

## Trident Investment Management, LLC Opportunities Funds Commentary

January 31, 2008

### Performance Summary

January 2008 proved one of the most eventful months for markets in recent memory. We saw weakness in the equity markets with the S&P500 down 6.00%, the MSCI Europe Index down 12.10% and the Nikkei down 7.47%. The performance was much worse intra-month, and even two rate cuts by the Federal Reserve in the latter half of the month could not prevent this unpleasant start to the year. Gold however, was strong being up 9.89% to end at 928 an ounce, a high for the current cycle. Oil suffered with WTI crude down 4.21% to end at 91.75 a barrel. The Treasury market celebrated the Fed's rate cuts with the 10-Year Treasury yield dropping 0.43% to end at 3.60%. Finally, the U.S. dollar was weaker on the month down 1.98% (all figures in U.S. dollars)

### Market Outlook & Portfolio Strategy

The credit and economic concerns that appeared to have receded partially in December resurfaced in January with a vengeance. Christmas sales in the U.S. were very weak with sales growth in December being the worst in over 15 years. Much of the other economic data also suggested intensifying economic weakness if not even outright recession in the U.S. On the credit front, the problems faced by the monoline bond insurers were the center of attention with markets finally coming to terms with the fact that these firms might actually face insolvency.

The bond insurance companies are a small group of little known companies (MBIA and Ambac are the largest of the group) which, in 2008, have come to the forefront of the credit crisis. We have discussed these companies in our letters several times before but we take them up again now given their importance to markets today.

Consider a company that provides home insurance for residences built on the flood plain of a river. If the company is set up after a recent flood, one could expect that the premiums it would charge for such insurance would be high given the claims experience. Moreover, it might not have many policyholders because few would brave building a house in a just-flooded area. Now, if the region experiences a period of drought and lowered water levels, it is likely that more would venture to build on the flood plain, purchasing the still-expensive flood insurance. A few more dry years however, and more participants would enter the business of insurance attracted by the high profits and continued new building. This has the paradoxical result that the insurance gets cheaper due to recent history and to competition, even as the number of the insured increases. Thus, even though the risk of a flood may not have changed appreciably since the last flood, many more people are getting insured at very low premiums that a few years ago would have been unthinkable.

In this environment, if there is a minor flood and it is controlled with levees built by the owners, that only emboldens all parties. The owners, insurers and the authorities all begin to believe from their success, that they have the flood problem under control. The cautious few are dismissed as being too pessimistic and we enter a bubble phase of flood-plain homebuilding with even lower insurance premiums. Our river town's authorities and company managements would all be experiencing the best of times with record profits and taxes while commanding public adulation. This goes on until of course, a real flood

hits like it did New Orleans. When that happens, the houses are wiped away and the insurers cannot pay even a fraction of the claims filed because they just did not believe a serious deluge could ever occur.

The credit insurers play the role of flood insurers but in the credit markets. These companies were created originally to insure the relatively safe obligations of municipalities, townships and states. The bonds of these entities were credit-enhanced by the insurers typically to AAA. The premiums they received for such enhancement were more than adequate since the municipalities as a group defaulted much less than their credit ratings would suggest. This business was relatively predictable, though profitable, and gave little scope for delivering the consistent strong “earnings growth” that Wall Street expected from its chosen. To turbo-charge their earnings, these companies decided to enter the burgeoning market for credit enhancement of structured credit (read Collateralized Debt Obligations or CDOs, synthetic CDOs, PPDOs etc) which are the credit equivalent of truly risky flood insurance. The companies insured a diversified portfolio of credits and as such, the total losses that they expected were small – in fact they often said that they wrote “zero loss insurance”. In the credit bubble we had from 2002 to 2007, all credit was highly correlated and performed much better than under normal conditions. As such, the zero-loss concept only seemed to be borne out in practice over this period emboldening these firms to increase risk. Unfortunately, when the bubble burst as it did in 2007, the losses on credit were highly correlated too. For the insurers, the credit equivalent of Hurricane Katrina has hit and they are still unwilling to accept the consequences.

