

Trident Investment Management, LLC Opportunities Funds Commentary

February 28, 2009

Performance Discussion

February proved to be as miserable a month for global equity markets as did January 2009. The S&P 500 was down 10.65%, the MSCI Europe Index down 9.70% and the Nikkei down 5.25%. In fact, the S&P 500 is down a whopping 18.18% in the first two months, making this the worst start for the year in 76 years. The fixed income markets did not do much better. The U.S. 10-year Treasury yield rose 0.17% to end the month at 3.02%, while the two year rates were largely unchanged at 0.97%. The commodity markets were mixed with oil declining 2.97% to end at \$44.76 a barrel and gold rising 1.52% to end at \$942.5 an ounce. Credit markets continued their improvement from the previous month with investment grade issuers doing relatively better. The U.S. dollar continued its remarkable rally with the U.S. Dollar Index appreciating 2.34% on the month (all figures in U.S. dollars).

Our funds had a relatively quiet February. Our long positions in gold and gold stocks helped our performance, but we suffered from our short-dated non-U.S. fixed income instruments. Our short positions in credit helped our performance as did our U.S. curve steepener options, but the short positions we had initiated in the U.S. dollar hurt us. The overall economic environment still remains bleak and policymakers have done little, in our opinion, to provide solutions that will allow for longer-term stability. But we believe that we might be closer to some kind of resolution – economic and market conditions could soon force the correct response.

Market Outlook & Portfolio Strategy

The Obama team had a chance in February to make its imprint on the markets. Treasury Secretary Tim Geithner put forth his plan for stabilization of the U.S.' financial system during the month. Also, President Obama announced his ambitious 2009 budget designed to shore up the economy with huge new spending. Markets had much news to digest and the reaction did not suggest a strong show of support for either of these initiatives.

The Geithner plan had three main elements. First, the Treasury would subject the banks to “stress tests” to determine whether their capital levels were adequate. Banks failing these tests would be required to raise more capital either from private sources or from the government under set terms. Second, the Treasury would attempt to unfreeze markets for credit by creating a “public-private” partnership to purchase toxic assets. The way such a partnership was expected to work was not fully explained, but one possible approach was that the government would provide substantial leverage, amounting to possibly as much as \$1 trillion, to private sector capital if they purchased troubled assets, with the proviso that the private capital be subject to the risk of first loss. The third element of the plan was an expansion of the Federal Reserve’s Term Asset Backed Securities Loan Facility (TALF). The Fed had set up this program in November 2008 to provide support for the issuance of asset-backed securities collateralized by student, auto, credit card and Small Business Administration loans. The TALF would work by providing non-recourse financing to holders of AAA rated tranches of such securitizations with a maximum of \$200 billion in such lending contemplated. The Geithner plan envisions expanding this limit to \$1 trillion. There were other

elements to the plan including a commitment to announce a new housing program to deal with the foreclosure crisis within a few weeks.

Markets reacted to the Geithner plan very negatively since it was widely perceived as being very short on specifics. Some of the details were made available later in the month, and they did little to provide reassurance and, in fact, suggested that the Obama administration had no better a grasp on this financial crisis than did the Bush administration. This is not surprising, because the Obama financial team is made up of many of the same members that navigated us into this financial mess to begin with.

Let us consider each of the Geithner plan's elements in some detail. The government, shortly after the plan was announced, provided the terms of the stress tests that the banks had to undergo. There were two scenarios the banks had to consider and these are laid out in the table below:

	Baseline		Pessimistic	
	2009	2010	2009	2010
GDP Growth	-2.0%	2.1%	-3.3%	0.5%
Unemployment	8.4%	8.8%	8.9%	10.3%
Home Prices	-14%	-4%	-22%	-7%

The problem with the scenarios postulated above is that they are almost certainly too optimistic. The worst contraction expected for the economy is just 3.3% for 2009, a far cry from the more than 12% contraction experienced by Japan in just the fourth quarter of 2008. Japan, it should be remembered, has not suffered a banking or financial crisis over the last three years. Bank regulators expect to apply the stress tests by requiring banks to value their own portfolios and project their resources available to absorb losses under the scenarios provided above. The regulators will then meet with the banks' managements to discuss their revenue and loss forecasts so as to assess institution-specific losses and the need for more capital.

