

Trident Investment Management, LLC Opportunities Funds Commentary

January 31, 2009

Performance Discussion

2009 started on an unpleasant note for global equity markets with the S&P Index down a horrendous 8.43%, the Nikkei down 9.76% and the MSCI Europe Index down 3.35%. The S&P 500 in fact, had the worst January in its history. The U.S. dollar rallied with the U.S. dollar index appreciating 5.77% on the month. Fixed income markets outside the U.S. also rallied with yields on the Australian 2-year Treasury falling 0.45% to end at 3.08%. Oil suffered, as did most other commodities, falling 14.22% to end at \$41.68 a barrel. Gold was a bright spot in the commodity universe rising 4.86% to end at \$927.3 an ounce. Despite the equity market carnage, credit markets overall did well, with most credit spreads trending tighter on the month (all figures in U.S.).

Our funds had a good January in large part due to our long positions in short-dated, non-U.S. fixed income instruments. The gains on these holdings were very significant and outweighed our losses in credit. Our commodity and equity holdings also helped our performance with our long positions in gold and gold stocks being the primary contributor to performance.

We continue to believe, as we did entering this year, that markets will be volatile for the first several months of 2009. The economic news so far has been terrible and provides further confirmation of how bleak the global economic environment has now become. As such, we see no reason to change our views, and remain with our core investment positions. We continue to stay long gold and gold stocks, as well as short dated fixed income. We believe that the recession we have entered will be the most serious one since the Great Depression of the 1930s. The U.S. consumer is unlikely to become an engine for global growth and consumer stocks and credit still remain excellent shorts. The clarity on policy we are waiting for still seems some time away.

Market Outlook & Portfolio Strategy

The big news for January was, of course, the inauguration of Barack Obama as President of the U.S. His election represents a milestone in American politics and a triumph of American ideals. Unfortunately, that is about all one can celebrate for the month – the rest of the news especially on the global economic front, was more than dismal. While a U.S. recession was inevitable what was shocking was the remarkable deterioration that we saw in the rest of the world. Japan is now suffering from a staggering decline in exports as are China, Singapore and a host of countries that export a lot to the U.S. The slowdown in the U.S. economy appears to have led to an amplified slowdown globally, even in countries that were not directly affected by the global credit crisis.

The policy responses so far, especially outside the U.S., have been lukewarm. While many countries have cut rates aggressively, this approach has modest to no impact in an environment of excess capacity. Direct fiscal stimulus has a much better chance of working. Most of the U.S.' trading partners (excluding Japan)

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are in relatively sound fiscal shape and as such have the means to directly stimulate their domestic economies with government expenditure. However, the scale of their response has been very limited so that the sharp reduction in exports has meant a dramatic erosion of domestic confidence. We have now entered a vicious cycle of weaker growth which in turn begets greater reductions in consumer spending. Not surprisingly, global recessionary conditions are being exacerbated.

Few would deny that the response to the current crisis has been the most aggressive in the U.S. The U.S. Federal Reserve has already cut interest rates to virtually zero and has provided more than \$10 trillion in guarantees of toxic assets to the financial system. The Trouble Assets Relief Program (TARP) has directly injected \$350 billion in capital into the financial system with at least another \$350 billion already earmarked. Also, the Obama administration is contemplating direct fiscal stimulus totaling at least \$400 billion per year over the next two years or longer.

The first problem with the U.S. response is that the country lacks the resources for further fiscal stimulus. Estimates for the U.S. annual, fiscal deficit exceeded \$1 trillion even before the Obama stimulus. With the Obama expenditures, the U.S. can expect an extended period of annual deficits exceeding \$1.4 trillion. Unfortunately, the world as a whole does not generate the excess savings to fund such a huge deficit even for one year, let alone for several. The only alternative therefore that the U.S. has, is to monetize these deficits. The Federal Reserve has expressed its willingness to print money to fund these deficits. In fact, in its January meeting, the Fed explicitly said that it would consider purchasing U.S. longer-dated bonds outright if the circumstances warranted. Unfortunately, huge deficits monetized by money printing are a recipe for hyperinflation as we know very well from the economic history of the banana republics of yore.

