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Trident Investment Management, LLC
Opportunities Funds Commentary

February 28, 2010

MONTHLY UPDATE

Performance Discussion

In February, markets shrugged off any concerns they might have had about China and Greece the previous month. The S&P 500 index was up 2.9%, the MSCI Europe Index was down 0.4% and the Nikkei was down 0.7%. The U.S. dollar appreciated with the U.S. Dollar Index up 1.1%. Fixed income markets were mixed. The 2-year Treasuries remained unchanged at 81.6 basis points and the 10-year Treasuries sold off by 3 basis points to finish at 3.6%. Commodities performed well. Oil rallied 9.3% to end at $79.7 a barrel, while Gold rallied 3.4% to end at $1,117.6 an ounce. Credit markets rallied as well, but much less so than the overheated equity markets (all figures in U.S. dollars).

Our funds suffered in February. In equities, the gains in long positions in gold and oil stocks did not offset the losses in consumer discretionary shorts. Our fixed-income positions in Australia hurt with short rates backing up as global risk appetite returned. Our short credit positions contributed negatively to performance, while the U.S. curve steepeners performed positively. We made very few adjustments to our portfolio given the price action and in fact, are looking to boost our core positions. Market valuations today are based on hope and a painful adjustment to reality is virtually certain.

Market Outlook and Strategy

The world faces a number of challenges today. The economic imbalances across regions are extreme, debt levels in the developed world are at very high levels and there is little consensus among policymakers about how best to ensure medium-term stability. Even worse, there seems to be no political will, especially in the U.S., to attempt any real resolution of the underlying issues. If anything, U.S. lawmakers appear to be focused on ensuring their re-election with short-term palliatives. Even the most rabid optimists would concede these points with the main point of contention being in regard to the economic path we are likely to follow – the optimists would argue for a benign ultimate resolution, while we believe we are firmly on a road to greater pain that should culminate in a major crisis for our capitalist ideology.

1. *The Nature of Capitalism*

There is no consensus definition of capitalism. However, one could characterize it as an economic and social system that relies on private ownership of the factors of production other than labour, with free markets for the trading of goods and resources. The profits of private enterprise under capitalism are supposed to accrue to the owners of the same. At its core, the ideology relies on and rewards the ingenuity and hard work of the entrepreneur. What is good for the individual is, in the aggregate, expected to be good for society. Thus, the oft-heard slogan of capitalism so popularized in the movie Wall Street – "greed is good."

There are two basic requirements for capitalism. First, we need contract rights both in regard to ownership and business dealings, as well as a system of justice where these can be enforced. Where property rights do not exist, any entrepreneur that takes risk will always have to worry whether his business may be expropriated after he has worked to make it successful. This is frequently a concern with many developing countries. Second, we need free and fair markets to ensure the most efficient allocation of resources. With a command economy that pays no attention to free markets, the prices of products could be set at levels that bear no relationship to the costs of creating them, and these prices could be changed arbitrarily as well. As such, the fates of whole industries could be altered by a few bureaucratic pricing decisions, making entrepreneurship without government connections virtually impossible.

Capitalism in its pure form suggests a very limited, but nevertheless critical role for government. First, the state has to provide the system of justice to enforce property rights. Next, since markets are prone to manipulation by charlatans, the state needs to regulate them to ensure their proper functioning. Such regulation might involve requirements for transparency and accuracy in information provided to participants, as well as appropriate penalties to violators. That is, the state needs to establish conditions where the public can trust the markets and their ability to allocate capital. There are also some actions that a capitalist government should not take. In particular, it cannot interfere with the underlying operations of the private firms themselves, especially by bailing them out from the consequences of their own failures. Next, it should not work to undermine the functioning of markets by interfering directly with the price-setting mechanisms on the basis that the prices arrived at are somehow incorrect. Thus, the laissez faire ideal for markets does not mean that they should not be regulated – rather, the concept refers to the actual price-setting mechanism in markets without reference to the need to regulate potential crooks who might participate in it.

The idealized version of capitalism that we have discussed above is obviously very different in practice. The main divergences perhaps occur where it comes to income distribution. Societies have differing perspectives on what a fair distribution of the output of the country should be. The tax regimes even of different capitalist countries have significant differences which largely reflect their respective social aims. While these normative decisions on social policy change considerably over time, even with a single country based on its social leanings, one should recognize that such changes do not fundamentally alter the nature of capitalism – they only change the distribution of its rewards.

