 3.51% (all figures in U.S. dollars).

### Market Outlook & Portfolio Strategy

Trident Investment Management, LLC Virtually all of the data coming out of the U.S. in February suggested that the economy is in trouble. Payrolls, consumer confidence, housing prices, auto and retail sales and other high frequency information suggest that the U.S. economy at best is at stall speed and at worst has already slipped into recession. Unfortunately, the inflation figures continue to rise with prices of metals, oil and agricultural products at multi-year highs. Even the highly-doctored, official U.S. CPI figures suggest annual inflation in excess of 4.0%, considerably higher than the Federal Reserve's 2% threshold. Moreover, inflation in other parts of the world is much higher – China for example, is reporting official inflation approaching 9% – a new cycle high. We appear, at least in the short run, to be caught between a stagflationary bust in the U.S. and an inflationary boom in the rest of the world. This situation vastly complicates the policy responses needed to cope with the myriad challenges the markets face today.

The U.S. today is the biggest debtor nation in human history. Despite a sizeable drop in the U.S. dollar in the last five years against most of its trading partners, its trade deficit has only increased over the period. Even its bilateral trade deficit with many of the countries whose currencies have appreciated and which have experienced record domestic growth rates has not declined let alone moved into surplus. A period of relatively strong overseas growth with substantial absorption of U.S. exports, and weak U.S. growth with reduced imports into the U.S. is virtually essential to deal with the huge structural imbalance created by the size of the U.S. trade deficit. Such an outcome can be arrived at only with coordination between policymakers on a global basis. In particular, the policy leadership has to come from overseas because the U.S., and in particular the Fed, will not adopt the painful measures to deal with the structural imbalances unless forced to by the markets. As things stand, the U.S.' trading partners are all relatively hawkish on monetary and fiscal policies given high domestic inflation, while the U.S. is moving aggressively to boost domestic growth using a combination of easy money as well as tax cuts and bailouts for the real estate market, while paying scant attention to a falling dollar. This policy mix makes the global economy even more vulnerable to a destabilizing fall in the U.S. dollar – one could argue in fact, that such a collapse has already started.

The lack of global policy coordination over the last several months is in large part because markets still continue to rely on the U.S. Federal Reserve to provide global "policy leadership". The problem is that Fed's charter limits its ability to make the hard choices that the conditions of today require. The Fed's responsibilities (and this is paraphrased from the Fed's own website) fall into four general areas:

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- Conducting the nation’s monetary policy by influencing money and credit conditions in the economy in pursuit of full employment and stable prices.
- Supervising and regulating banking institutions to ensure safety and soundness of the nation’s financial system and to protect the credit rights of consumers.
- Maintaining the stability of the financial system and containing systemic risk arising from the financial markets.
- Providing certain financial services to the U.S. government, the public, the banks and others including operating the nation’s payments system.

The difficulty with the Fed’s responsibilities as listed is that it often has to choose which objective to focus on. Specifically, achieving long-term price stability might require higher interest rates and short term unemployment. Again, a safe and sound banking system might require bank failures so that some discipline is instilled in bankers. Also, the Fed’s main role of conducting monetary policy in pursuit of full employment and low inflation forces the institution to set policy based on factors that it really does not control in the short run, and which it strongly influences but does not fully control even in the long run. A central bank can control the level of interest rates or the quantity of money with precision but has to accept that the ultimate translation of these policy tools into growth and inflation is imprecise at best. When these coarse tools are applied to deal with every blip in the financial markets or the real economy, they can set the stage for a disaster. To understand why, one needs to understand the fundamental nature of capitalism.

The great economist Joseph Schumpeter introduced the expression “creative destruction” into economic discourse in his book *Capitalism, Socialism and Democracy*, first published in 1942. The creative part of capitalism involves the transformation that comes from innovation. The destructive part refers to the elimination of non-viable technologies and companies as change overtakes them.

The concept of creative destruction is even more applicable in the financial world where it comes to risk-taking. Financiers and investors as a group are highly prone to trend following. The most recent trends are typically extrapolated far into the future and the longer a trend lasts, the more the justification for the extrapolation of the trend. Not surprisingly, managements of companies who are typically incentivized by short-term earnings results, tend to follow trends. There is no advantage to fighting a trend, however prudent that might be, simply because a manager might not retain his job long enough to see his prudence pay off. In fact, the more aggressive a manager is at exploiting a trend, however risky it might be, the higher his short-term profits and the greater his compensation. Thus, the nature of financial markets and institutions makes trend following almost inevitable and the longer a trend lasts, the more the risk that will be taken on the basis of its permanence. The only discipline for markets comes from the destructive phase when the trend finally reverses. When that happens, the trend followers are put out of business en masse. The losses sustained serve as a disciplining tool for future risk-takers – the possibility of catastrophic loss has to be considered, at least when the memory of such loss is fresh, while making the investment decision. Losses are thus an integral part of a sound, capitalist financial system.