Put bluntly, the bank stress tests assume a variety of overly-optimistic scenarios for the economy and require the demonstrably incompetent, if not totally corrupt, managements at the large banks to apply these stress tests to their own portfolios. The results will be vetted by a group of bank supervisors who were already required as part of their jobs to conduct such tests and have abjectly failed. And this idea is being floated by a Treasury Secretary who previously headed the New York Federal Reserve, which should probably be held up as the poster-child for being an incompetent regulator.

The second element in the Treasury plan, the public/private partnership for dealing with bad assets, seems more reasonable but does not address the issue with problem assets faced by the banking system. Any bank can choose to classify assets as either being available for sale (AFS) or held to maturity (HTM). If an asset is declared to be AFS, then it needs to be marked to market, and current market prices, however unpleasant, need to be used. A security that is declared as HTM however, does not need to be marked to market under current accounting rules unless it has a significant impairment such as an explicit default or writedown. As such, a bank can carry "good quality" HTM assets at cost

until the asset pays off, hopefully without loss. Under certain limited conditions, a bank can even re-classify assets that were AFS to being HTM or vice versa, though such changes cannot be done repeatedly. The auditors might require some writedown of assets while moving them from AFS to HTM possibly to levels suggested by current market prices. There are two main issues faced by the banks relating to both the AFS and HTM assets which we take up below.

Assets that were AFS could have been sold by the banks and technically should have been written down already. The issue that the banks face in their AFS assets is that many of them have not marked a large portion of these assets to market in part because markets for these assets have all but dried up. If investors were truly certain that these assets were of high quality and that there would be no risk, there is no reason why they would not purchase them. For example, when one looks at the debt of high quality companies like Merck or McDonald's in the U.S. today, there is substantial appetite for their bonds. In fact, the Credit Default Swap market actually views these companies as being even better credit risks than the U.S. government itself. So, the problem with the pricing of the AFS assets on banks' books is that they truly are toxic in the market's perception. Banks are arguing that these assets are of better quality than the markets believe them to be, but that ignores the fact that the banks themselves are active market participants. To the extent that the banks really understand these instruments and their valuations, there is no a priori reason as to why they cannot transact in these markets and exploit the supposedly hyper-cheap market prices. But here we run into the problem – the banks as buyers want to transact at market prices which they know to be largely accurate, but as sellers they refuse to, given the necessity then to own up to their losses.

Bad assets that have been declared to be HTM assets and marked down should be written down – there were actual impairments resulting in the reduction in value. The problem here for the banks is that the markets have lost faith in the carrying costs of these holdings, given the deterioration we have seen in credit quality and the incredibly bad lending decisions the banks appear to have made over the last several years. Markets believe that the losses on these HTM assets will be far greater than banks project and refuse to go along with the banks' optimistic assessments for the same. But the markets' view on HTM assets should not matter to the banks. After all, the Fed provides the banking system adequate funding to hold HTM assets to maturity and these assets should not be toxic to begin with. But this is where the real issue emerges. We believe that many banks classified truly poor quality assets as HTM to avoid marking them to market but cannot really hold them to maturity because of the huge losses that they know to be inevitable.

A public/private partnership where the government does not take the first loss in assets purchased cannot solve the problems faced by the banks. Private capital will want to purchase assets, be they HTM or AFS holdings, at fair value for which market prices would almost certainly be the best benchmark. This unfortunately, takes us back to square one which is the question of what prices other than market prices are reasonable for these assets. But it should also make one realize that what the banks really want is a taxpayer bailout that compensates them for their past errors by purchasing bad assets at inflated values from them. It is unclear why the government should do that without forcing bank stock and bondholders to take the losses first and get wiped out if necessary, which is something that the Geithner plan totally avoids doing.

