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Trident Investment Management, LLC
Opportunities Funds Commentary

January 31, 2010

Performance Discussion

January 2010 started with the same rampant bullishness of late 2009. In the first few days of the year, most equity markets were up significantly, credit tightened and bullish analysts held sway. Things took a dramatic turn mid month however, thanks to concerns regarding a tightening of Chinese monetary policy, as well as the potential for a debt default by Greece. The month ended with much of the euphoria gone. Equity markets finished down with the S&P500 down 3.7%, the MSCI Europe Index down 2.9% and the Nikkei down 3.3%. Fixed-income markets rallied with the yield on the 10-year U.S. Treasury falling 25.3 bps to end at 3.6%. Credit spreads widened fractionally. Commodities sold off with gold down 1.5% to end at $1,080.85 an ounce and oil down 8.2% to end at $72.89 a barrel. The U.S. dollar rallied with the U.S. dollar index appreciating 2.1% on the month (all figures in U.S. dollars).

Our funds were unchanged in January. We had gains in our long positions in Australian fixed income and U.S. curve steepeners, as well as in our short credit book. These were almost entirely offset by losses on our commodity and stock positions in gold and oil. That said, a number of our options positions in fixed income have moved from being substantially out of the money to now being almost at the money. A continuation of the January price action in fixed income could therefore bring about a dramatic boost to our performance.

Market Outlook and Strategy

In our previous letter, we had discussed a variety of scenarios for the world given the numerous global imbalances we face. A significant tightening in China was one of the factors that we had highlighted as a catalyst for a deflationary world. To recapitulate, the Chinese in 2009 responded to global economic weakness with dramatic credit creation to the tune of almost 30% of GDP and thus achieved an impressive 8.7% growth in GDP. The investment to GDP ratio in China was over 40% even prior to last year, but a staggering 70%+ of the 2009 growth came from investment. While much of the new investment went to improve the country's infrastructure, there is no doubt that a significant fraction also went to adding new production capacity. Thus China added to its export capacity in a world that is already short of final demand. The Chinese authorities by their actions prevented a more significant slowdown in the country. They expect that their policies of continued credit creation and investment can be continued for a year or two until the global economy recovers with any mal-investment over the period being an acceptable price for fostering domestic growth. Unfortunately, these policies do nothing to boost global consumer demand which is ultimately necessary to boost Chinese exports. A China determined to grow exports over the medium term, in a world with an already weak global consumer, is inherently deflationary for the global economy.

In the first two weeks of 2010, the Chinese financial system created credit at a pace that appeared even more frenetic than that of 2009. Chinese policymakers, who appear increasingly divided as to the efficacy of credit expansion, responded with some half-hearted tightening. Specifically, they increased the reserve requirements for banks and conducted open-market operations that caused a marginal increase in interest rates. While these measures almost certainly have little effect in themselves, the markets perceived them as harbingers of a more dramatic Chinese crackdown – a belief that led to a reversal in the global market euphoria, especially in commodities. China currently operates within a fragile global economy and with a real estate and financial bubble that, in some respects, dwarfs those seen in the developed world. Truly tighter monetary policy could prick the domestic asset bubble and lead to a prolonged recession in the country – something that policymakers want to avoid at all costs. Thus, we do not believe that any serious policy tightening is imminent.

The Chinese actions were compounded by what was literally a Greek tragedy in Europe as markets began to focus on the parlous state of affairs in one of the European Union's (EU) smallest member economies, Greece. We have rarely, if ever, mentioned Greece in our communications, not least because this country of 10 million represents just 3% of the EU's GDP. Unlikely though it may seem, this nation has become the first proving ground for the Union itself.