2. *Recent Trends in U.S. Capitalism*

Perceived as the world's champion of capitalism, the U.S. has had an economic history which we would characterize as marked by progressive enlightenment, at least through the 1970s. The roaring 1920s were a period of unbridled speculation and fraud where crooks and shady operators rushed to participate in the stock market. The ensuing crash and Great Depression of the 1930s convinced the U.S. government to address many of the fundamental failings of the system as it existed then. A number of rules were established in the 1930s to ensure transparent and fair markets. Thus, rules prohibiting stock price manipulation, insider trading and the like all stemmed from lessons learned during the Crash of 1929. The Glass-Steagall Act that separated commercial and investment banking and established deposit insurance through the Federal Deposit Insurance Commission were products of the need to ensure a stable payments system through the banks, while preventing these socially vital and taxpayer protected entities from engaging in excessive risk-taking at public expense. Without dwelling too much on history, the main point we would make is that the U.S., starting in the 1930s, tweaked the rules of capitalism progressively to prevent a recurrence of the painful events of the 1930s. By the mid 1980s, it could have been argued that the country had probably the best balance of regulation and freedom when it came to the practice of capitalism. And there is no doubt that these changes delivered impressive GDP and productivity growth, not to mention innovation, during the entire post-War period.

The problems in the U.S. capitalist framework started in the 1970s when high inflation post the 1973 oil crisis drove up inflation and nominal interest rates. This dramatic increase in rates and the corresponding decline in the values of mortgage assets bankrupted most of the thrift institutions that lent at fixed rates against housing. A free-market resolution of the thrift crisis in the early 1980s would have meant the industry's closure – something that happened anyway for the most part in the early 1990s when the Resolution Trust Corporation was created. The Reagan administration, however, allowed these bankrupt thrifts to continue operating. In turn, these firms engaged in much of the speculative activity in the 1980s. In fact, the thrifts, which were already a taxpayer liability, were among the biggest buyers of the rubbish

junk bonds of that era, which in turn led to the reshaping of corporate America with many respected and stable companies being turned into veritable debt mountains. After the sobering crash of 1987 and the real estate crisis of the early 1990s, it was fair to say that the country appeared to have put these problems behind. Unfortunately, the relatively stable decade of the 1990s, coupled with the flawed ideology of the Clinton era, led to irreversible changes to the structure of American capitalism.

The Clinton Treasury spearheaded by Robert Rubin and Larry Summers, along with then Fed Chairman Alan Greenspan, believed in the need for "free" markets although their definitions of freedom in this context differed sharply from the version required by capitalism. This trio dismantled many of the regulations instituted after the 1930s, particularly the Glass-Steagall Act. Even worse, the culture that financial sector mistakes would be paid for by the taxpayer became firmly entrenched in this era thanks to repeated bailouts spearheaded by the U.S. In the 1994 Tequila crisis and the 1997-1998 Asian/LTCM crisis, the U.S. government and the Federal Reserve rushed in to help failing governments and institutions both with direct bailouts and rate cuts so that the notion of a Greenspan put was firmly entrenched in the financial arena. In fact, the U.S. government in the 1997 Asian crisis actually pushed the Asian sovereigns not only to take on the debts of their private sectors, but to do so at higher rates than they had been originated at, so that U.S. banks would not take significant losses. The unwillingness of the U.S. government to permit the failure of institutions from their own bad decisions was one of the first serious chinks in the capitalist foundation.

The willingness of the Fed to use monetary policy as a tool to help the financial system avoid the consequences of its poor decisions became starkly clear in 1998 during the LTCM crisis. There is no doubt that this action reinforced the financial system's view that the largest firms would not be allowed to fail and led to the huge technology bubble of 1999-2000, and in turn to the frauds at Enron and Worldcom. Despite the gargantuan misallocation of resources and the numerous documented instances of financial fraud, there was little attempt made by regulators to rein in the financial system. Rubbish concepts such as non-GAAP "pro-forma" earnings and off-balance sheet partnerships (or today's Special Investment Vehicles) were not prohibited by the regulators. This laxity in regulation represented another serious blow to the capitalist foundation. Governments are supposed to promote ethical and honest behavior in markets, not work with wrongdoers to obfuscate the truth from the public.