The expansion of the TALF, which is an already flawed program of the Fed, represents yet another attempt by the policymakers to resuscitate the world of shadow finance – a move that is neither desirable nor essential for the U.S. economy. The Fed is willing to provide up to 95% in non-recourse financing for purchases of eligible AAA securities backed by auto, consumer and student loans. Leaving aside the problem with AAA ratings which of late have become virtually meaningless in the world of securitization, the Fed requires that participants in TALF have their books be subject to considerable scrutiny. Potential investors, many of which are funds with huge portfolios of assets marked at fantasy prices, are balking at such scrutiny. The dealers who implement this program moreover, wish to avoid accountability if their clients make mistakes and the collateral provided is ineligible for TALF. With such “protections” it is almost certain that TALF is going to become a repository for junk. Even worse, a number of Wall Street dealers have worked to set up vehicles that will allow investors to participate in the TALF while circumventing many of its protections for the taxpayer. The structures set up, which amazingly have been blessed by the Fed, resemble the CDOs and SIVs of old, with toxic assets to be held at the level of the vehicle and a host of tranching bonds issued against it. The ratings agencies almost certainly are only too eager to assign AAA ratings to most of the toxic mess, which in turn means that it can receive TALF funding. In a world where opacity has been the key problem, the Fed is using the taxpayer’s funds to actually encourage the creation of a new layer of complexity. Wall Street, which created the toxic derivatives that now clog our financial system, is eager to use this opportunity to produce even more rubbish that will jam up the workings of the central bank and ultimately bankrupt the taxpayer. The sad part is that the truth is totally lost in all of this legerdemain. A bad asset, however disguised, is still a bad asset. A leveraged player that purchased assets that have gone bad, must be forced to recognize the losses on these assets and put into bankruptcy if necessary. Markets cannot and will not change this, but incompetent and/or crooked policymakers can magically transform these losses for the financial system (which they should have regulated properly in the first place) into massive losses for the taxpayer. In a world where blame is easy to assign, we have policy czars, who are probably most at fault, working overtime to cover up mistakes while raiding the taxpayer till.

The actions that are needed to deal with the current problem are still rather simple. The U.S. economy and financial system have been brought to a precipice because of too much leverage and too much consumption that was fuelled by leverage. The philosophical thrust of any plan to deal with the mess has to be to de-lever and prevent a recurrence of the problem with better regulation. Critical steps to achieve these ends would be to dismiss the chief architects of the current problem, pass laws to create a special type of bankruptcy for a financial firm that will permit the government to choose which classes of creditors it will make whole and finally, permit the public to force corrupt management to disgorge bonuses and other payments made on the basis of fraudulent earnings. Such laws, if implemented, would permit the government to quickly nationalize failed banks while ensuring that managements of potential problem institutions are incentivized to run them safely. Moreover these measures should have overwhelming taxpayer support. Unfortunately, reality is much different. The plutocrats that created the problems are still very much in charge, and are strongly against the ideology of holding financial firms and their managements totally responsible for their own losses. Predictably, the public had little confidence in the Treasury plan, and markets plumbed new lows after its announcement.

The 2009 Obama budget, details of which were also released in February, involves an ambitious program of fiscal expenditure to deal with the current economic malaise. The plan involves substantial outlays for

education, healthcare and energy and a move away from private contractors in these areas to direct government administration of several high profile programs. Tax cuts are proposed for most families with household incomes of less than \$250,000 and tax increases for those above that threshold. Numerous corporate tax increases are contemplated including a repeal of LIFO accounting as well as new taxes on oil and gas and on carried investment interests. As such, there is a redistribution of tax liability from individuals to corporations. The budget also expects higher costs in relation to the current Troubled Assets Relief Program for the financial system, and in fact requests further funds of as much as \$250 billion for the same. The budget also, for the first time, includes the costs of the wars in Iraq and Afghanistan in calculating the projected deficit. All said, even the White House projects a \$1.75 trillion deficit in 2009 which represents about 12% of GDP. With a resumption of GDP growth (and increased tax receipts) in 2010, the deficit is still forecast to be over \$1.17 trillion in 2010 (or over 8% of GDP). With new taxes kicking in after 2010, the Obama team has pledged to reduce the budget deficit to about \$533 billion or under 3% of GDP by 2013, which, given the economic conditions facing the U.S. today seems like a pipe dream.