A country that joins the EU and adopts the Euro is establishing a monetary union with the bloc and not a true political union since it will still have its own government. A nation has to make two major adjustments to join. First, it has to get its fiscal house in order, in accordance with the criteria established in the Maastricht treaty of 1992 that governs Euro zone membership. In particular, the country's fiscal deficit cannot exceed 3% of GDP. Next, it abandons its ability to conduct independent monetary policy. The European Central Bank (ECB) determines the level of Euro rates based on what is appropriate for the entire bloc. When economic conditions vary widely across the group, the ECB rates may be far from ideal for an individual member. In particular, when rates are too high given a weak economy in a member state, the government has to contend with a restive domestic electorate and its own ultimate survival. Unfortunately, there is no automatic mechanism for the EU as a group to help member states facing difficult conditions. While under certain conditions, as delineated in the Treaty of Lisbon of 2007, such help may be possible, it is nevertheless not something that the creators of the EU had anticipated.

While accession to the EU might appear to be a fiscal and monetary straitjacket for the member countries, there is no doubt that a number of the more indebted participants benefited enormously from being in the EU. Prior to monetary union, there were wide divergences in debt levels and fiscal policies across the member states. Spain and Italy, for example, had more debt (denominated in their respective local currencies) with correspondingly higher interest rates than Germany. With the creation of the euro, the more indebted states converted their

debt from their currencies into the common currency, the Euro, and benefited from a dramatic decline in their borrowing costs. Greece, which was a later entrant into the euro bloc, saw a significant decrease in its financing costs as well. The lower fiscal outlays on interest should have given these more indebted countries ample room to make the fiscal adjustments needed to put their deficits on a sustainable longer-term path. Unfortunately, the era of relative prosperity that followed the entry into the EU was generally not accompanied by an equal measure of fiscal restraint. A number of the indebted states, including Greece, did little to reduce their overall debt burden. Even worse, the much lower interest rates in what were originally higher-rate countries led to a property bubble that was most pronounced in nations such as Spain. The crisis of 2007-2008 proved to be an unmitigated disaster for most of these countries. Their fiscal deficits now vastly exceed the 3% levels established in Maastricht, and making the necessary adjustments to reduce them in an already weak economic environment could well be political suicide for the respective governments.

Where it comes to Greece in particular, the economic situation in the country is not pretty and reflects decades of policy mismanagement. The country labors with a fiscal deficit of about 12.8% of GDP and government debt at a whopping $441 billion or 125% of GDP. It is likely that the true level of Greek debt is much higher especially when promises made by the government for future benefits to its citizens are factored in. The institutional environment in Greece is not much better. The country has a highly regulated labor market, one of the world's most complex and deficit-ridden pension systems and worst of all, an already-high tax burden. While the country's challenges are certainly immense, it should be pointed out that a number of countries in the developed world are in similar situations. The U.K., the U.S. and Japan all share some of the same economic fundamentals that characterize Greece. However, the Greeks, by being part of the EU cannot simply run big deficits and print money to finance the same. They are forced by the institutional framework under which they operate to actually deal with the problem head on.

Greece has some important policy choices to make in dealing with its current situation. The country has to decide first whether it should attempt to pay back its sovereign debt or simply default on some or all classes of its debt. Next, it has to decide whether to remain within the euro monetary bloc, or leave the union and reinstate its old drachma currency. Were the country to default today, it is almost certain that it would be shut out of the global debt markets which would mean an immediate need to restore fiscal balance. After all, if the government cannot borrow, it cannot run a deficit either. If it were to leave the EU and create its own local currency, it will have to forcibly convert some or all of its debt to the new currency, and can then resort to monetizing the debt by printing. Unfortunately, were it to do so, the new currency would almost surely be devalued relative to the Euro resulting in an almost certain default for at least the debt that it retains in Euro. In fact, even the possibility of such a policy would lead to immediate and significant capital flight from the country resulting in its possible collapse, not to mention that Greek creditors will likely attach all the

assets of the country outside its borders. Paradoxically thus, the best Greek alternative would be to stay within the Eurozone and attempt a fiscal retrenchment.