Despite being very small firms, the credit insurers guarantee a disproportionate amount of debt. The two largest firms, MBIA and Ambac together have shareholder equity that is well under \$10 billion. However, with this sliver of capital they have insured over \$1.6 trillion (\$1,600 billion) of debt. In particular, these firms guarantee over \$200 billion of especially toxic CDOs and other similar obligations. They claim that most of their exposure here is AAA rated, but these ratings have proved unreliable in 2007 with large swathes of supposedly AAA securities often being downgraded several notches and sometimes even to junk. These complex credit structures were among the main areas for growth for these firms over the last few years. Unfortunately, these are precisely the areas that are threatening their very solvency today.

The companies claim that their equity cushions are more than adequate because of their expectation of zero losses. The rating agencies seem to endorse this point of view because they continue to rate these companies AAA. However, markets have begun to anticipate a bankruptcy of these firms based on the current prices for uninsured CDOs and other structured credit products. Many of these products now trade at prices approaching 20 cents on the dollar. If these prices reflect the actual losses that holders can anticipate in these securities, there is no doubt that the credit insurers will be forced into bankruptcy because of the scale of the losses in relation to their small capital cushions.

A bankruptcy or even a significant ratings downgrade of the credit insurers will have seismic effects on the financial markets and especially for structured finance. Almost \$2 trillion of debt could lose its insurance guarantee in the event of these firms being downgraded or being forced into bankruptcy.

This could create a bond rout in the near term as numerous investors are forced to liquidate downgraded bonds. This effect might prove relatively short-lived in the municipal bond market given the generally superior credit quality of these obligations. In fact, in a perverse twist, some of the insured bonds in the municipal space are trading at levels below those of uninsured bonds suggesting that the credit “insurance” is actually having a detrimental impact on these issues.

Significant problems with the bond insurers will have cataclysmic implications for the world of structured finance and for Wall Street overall. To understand why, consider that numerous loans in real estate were made in the last few years to borrowers who were virtually certain not to pay. These loans were such that any normal bank or investor which had its own capital at risk would never make them. The loans were securitized and sold to capital markets investors typically using a corporate structure that purchased the loans and funded the purchase by issuing numerous tranches of senior and progressively subordinated bonds to investors. The bonds were collateralized by the underlying loans in the company and commanded different ratings based on their seniority in the capital structure. A classic structure like this, is nevertheless extremely difficult to stress-test. With 1000 loans making up the collateral pool, a credit stress test would require, for each loan, gathering of borrower information, house information, economic data about the relevant zip codes and a host of additional data making this task very difficult. The credit modeling that was done on these types of transactions was inherently suspect given the transaction mentality of Wall Street – after all the job was to get these deals sold, not to own them.

A Collateralized Debt Obligation (CDO) is essentially a second level of the securitization process described above. The CDO raises funds from the markets and invests in a portfolio of bonds. A real-estate CDO thus, might invest in numerous simpler securitization deals purchasing either senior or subordinated bonds as it sees fit. The problem with the CDO structure is that it adds more complexity to what was already a complex securitized product to begin with. In fact, were a CDO to invest in 10 different securitized transactions each in turn involving a securitization of 1000 mortgage loans, a true CDO stress test will require full data now, not on 1000 loans but on 10,000 loans with all their associated documentation not to mention their complex deal terms. While even a simple, single-level securitization would strain any investor’s understanding, a CDO transaction that invests in other securitizations would tax a Yoda. Unfortunately, thanks to our credit insurers, these complexities could be ignored – a guarantee from one of these firms and the investor could look to the insurer’s solidity rather than muddle through the transaction’s opaque terms. Considerable amounts of questionable bonds were securitized in this fashion to be sold to willing investors – any pig of a transaction could be magically dressed up in full lipstick glory to be presented at the ball. Of course, our alchemist insurers did all this for a nice fee. And this would not have been possible without the willing cooperation of the ratings agencies who were only too happy to stamp these transactions with their AAA imprimatur, for a hefty fee, so that investors would buy them. The regulators of course, were notably absent in all this – why interfere when everyone is happy? In fact, the insurance regulators were the ones that approved the entry by the credit insurers into the structured finance space in the first place.