The response of the Fed to the events of 9/11 was another serious blunder, in that the central bank actively fostered a real estate bubble to deal with the economic fallout from the terrorist attacks. After 9/11, the U.S. has been engaged in a set of expensive military actions in the world, a situation that would have typically called for increased national savings. Instead, policymakers encouraged an orgy of spending and consumption, directly contributing to the real estate and credit crises of 2007-2008 which are the biggest in human history. It is important to note that without the continued expansionary monetary policy and lax regulation of the banks post 2001, it is unlikely that the real estate bubble in the U.S. would have even occurred – after all, the nation was reeling then from the aftermath of the technology bubble and the blow to the national psyche from the horrific terrorist attacks.

3. *The Current Crisis for Capitalism*

While it is certainly true that some elements of capitalism were undermined in the lead-up to the 2007-2008 crisis, it is only in the period since that we have abandoned virtually all the foundations of capitalist ideology. While these changes are significant, most market participants have not fully gasped their implications. Let us consider the measures introduced in some detail.

MONTHLY UPDATE

3.1 Rewarding Failure

The Fed dealt with the financial failure in 2007-2008 by providing virtually unlimited credit to bail out the system. Over $12 trillion in loan guarantees were provided by the FDIC and the Fed, not to mention over $700 billion in TARP funds. While these supports were justified on the basis that the system might have collapsed without the same, the bigger problem was that they allowed the vast majority of failed firms to remain in business. In fact, the biggest institutions were the worst offenders in the financial crisis and were, and probably still are, insolvent. Amazingly, the bailout measures allowed most of the same managements (both executives and directors) that brought the system to the brink with a combination of incompetence and fraud to remain in their jobs. A number of Wall Street houses that were never banks were allowed to declare themselves banks at the height of the crisis, becoming immediately eligible for Federal banking support. This can be likened to a person being allowed to purchase homeowner's insurance after his house is already on fire. Even worse, the firms that carefully managed themselves through the crisis, the true successes in the financial system, had to both pay higher insurance premiums thanks to the mistakes of their larger brethren, while watching the latter get even more market power as failing firms were merged into the largest of the institutions. We are well out of the domain of capitalism here – if one rewards failure and punishes success it is probably anti-capitalism if anything.

3.2 Reduction of Transparency

Even the aggressive guarantees did not do the trick of "stabilizing" the failed firms – the free markets simply would not be convinced of the solvency of these companies given the toxic assets they had accumulated on their balance sheets. The authorities in the U.S. therefore meddled with the very accounting rules that guaranteed transparency. The mark-to-market rules that were so eagerly embraced by the financial firms when asset prices were going up were abandoned, permitting these companies to operate with a level of opacity that has rendered their valuations, earnings and virtually all other financial metrics essentially meaningless. Thus, we have equity and credit markets today where the single largest sector, which is still the financial group, operates under a financial reporting system where fantasy has replaced reality with regulator support.

3.3 Outright Market Interference

Even with all these changes, the markets remained unconvinced. After all, when virtually all the banks, insurers and industrial companies that relied on credit for their earnings (think General Electric and General Motors) are flirting with bankruptcy, it is exceptionally difficult to change market sentiment. Even worse, when the government's repeated huge bailouts led to more concerns about the scale of its indebtedness, the free markets could have been expected to force policy discipline by forcing bond yields upwards. But the Fed interfered in this situation in early 2009 with a commitment to monetize debt by buying mortgages to the tune of about $1.3 trillion. Thus, when the bond market oversight of policy was sorely needed, the Fed moved to prevent its functioning. The depression rhetoric that has become a trademark of Fed Chairman Bernanke as a justification for his actions should be viewed for what it is – a dramatic assault on the functioning of free markets because of the unpleasant message they are likely to send policymakers.

The willingness of policymakers to force markets to deliver preferred outcomes through intervention means that markets can no longer be the policy vigilantes. If intervention is going to be the norm, markets are essentially unnecessary because they cannot perform the function of properly allocating capital by penalizing bad measures and rewarding superior performance. As such, the entire investment industry with all its frictions and fees is completely unnecessary for society at large. Unfortunately, the investment pundits today do not appear concerned about any of these issues. In fact, the industry, along with the

complicit financial media, simply touts the U.S. policy line by playing the role of a glorified Pravda. The average USSR resident however, unlike his American counterpart, did not rely on Pravda with starry-eyed idealism for his daily news.