If the Greek government receives support in its fiscal adjustment effort either from the EU or the International Monetary Fund, the pain involved might be lessened, but there is no doubt that the pain will still be considerable. More creative measures are also possible to reduce the pain of adjustment. Specifically, Greece could introduce a domestic pseudo-currency which, for convenience, we shall refer to as the re-drachma. The government would make the re-drachma acceptable for payment within Greece, and establish a free market where re-drachmas could be converted to euros. The government would also announce its intention to eliminate the re-drachma after a set period of say five years, with all holders of this currency receiving euros at that point at the then-prevailing exchange rate. By paying its contractors and civil servants in re-drachmas, the government could effectively force the domestic payments system in the country into the new currency, while still retaining the link to the Euro through the currency exchange market set up. This would allow the government a modicum of monetary policy flexibility to further lessen the pain of adjustment. It is very likely that a credible plan along these lines would have full EU backing as well, a critical requirement to prevent capital flight and retain the link to the Eurozone. Unfortunately, this creative approach is rather messy to implement properly and still will not substantially lessen the pain of adjustment. The simple fact is that the EU rules simply require that any member country live within its means as specified in the Maastricht agreement. Doing the right thing in this context requires that a country like Greece take the necessary steps towards fiscal discipline.

The alternative that we have not discussed above is the one about which countries are most optimistic. The EU members could agree to collectively help Greece either by guaranteeing its debt or making outright and substantial transfer payments to the country. The cost of such a bailout is likely to be small relative to the size of the EU economy – if anything, the cost should be considerably less than what was expended in the U.S. to save AIG. There are two major problems with such an approach. The first is that a lack of political union in Europe means that such a decision would be inherently unpopular – after all, why should frugal Germany (and other members in good fiscal shape) pay to keep profligate Greece in the union? A majority of Germans in fact, would prefer to see Greece leave the EU than countenance a large transfer payment to the nation. The second problem is much more serious. A bailout for Greece means that any member state in the EU that does not adhere to the union's fiscal rules could hold the EU hostage and demand bailouts. The cost of a bailout for Spain or Italy, which also have serious fiscal problems and huge levels of debt, would be prohibitive and impossible given the resources of other member states. Thus, a true bailout without draconian fiscal adjustment conditions for the problem member state would set a bad precedent and ultimately doom the entire EU. The EU rules have been well established and clear and members voluntarily signed on the union fully understanding the compromises involved. Any attempt to change the rules at the behest of

violating members would permanently undermine the structure and virtually guarantee the demise of the euro.

We do not believe that the EU is going to unconditionally bail out Greece. There might be assistance offered by the member states to Greece, but we expect that such help will be laced with significant requirements for Greece to reform its finances. Given that Spain, Italy, Ireland and Portugal are all in similar fiscal straits, we expect fiscal retrenchment in all of these nations as well. As such, Europe is more likely to be a drag on global growth than a locomotive for it. The EU's structural framework forces nations to deal with too much debt by the simple process of deleveraging. This is something that the U.S. and the U.K. should emulate – after all, more debt in an already-leveraged world only creates conditions for an even bigger global collapse. But today's world is sufficiently topsy-turvy that the only policies that markets reward are those that are the most profligate measures and with the highest ultimate risk.

The conditions in China and Europe have made us feel that the odds of a deflationary bust have increased. That said, we still feel that an inflationary resolution of global debt is still the most likely outcome because the consequences of global deflation are just too unpleasant to contemplate. We have added recently to our long positions in Australian fixed income and our short positions in credit where we feel the payoffs are skewed in our favour if a deflationary scenario comes to pass. Things are rapidly coming to a head and the next few months promise to be exciting.

Performance Summary at January 31, 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)
0.0%	-1.9%	-2.8%	-6.4	15.0%	37.8%	22.3%	N/A	0.0%	13.4%

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)
0.0%	-1.7%	-2.6%	-6.0%	16.2%	42.6%	23.2%	8.7%	0.0%	20.3%

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