The second more significant problem with the U.S. response is that it is an aggressive cyclical response to what is inherently a structural issue. The U.S. is hyper-levered with the total credit to GDP ratio exceeding 350% – a ratio that is about the highest observed in human history. The U.S. consumer is also the most levered he has been in his history and much of the growth of the economy, especially following 2000, has come from expenditure arising from his increased leverage. By some estimates, fully 55% of all the jobs since 2000 were created in the construction and retail industries both geared heavily to consumer spending. Without the huge leverage at the level of consumer and the financial system, any correction in U.S. real estate prices might have been painful but not catastrophic. However, when much of the leverage has gone to finance assets at inflated values and we have a decline in these values, there is capital destruction in leveraged financial institutions leading to a credit crunch. This in turn, leads to job losses, consumer distress and a pullback in consumer spending intensifying the downturn. Unfortunately, the only solution to this situation is to address the problem of too much leverage and too much spending. The U.S. policy responses so far have done little to reduce the country's expenditure or its incredible reliance on foreign capital. If the structural reasons for the current crisis were too much leverage and too much spending, how could the solution involve even more of the same? The U.S. policy mix reminds one of the old joke that says that the best way to avoid a hangover is to stay drunk!

The most serious issue with the U.S. policy mix is that it has been almost totally ineffective, while depleting a huge amount of the taxpayer's scarce resources. The TARP, as implemented by former Treasury secretary Paulson, spent an initial \$350 billion in providing more capital to the banks. Unfortunately, a considerable amount of the money was used by the financial firms first to pay huge compensation packages to their employees and managements, and next to buttress their capital that had been badly depleted by asset price declines. The bonuses paid by financial companies receiving TARP funds in 2008, a year of record losses, were the same as they had been in 2004 which was a year of significant profitability. None of the funds injected by the TARP have gone to new lending, and it is unclear that they have even succeeded in stabilizing markets because post the injections, things have got much worse.

The poster child for the ineffectiveness of TARP in January was Bank of America, an institution revered by the analysts as being one that had successfully navigated the credit crisis. The latter firm had purchased Countrywide Financial Services in the beginning of 2008, and swooped in to buy Merrill Lynch in September 2008 at a significant premium to its then stock price. At the time of the Merrill purchase, Ken Lewis, the Chairman and CEO of Bank of America, had assured investors and analysts that they had done adequate due diligence, it was an "ideal fit" and that "Merrill had the liquidity and capacity to see this through" and that he foresaw few problems because, in his words, "We're good at this". And this is despite the fact that "superstar" John Thain who had taken the helm at Merrill in late 2007 when the firm's problems were apparent had spent \$1.25 million renovating his already hyper-plush office. The analyst reports after the acquisition were, of course, worshipful in their praise of Ken Lewis' genius but January proved that their idol had feet of clay. Merrill Lynch reported record losses of \$27 billion resulting in the dismissal of John Thain, and Bank of America itself reported disappointing earnings. After all, the latter has a huge presence in California, which is the epicenter of the real-estate crisis, and as such was almost certain to have trouble especially since its Countrywide acquisition was ridiculously ill-timed. Even worse, the Merrill deal closed on December 5, 2008 and the Bank of America management did not inform its shareholders of the huge loss that Merrill had experienced in the fourth quarter before the deal's closure. The management argued that it was not aware of the losses until January – a ridiculous claim given the oversight that needed to have been exercised post the takeover agreement. So, here we have a bank chieftain who purchased toxic firms at absurd valuations during the credit crisis, presided over a 90+% decline in his stock price and can be reasonably questioned about what he knew and what he disclosed to shareholders before the Merrill takeover closed. His supporters argue that he is a victim of a difficult macroeconomic situation. But is it unreasonable to expect a highly compensated head (making in excess of \$20 million per year for each of the last 7 years) of one of the world's largest banks to at least make a cursory attempt to manage the risks in his firm during one of the worst crises of the last 70 years? Obviously not, because Ken Lewis was actually voted Banker of the Year in 2008!