3.4 The Assault on Contract Rights

The U.S. government has recently begun to tamper with certain property rights that are arguably even more fundamental to capitalism than free markets. The GM bailout, discussed at length in an earlier letter, represented a significant shift in government thinking where it came to the sanctity of contracts. In this situation, the government decided to pay off unions and some other unsecured creditors at rates considerably better than those offered to secured holders of GM debt. Unfortunately, a bigger assault on contracts might soon occur in the housing market.

The housing market is still suffering massive delinquencies with numerous homeowners making no payments at all on their mortgages for two years or more. The government chose to interfere with the normal process of foreclosure, initially by requiring a delay in the legal process, thus leaving thousands of homes in limbo, and "homeowners" living in them payment-free with banks unable to foreclose. Of course, thanks to the mark-to-market rule changes and regulator forbearance, these defaulted loans did not have to be recognized as such by the banks. Under the current rules, lenders are required to modify loans to defaulting owners, when possible, under the guidelines of the Home Affordable Modification Program (HAMP) sponsored by the government. The HAMP program involves a reduction in interest payments possibly with some reduction in principal for eligible borrowers. History suggests that most homeowners who receive such modifications will typically default again anyway, a fact that is already well known to the lenders. However, lenders/servicers now have to certify that they underwent the HAMP process before foreclosure – a direct interference in the workings of the free market that is going to get worse for reasons we detail below.

Many of the mortgages that come under HAMP may involve second liens, home equity lines of credit and the like, all of which should typically be the first lines of defense to the lender providing the first mortgage. That is, when a homeowner defaults on his home payments, the primary lien-holder gets to be paid first on foreclosure, followed by the other lien holders – this is why second mortgages and home lines of credit carry much higher interest rates. In this context, any principal reduction for the homeowner should be 100% borne by the second and lower lien holders before the primary mortgage holder sees any writedown. A government mandated HAMP should retain these contractual priorities. However, the largest money center banks, which are already wards of the U.S. government, have over $442 billion in second lien mortgages, most of which are currently worth pennies on the dollar. Of course, these special interests are now lobbying to have the HAMP principal writedowns spread out among all the mortgage-lien holders despite their differing seniority. The government may agree to these demands since the HAMP is technically not a foreclosure, which means the standard contract laws may not apply. The seismic implications of this on the securitization markets are yet to be fully understood or discussed. By adopting such policies, the U.S. government can continue with the fiction that the banks are somehow solvent, even if the core foundations of its economic ideology are in jeopardy. Of course, the financial industry only continues to cheer such short-sighted quick-fixes. After all, the only thing that matters it seems to Wall Street, if not the Washington consensus, is that the financial oligarchy that has evolved in the U.S. remain firmly in power.

To summarize, we have a world today where the practice of capitalism is very much under threat. We have the U.S. government interfering with the workings of the whole economy on an unprecedented

scale, acting to affect markets overall with direct intervention and even worse, explicitly supporting the largest financial firms that are supposed to provide the market discipline. We do not believe that the world's largest markets are really free any more – if anything, we feel that the investment business has deteriorated into the unpleasant exercise of determining where the next government bailout is going to be. The only way to shake this "equilibrium" is with a crisis. The complexity of the world's economic and financial system is such that virtually anything could trigger a crisis – the ending of the Fed's direct intervention in the mortgage market in March could well be an important catalyst. Unfortunately, the next crisis will mean draconian market and policy adjustments.

4. Conclusions

Given our views, we have not changed our portfolio holdings significantly over the last few weeks. The continued euphoria is very worrisome since much of the economic data, especially in regard to government finances globally, have deteriorated considerably. The current market thinking is that the countries that adopt the most irresponsible deficit expenditures, along with monetization to prevent market upheaval, have the best investment potential. That is, the less capitalism (of the pure kind) is allowed to flourish, the more the investors seem to rejoice. Even more joy seems to be occasioned when bailouts and ultimately public control are extended to more of the private sector. With such bullish thinking, we feel more than comfortable betting against the consensus.

Performance Summary at February 28, 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)
-0.9%	-3.9%	-3.0%	-8.0%	11.8%	35.9%	21.1%	N/A	-0.9%	13.1%

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)
-0.9%	-3.8%	-2.6%	-7.3%	13.2%	38.7%	22.1%	6.8%	-0.9%	20.2%

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