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MONTHLY UPDATE

Trident Investment Management, LLC
Opportunities Funds Commentary

July 31, 2007

Performance Summary

Equity markets suffered in July with all major indices posting losses. The S&P 500 Index was down 1.5%, the MSCI Europe index was down 2.2% and the Nikkei was down 4.9% (in U.S. dollars). Sovereign bonds rallied, with the 10-year U.S. Treasury falling in yield 0.29% to end the month at 4.74%. Oil rose with WTI crude finishing at US$78.21 a barrel, a gain of 10.2%. The U.S. dollar was down slightly, with the trade-weighted dollar depreciating 1.4%. The credit markets continued their sell-off that started in June, with most credits widening dramatically. Trading in several of the riskier sub-sectors of the credit markets virtually ground to a halt, with sub-prime credits in particular suffering huge losses.

Market Outlook & Portfolio Strategy

The credit issues that we have been writing about at length over the last few months are finally starting to be reflected in market prices. To recapitulate from our previous letter, we had likened the compression in credit spreads since 2003 to a building boom in the flood plain of a river, with builders taking comfort in the fact that the river had not flooded its banks for the last few years. The absence of major credit accidents and the low levels of interest rates convinced everyone that such risky investments were in fact, safe, and allowed a massive repricing of credit, all predicated on the fact that there would be no more catastrophic losses. Moreover, the mad rush for yields allowed Wall Street's financial engineers to conjure up complex credit derivatives that tranched up credit risks in weird and wonderful ways, making it virtually impossible to link the behaviour of specific securities to underlying credit trends in a simple fashion. To value these instruments, market participants have to rely on complex models that require numerous assumptions for their operation. Thus, in our flood-plain-land-rush credit environment, many investors, including several with significant leverage, own opaque securities whose valuations are entirely driven by models that few people can understand or critique.

The reliance on models in the financial and economic spheres is widespread. The quest of every economic or financial forecaster is to develop a robust model that will allow for forecasts with high conviction. The more rigorous and mathematical such a model is, the more one can quantify the precision of these forecasts. However, a critical requirement of any such model is that it capture the important phenomena that one is trying to study. Thus, for example, a model that attempts to explain corporate balance-sheet leverage must, by necessity, capture issues relating to the taxation of debt, bankruptcy risks from excessive indebtedness and the like, all of which play an important role in determining leverage. Unfortunately, the more variables, the more intractable the model becomes. Thus, in building any model, a tradeoff between precision and relevance is called for. A mathematically elegant model can miss several essential elements of reality, while a more comprehensive structure could prove so hard to work with that it would permit no easy forecasts. An attempt has to be made to focus on the most important variables to the exclusion of other possibly less-relevant issues so that one can balance complexity against usability.

Given that models are approximations, in working with them one needs a detailed understanding of their assumptions and limitations. The model builder will, most likely, have to recalibrate his model significantly if there is a big change in circumstances. Thus, our model above may require significant modification if the companies under study shift their operations overseas with debt taken on at different interest rates abroad. The more such large changes external to the model occur, the less reliable the model becomes and the more one needs common sense, experience and judgment in its applicability.

Where it comes to the credit markets, the models that one needs to use are of horrendous complexity. Consider that credit quality is inherently tied to economic performance – the weaker the economy, the more the defaults on debt tend to be. Interest rates affect credit performance too, as does the level of leverage already among the borrowers. Moreover, in looking at the current crop of credit instruments, one needs to understand the specifics of the actual deal as structured so that the risks of the various underlying tranches can be accurately assessed. Modelling even one of these variables requires substantial effort – studying all of them in unison would daunt a Hercules. These markets beg for hard-nosed common sense and experience with models being used to aid analysis rather than analysis being done to conform to models. Unfortunately, the pointy-headed financial engineers that seem to dominate the credit markets today have an excellent understanding of the minutiae of their deals and their credit models but lack even a rudimentary understanding of a credit crunch and risk aversion – both features that have not been very visible in markets over the last several years.

The models in use by the credit and mortgage insurers and by the rating agencies in particular deserve special mention. The implicit assumption that is made in all of them is that the underlying deals that are evaluated using these frameworks are somehow uncorrelated. A number of the Asset-Backed Market Indices (ABX) are in fact rated by the agencies in a fashion that touts the benefit of diversification. Thus, many of the A-rated deals in the ABX market have collateral that is typically of a lower grade like BBB. The expectation is that a diversified pool of BBB instruments would allow for an A-rated portfolio. Unfortunately, that assumption ignores the facts that most of these transactions are housing related and that most lenders are in fact national in scale. Major losses in one region often translate into increased risk aversion in others. Couple that with stretched housing valuations nationally, and the stage is set for virtually perfect correlation across these underlying assets. Such thinking is all but absent even at this stage in the credit crisis that is ongoing.