The sad fact in the Bank of America debacle is that the taxpayer has been forced to pay for Ken Lewis' mistakes. It appears that Bank of America threatened to pull out of the Merrill deal in private

discussions with the government. Its tactics of extortion were rewarded in January with the government providing the firm \$20 billion of taxpayer funds and an amazing \$118 billion of guarantees against bad assets. And this is for a company whose total market capitalization is less than \$30 billion. And, in an absurd twist, the Board of Directors continued to express confidence in Ken Lewis and the firm's business model. All this makes one feel that US policymakers are being held to ransom by a group of incompetent, and certainly home-grown, financial terrorists.

The lack of an effective, long-term strategy is apparent also outside the U.S. The U.K. is dealing with a situation where its financial industry (its unique competitive advantage) is fading into irrelevance. China and Japan are facing the demise of their economic growth models driven by exports to the U.S. Most developing countries which looked to the U.S. for financial acumen and investment capital after the Asian crisis of 1997, are discovering that the miraculous growth of the U.S. economy for the last decade or more was largely a myth even as they are being called on to fund ever-increasing U.S. fiscal and trade deficits. It should be obvious to everyone by now that the U.S., and particularly the U.S. consumer, cannot be expected to lead the world out of recession. The structural impediments the U.S. faces require that it limit its expenditures and focus on creating a more stable platform for longer term growth. Unfortunately, the world still looks to the U.S. for growth leadership and the more the U.S. dollar strengthens in response to the U.S. policy actions, the worse the structural problems become. While the current market dynamics might even engender a period of superficial stability, we are setting the stage for a potentially more painful extension of the current crisis.

The situation we are in calls for strong, global economic leadership with leaders committed to ensuring that a reasonable and stable solution is arrived at for the world. Any measures agreed on will be painful – the complex global negotiations will involve just how this pain is to be shared across countries. Unfortunately, there has been no coordination to speak of so far. The U.S. is spending more resources than the rest of the world combined with little consideration being paid to the terms at which the world may be willing to finance such expenditure. The U.S. dollar's status as a reserve currency allows the country to operate unilaterally in this fashion – after all, any attempt to discipline the U.S. through forcing a U.S. dollar devaluation will mean huge losses to foreigners' existing multi-trillion holdings of the currency. The problem with the U.S. approach is that it will unquestionably make the global problem worse. If the world continues to fund the U.S. at favourable terms and maintains the illusion that the U.S. is a good credit, U.S. government borrowings will take up more and more of the world's savings leaving much less for the rest of the world, unless these borrowings are monetized. Thus the countries outside the U.S. are faced with a hard choice. They can join the U.S. in monetizing huge deficits and collectively set the stage for a global hyperinflation that devalues paper money. If not, they can risk a massive fall in the dollar as the U.S. continues on its borrowing binge but then be forced to contend with the consequences which that will entail for their domestic economies. There is a compelling case for joint global action, but so far unilateral policy has been the norm.

Unfortunately, the world today has little in the way of economic leadership. The International Monetary Fund and other agencies are bound to the crony capitalist ideology so long prevalent in the U.S. and

continue to believe in “private sector” solutions to the current crisis despite overwhelming evidence as to the incompetence of the private sector managements. The capital markets are proving to be inadequate where it comes to disciplining policymakers because most participants in the markets are still residents of the world of Oz. After all, the financial statements of most of our leveraged institutions today are just creative fiction, our ratings agencies continue to churn out equally escapist analyses unworthy of village idiots and the investors themselves continue to believe in miracle bailouts to save them from their bad judgments. With this backdrop, it is easy to see why U.S. dollar has rallied strongly in the last few months despite huge U.S. problems. Even worse, most observers now argue that the rest of the world (which is still much more prudent) is in worse shape. And to add insult to injury, the rating agencies recently downgraded the country credit ratings of Greece and Russia while continuing to give the U.S. and the U.K. (the chief problem areas in the world) their highest ratings. Denial of reality seems to be a common, global affliction now.