The Obama budget is trying to deal with the aftermath of the economic crisis we are in, while at the same time attempting to build a framework for sustainable U.S. growth through investments in alternative energy, healthcare and the like. We are broadly in agreement for the need for fiscal stimulus and support the overall goals of the budget. However, we believe that the budget is attempting to address too many issues at once and pushes the U.S. into a deficit spending cycle which could backfire badly. Rather than deal with the budget specifics which could change significantly in Congress, the main issue we are concerned about is that at \$1.75 trillion, the U.S. deficit far exceeds the U.S. domestic savings rate, which is barely positive and is larger than the combined surplus savings of the rest of the world. Coupled with an already-heavy need for bond issuance, the U.S. is expected to issue well over \$2 trillion in Treasury securities just in 2009. If the world balks at purchasing the huge quantity of Treasuries issued, we could have a bond market crisis with U.S. yields spiking dramatically. If the Federal Reserve were to step in to monetize the debt by printing U.S. dollars, it would be a Zimbabwe-style response to the problem and could trigger a currency market crisis. These unpleasant choices suggest that the top priority for the current U.S. administration should be to get agreement and support from the rest of the world where it comes to financing the huge expenditures being contemplated. Such support does not appear to be forthcoming. In fact, both the Europeans and the Chinese believe that the U.S. has not acted forcefully enough to rein in its financial institutions with new regulation and believe that such regulation should precede any further expenditures. While we do not entirely agree with the latter position, such dissent does not bode well for financial stability going forward. We are very likely setting the stage for a significant bond market crisis this year.

In sum, we remain extremely concerned about global developments in February. We believe that the Geithner financial plan will ultimately prove ineffective and succeed only in squandering huge amounts of taxpayer funds. The Obama budget, while well-intentioned, is likely to engender large U.S. fiscal deficits for the foreseeable future, in part because the cost of the financial bailout remains huge and is ongoing. With the indebtedness of the U.S. reaching record levels, serious questions can be raised as to the country's long-term safety and solvency and not surprisingly, the Chinese, one of the U.S.' biggest creditors have recently started to voice such concerns. The problems facing the financial markets have therefore not abated. We appear actually to have entered a new and possibly terminal phase of this crisis. We had believed that we would enter this phase as early as the latter half of 2008, but policymakers have successfully extended this crisis with their inability to acknowledge and deal with reality.

On the portfolio front, we have made very few changes. We have increased our short positions in U.S. Treasuries, with these positions being taken in the long-dated U.S. swap market using curve-steepener options. We remain short consumer stocks and credit instruments seeing no respite to the problems faced by the U.S. consumer. We have finally started to add to our short positions in the U.S. dollar and have also increased our long positions in gold and oil which we believe could perform well in the event of sustained dollar depreciation. Once a definitive resolution of the current turmoil seems likely, we expect to find even more opportunities for profit. “May you live in interesting times” is a saying that is that euphemistically referred to as the Chinese curse, though analysis shows that it was not of Chinese origin at all. Whatever the provenance, this curse is surely upon us today.

Performance Summary at February 28, 2009

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)
0.8%	5.5%	25.4%	35.8%	65.1%	40.3%	24.0%	N/A	3.7%	16.1%

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)
0.5%	4.6%	27.8%	38.3%	69.8%	42.9%	22.8%	15.7%	2.9%	22.4%

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