A central bank attempting to regulate a banking system to ensure overall stability and prudent risk-taking has to be very selective about interfering when markets wreak havoc on bad investments and risk decisions. By attempting to prevent or lessen the pain of market corrections, the central bank fosters moral hazard. Financial institutions believe then that more risk is warranted because they expect every correction to engender a policymaker-led bailout. The more apparent stability a sequence of small bailouts creates, the more the risk-taking that is fostered and the more

vulnerable the overall financial system becomes. At some stage, the scale of risk-taking is so large that no bailout is possible and markets have to retreat to an extremely painful reality. In such a situation, a deep recession with financial institutional failures cannot be avoided. The U.S. unfortunately, is close to reaching that stage.

Since the mid 1990s the Federal Reserve has come to believe that it can fine-tune policy to address every economic or market hiccup. The Greenspan Fed managed to deal successfully with the Mexican crisis of 1994/95, the Asian crisis of 1997, the 1998 Russia and Long Term Capital Management crisis and the NASDAQ/911 crisis of 2000-2002. In fact, there has never been a single crisis where the Fed has not rushed to the rescue with easy money and promises of bailouts. The current Fed Chairman, “Helicopter” Ben Bernanke made a famous speech during the Greenspan era saying the Fed would not tolerate any deflation – a helicopter drop of money would be a preferred alternative. In its bailout actions the Fed has been strongly supported by the U.S. Treasury. U.S. policymakers while sanctimoniously preaching for transparency and letting market forces work their magic to the rest of the world, have been only too eager to interfere when the smallest concerns about U.S. growth surface. Amazingly, most global policymakers have attempted to emulate the recent U.S. model of “regulated crony capitalism” even though the economic results it has engendered are hardly remarkable. In fact, by many measures today, the U.S. looks like a developing country, especially where it comes to the fragility of its financial system.

The financial system’s problems in the U.S. are undeniable. Some facts make this all too obvious. At the end of 2007, the total credit market debt in the U.S. was \$48.8 trillion according to figures published by the Fed. This makes the total credit to GDP ratio in the U.S. about 350% – a record for any country, let alone the one with the world’s largest economy. A ratio of this magnitude creates a definite problem for monetary policy – any significant rise in interest rates has to create a crisis since the scale of borrowing is just too large. The issue is not whether all the debt accumulated can be paid back – virtually all of it is denominated in U.S. dollars and the printing presses can work overtime. However, the private sector has taken on about 65% of all this debt. Any sustained rise in rates or a major recession will create huge problems for the borrowers and could lead to significant dislocations in the non-governmental debt markets. Moreover, much of the growth in debt has come through swaps and other credit derivatives which are off-balance-sheet and are not even captured in the above figures provided by the Fed. As such, the Fed has little clue as to the true extent of risk in the financial system and sadly, neither do the bank managements themselves, such has been the orgy of risk-taking over the last few years.

With the credit crisis been in full swing through much of 2007, what was remarkable was the degree to which policymakers and bank/brokerage managements maintained the illusion that things were fine and that the problems were “contained”. In February of 2008, that illusion is being shattered despite the best attempts of the regulators and policymakers to pretend otherwise. The credit problem that was “contained to subprime” has now begun to attack prime mortgage loans and even Fannie Mae and Freddie Mac agency obligations. The latter agencies have started taking big capital hits despite the fact that the losses on their guaranteed portfolios are still relatively minor under the circumstances. Their capital adequacy is already in question as is that of most of the large banks and brokerages in the U.S. The credit crunch that all these problems are spawning is badly affecting the leveraged world of shadow finance made up of the brokerage houses, private equity and hedge funds and investment trusts. The leverage taken on by these entities is staggering – they can routinely be levered more than 30X unlike the banks whose leverage is limited by regulation to about 13X. Any hiccup in asset values with this much leverage leads to bankruptcy almost overnight. In February we saw the first signs of pain among levered funds exposed to what they perceived to be high-quality “regular” mortgage assets.