The underlying loans backing the pyramid of securitizations are currently defaulting at record levels creating stress in this edifice. A problem with the bond insurers' solvency at this juncture would be the death knell for the entire alphabet-soup-market of credit derivatives. Without AAA guarantees fanciful prices on CDOs are simply not justifiable. Were one to make an attempt to sell these securities, the values are often as little as 20% of face – an unpleasant prospect for a holder carrying it at 100%. Banks and brokers which have “hedged” these instruments by purchasing protection from credit insurers (yes, they did that too!) suddenly find that the protection is worthless and that they need to recognize losses on billions of dollars of previously undisclosed risks. These institutions as well as the ratings agencies, might have to field numerous lawsuits in short order from irate investors who arguably could and should expect at least a minimal level of ethics and due diligence in these deals both of which were notably absent. And the regulators would face embarrassing questions of competence if not outright dismissal – after all, they turned a blind eye to the excesses with no attention at all paid to the public interest. A lynch mob looking for culprits here will find no shortage of candidates.

The market's concern about the credit insurers in January has prompted a flurry of calls for government intervention and bailouts, especially from Wall Street. The New York State Insurance regulator in conjunction with banks and other investment firms is attempting to formulate a rescue plan for these institutions. A full bailout of these firms would require capital in excess of \$200 billion according to rating agency Egan Jones, resources considerably in excess of what even the Federal government could muster at this juncture. Moreover, such a bailout, if taxpayer funded, would not adequately penalize the parties responsible for this mess. Splitting off and reinsuring the municipal bonds guaranteed, would be in the public interest though that would accelerate the demise of what is left of these companies. Since neither outcome is easy to achieve, the current discussions are centered on proposals that are ludicrous in the extreme.

One bailout idea that is being discussed is to force the banks most exposed to these companies' guarantees to put up additional capital or credit lines for them so that they could retain their AAA ratings. This way, the banks would not have to take the write-downs on their holdings and the capital hits that would result from a credit downgrade of the insurers. Everyone could go back to business as usual. In other words, the insured parties (the banks) which are already reeling from bad loans and inadequate capital would give more money to their bankrupt insurers (who cannot pay them in the first place) so that everyone could pretend that no problems exist. What is terrifying is that the regulators appear to actually be considering such a proposal despite the fact that it does nothing to solve the underlying problem. But when the insurance regulators and the Federal Reserve have failed so abjectly in their duties to regulate their domains, it is perhaps understandable that they want to espouse solutions that prevent the public from finding out just how badly they have failed at their duties.

The bond insurer problems and the equity market sell-off in early January also triggered a panic-stricken response by the Fed which cut its Funds rate by 0.75% between meetings in mid January – the largest single rate cut since 1982. Moreover, the Fed cut again at its regular meeting just a week later by another 0.50%.

Most of the world's central banks did not follow suit despite even bigger declines in their respective stock markets. The Fed's actions suggest that it cares little about the long-term implications for the dollar or about moral hazard – bad lending and fraud need to be bailed out, especially when the exposure of the same would reveal all the deficiencies in regulation. The U.S. which preached to the Asian countries in 1997 about the need for transparency, higher rates and bad bank failures even if it meant economic pain, is reacting with obfuscation, bailout plans and rate cuts when faced with similar problems. The power brokers here who preached full privatizations of huge profits in happier times are all clamoring now for ways to socialize the losses that resulted from their disastrous decisions. Foreigners, who are among the largest holders of U.S debt today, no doubt are beginning to understand that crony capitalism is alive and well in the U.S.

Faced with these realities, we continue to remain short in the U.S. We believe that the problems in the financial space, while serious, are likely to present issues mainly for the financial companies which should continue to have problems for years to come. We are constructive however, about most of the defensive and multinational companies in the U.S. simply because they are largely immune to these problems except to the extent that it might affect them through the real economy. We feel some global coordinated policy action will soon be forthcoming – the U.S. is sliding into a recession that a few rate cuts can delay but not prevent. As such, the world outside the U.S. has to serve as its own locomotive for growth and this should represent a wrenching adjustment to the investment paradigm so far prevalent. We remain very constructive on gold but continue to be relatively cautious overall because we believe that a period of volatility and down markets is likely in the near term. The testing period has started, but we are not sure yet where the test will be.

**Performance Summary at January 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)
4.6%	16.2%	58.4%	97.6%	36.2%	27.5%	17.6%	N/A	4.6%	12.9%

**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)
1.6%	10.3%	58.5%	115.1%	38.4%	28.1%	17.4%	17.5%	1.6%	21.0%

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