Reality, nevertheless, has started to intrude on the markets because of the continuous stream of bad economic news. This in turn, has resulted in a steady erosion of confidence, despite heroic efforts by governments to prevent the same. Every investor purchase of a bank equity offering has proved to be a disaster, every pronouncement by a financial chieftain has been fantasy and every policymaker’s assessment of costs has been hopelessly off the mark. The private investor has good reason to worry and governments, by not addressing these issues quickly, are virtually ensuring that they will be the only participants left in the financial markets. How ironic it is that governments committed to private sector solutions are in fact pursuing policies that squeeze out all private participation!

All this said, the actions that need to be taken to deal with the current global crisis are still childishly simple. The average bank in the U.S. and the U.K. operates with a ratio of assets to tangible capital of about 10X. The largest money center banks operate with a ratio well over 15X. When off-balance sheet obligations are brought on balance sheet, the ratio for the largest banks could well be in excess of 30X. Even the most optimistic of U.S. forecasters would conclude that at least a 5% decline in total asset values has occurred. This would mean that with 30X leverage, most of the larger banks are essentially bankrupt. And if the optimistic forecasts prove wrong, the losses in the system are only going to increase, necessitating the creation of a Resolution Trust Corporation (RTC) type entity to hold the assets of the now-defunct banks. With this rather simple backdrop, what is amazing is the degree to which policymakers refuse to accept reality. The quicker the banks are nationalized and de-levered, the more likely it is that taxpayer losses will be minimized. Moreover, a stable banking system can permit the rest of the economy to at least make an attempt to resume its normal business.

The new Obama economic team remains wedded to the ideal of private sector solutions for the banking crisis the U.S. faces. Even worse, at a time where global coordination is critical, cross country tensions have increased. In his confirmation hearings, Treasury Secretary Geithner accused China of currency manipulation, which has been the operating view in the current administration. This prompted an angry response from China which accused the U.S. of mismanaging its economy and blaming others for its own problems. Unfortunately, recessionary conditions in the U.S. and its trading partners mean that such wars

of words are going to occur more frequently. To the extent that these result in trade disputes, we could easily see a huge decline in global trade, making global economic conditions even bleaker. Moreover, the U.S. is in no position to dictate terms to the Chinese or any of its larger trading partners given its huge borrowing requirements. Any dispute with the Chinese has the potential to trigger a collapse in the U.S. bond market and/or the U.S. dollar – outcomes that would usher in a new and much more serious phase in this crisis.

To sum up, conditions in January globally have got considerably worse. While it is clear that policymakers understand the seriousness of the crisis we are in, they have yet to adopt any well thought out policies that will engender longer-term stability. As such, we continue to blunder along in the markets, lurching possibly towards the next crisis. With this backdrop, we remain in most of our core bets of being short the U.S. consumer both through stocks and credit, and have increased our long position in gold and gold stocks. We have increased our short position in U.S. long-dated bonds and the U.S. dollar, but still expect more volatility over the next several weeks when we can add to our positions. The environment is still exceptionally treacherous. The only silver lining is that market action might soon force a resolution.

Performance Summary at January 31, 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)
2.9%	13.4%	24.1%	41.3%	67.1%	37.9%	24.5%	N/A	2.9%	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)
2.3%	12.4%	27.6%	43.6%	75.7%	40.1%	23.4%	14.3%	2.3%	22.5%

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