The role of the Fed in setting the stage for all this is unfortunately downplayed. Funds usually do not obtain leverage directly from the capital markets. Every leveraged fund has a friendly prime broker or bank that has been only too willing to provide the loans. And the Fed did little to stop such risky activity despite previous experience with Long Term Capital Management. The risky loans that were made in the housing market and the bubble in real-estate prices were all too obvious to numerous observers and in fact, even to members of the Fed's Board of Governors. But such was the hubris of the Greenspan Fed that they ignored all the warning signs and worked to curry political and private sector favor. A simple directive from the Fed prohibiting low-documentation loans or loans in excess of 100% of home value would have greatly mitigated the current problems we face in housing. An understanding of risks in the credit insurers like Ambac and MBIA that together insure over \$1.5 trillion of securities in the market would have forced a prudent regulator to at least force the banks to limit their exposure to these entities. Instead our Fed was at the forefront of encouraging such risk. Structured Investment Vehicles, CDOs, Alt-A loans – there was nothing it seems our Fed really understood while our bankers were running amok, but yet they appear to have been the nominal regulators of the whole system.

The Fed's responses to the current crisis do little to inspire confidence and in fact suggest that the members have little understanding of the scale of the current problem. The policies to date have been panic-stricken reactions to market events that indicate that there is no real plan to deal with the ongoing crisis – in fact the only real plan is to avoid taking the blame that can reasonably be laid at the feet of the Fed and other regulators, the bank managements and other overseers like the rating agencies. In particular, the Fed has been cutting rates aggressively and penalizing U.S. savers at a time where the country is struggling with a savings rate that is already close to zero. Thus, it is encouraging spending at a time where the U.S. is already over-spending suggesting that it is not concerned about the structural instability created by the U.S. trade deficit and the huge foreign inflows needed to sustain the U.S. economy.

Where it comes to the banks, the Fed has proved even more ineffective. Chairman Bernanke has been exhorting the banks to raise more capital but has done little to force the banks to mark their underwater assets to market. The Fed has not taken the lead in forcing banks to disclose to their own shareholders the extent of their off-balance-sheet liabilities and other contingent liabilities they might face if some of their counterparties such as the mortgage and bond insurers fail. The Fed is certainly aware of these problems by now, but it continues to allow banks to fabricate financial statements that vastly understate the true risks in the system. And they do so knowing full well that investors who contribute new capital to the banks might suffer huge losses thanks to their creative financial reporting. Even worse, some troubled banks are changing compensation policies to permit management to get paid handsomely despite the losses their firms are suffering because the current crisis “could not have been anticipated”. The Fed is notably silent on these issues but has no trouble rushing in with free liquidity and discount window lending to keep in place numerous incompetent, if not totally corrupt, bank managements. A question that can reasonably be asked is just why the Fed does not put a number of the troubled banks quickly into administration and force them to recognize losses and limit risk taking and ridiculous compensation packages, much as they did with Citibank in 1990. They would rather serve the bank managements' interests rather than those of the stockholders or the public. As such, the Fed has failed abjectly in its role as regulator. In fact, one could argue that its poor regulatory supervision has been the root cause of much of the excess we have seen in the banks so far.

If I have reserved my criticism for the Fed here it is because we are rapidly reaching a point of no return for markets. The world looks to the Fed for policy leadership despite the fact that it has demonstrated its lack of ability in this regard. The Fed and the other US ancillary institutions like the rating agencies can be likened to a ship's drunken

captain who has run the vessel aground. The passengers and crew are looking to the drunk for ideas and directions – perhaps his slurred speech and confused thinking should convince them that a different leader might be needed. The US credit crisis has entered a new and even more dangerous phase where all assets are being affected. The Fed has to make numerous hard decisions on letting institutions fail and avoid any more bailouts and establish its credentials for being a policy leader. If not, we anticipate that the US bond market could suffer a major sell-off which would compound the US’ problems with housing and credit and lead to capital flight.

Our core positions in being short US equities and credit, especially of the banks, brokers and real estate lenders have not changed. We continue to remain long gold and defensive US stocks such as consumer staples and health care. We believe that a major shift in global policy is forthcoming – the US crisis is fast becoming a global one. The markets have been a rollercoaster ride so far in 2008. We are entering uncharted territory now and our trip will be akin to Space Mountain – a rollercoaster ride in total darkness.

Performance Summary at February 29, 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)
4.9%	10.5%	47.7%	100.7%	42.6%	27.8%	18.7%	N/A	9.7%	13.5%

**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)
4.4%	5.5%	46.5%	108.4%	45.2%	28.4%	18.3%	17.1%	6.1%	21.3%

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