The correlated nature of credit risk poses an especially acute problem for the mortgage insurance companies (the largest being MGIC, Radian and PMI Group), which I have frequently discussed in past letters. The mortgage insurers are in the business of insuring the 20% down payments that most banks require of homebuyers and which the latter often do not have the wherewithal to put up. Our history over the last few decades tells us that even the 20% down payment cushion does not make the mortgage loan risk free. However, the tendency of the last five years is to believe that homebuyers do not need to put in that down payment since home prices will forever rise and the 20% amount would be better invested elsewhere. Insurance for the 20% down payment is available from the willing mortgage insurance providers, who typically have risk in force in this arena that is typically over 10 times their shareholder capital. Their capital frequently also supports a host of ancillary businesses such as credit insurance. The national decline in home prices that is under way and the already very high delinquency and foreclosure rates together create a perfect storm for these companies – threatening their very survival. Amazingly, these companies model their insurance risk largely on a deal-by-deal basis, without much regard to the overall correlation of their risks. In fact, many of them were so confident of their risk controls that they, until very recently, continued to deplete their reserves by buying back their stock. The analyst shills on Wall Street, of course, cheered them on in this effort, while even now putting out ridiculous analyses of how these companies are cheap because they trade around book value. The rating agencies inexplicably continue to rate these entities A or above, despite huge risks of potential bankruptcy. An Enron-style unwinding in this area is more than likely.

The credit insurers (the largest being MBIA and Ambac) are on equally shaky ground. These companies typically enhance the ratings of public deals by guaranteeing the payment of principal and interest to the bond holders. This allows the purchaser of the bond to ignore the details of the corporate issuer and instead look to the guarantor's credit rating as a mechanism to reduce his risk. While it is certainly true that these companies mostly guarantee high-quality bonds (typically A or better), they do so with only a sliver of equity capital. As such, the leverage in this space is enormous – we estimate that the amount insured by each of these entities exceeds 100 times their equity capital. Just the complex derivatives in the insured mix can exceed 10 times the equity capital of these firms. In the current environment of risk aversion, these firms are already at significant trouble because they are in the business of insuring systemic risk. What is much more worrisome, however, is that their loss projections and reserves are based on highly flawed models. In fact, such is the group-think in this space that these companies gear their analyses not towards what their true risks of loss might be but towards anticipating rating company requirements for reserves against their risks. That is, the firms are trying largely to manage their reserves based on rating company models, which suggests that everyone is at huge risk if the models in question are flawed. The subsidiaries of the credit insurers that provide the guarantees usually have AAA ratings. Thus, investors are looking for guarantees from companies that have no ability to effectively pay claims if there is a real credit problem, and these firms in turn are rated among the safest in the U.S. Whoever said there was any common sense left in the credit markets!

MONTHLY UPDATE

The sub-prime market's problems have proved to be a tsunami for all of the credit models that are in use today. We now have a full-blown sub-prime housing crisis with defaults spiralling out of control even as home inventories are at highs. The markets have finally woken up to the reality of the problem and have hammered poor credits, and also the equities and credits of the credit and mortgage insurance Ponzi companies. That said, the market adjustments so far have been very limited. If anything, credit spreads have moved only to levels that a few years ago would have been deemed normal. Yet, a sense of panic has already begun to pervade the investor and brokerage community with widespread losses and fund failures. Numerous hedge funds have suspended redemptions and/or gone out of business. Several model-driven, quantitative trading funds have taken serious losses of late because of what they describe as an unanticipated breakdown in historic correlations. Several non-U.S. banks have reported staggering losses from sub-prime holdings in their portfolios. Remarkably, the U.S. lenders and insurers have shown little in the way of losses. The power of marking-to-fantasy is alive and well in the U.S. and this fantasy is rapidly becoming a nightmare.

We had one of our best months in July, with our hedge funds all up over 20% on the month. Our significant shorts in credit and real-estate lenders largely contributed to our performance. The credit rocket has just run out of gas and gravity beckons for the markets. A descent into reality is what we are positioned for.

Performance Summary

Trident Global Opportunities Fund

Performance as at July 31, 2007

1 Mth.	3 Mth.	6 Mth.	1 Yr.	2 Yr.	3 Yr.	5 Yr.	10 Yr.	YTD	Since Inception (Feb. '01)
22.4%	22.4%	24.8%	20.1%	14.6%	9.4%	6.6%	N/A	24.8%	6.1%

CI Global Opportunities Fund

Performance as at July 31, 2007

1 Mth.	3 Mth.	6 Mth.	1 Yr.	2 Yr.	3 Yr.	5 Yr.	10 Yr.	YTD	Since Inception (Mar. '95)
23.4%	28.7%	35.7%	25.7%	16.9%	11.2%	6.0%	13.1%	34.2%	17.5%