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MONTHLY UPDATE

Trident Investment Management, LLC
Opportunities Funds Commentary

July 31, 2008

Fund Performance

July proved to be one of the most volatile months in recent memory. Equity markets were in freefall during the first half of the month only to reverse course and finish down, but significantly off their lows, by month end. The S&P 500 Index finished down 0.84% although intra-month it was down almost 5.84%, the MSCI Europe Index was down 2.06% and the Nikkei was down 0.77%. Oil, reacting to fears of a global slowdown plunged on the month with the price falling 11.74% to end at US$124. Gold suffered, also falling 1.60% to end at US$923. Bonds rallied fractionally, with 10-year Treasury yields falling 0.02% to end at 3.95%. The US dollar appreciated with the US dollar index rallying 1.05% on the month.

July was a rough month with virtually all of our positions, which had experienced strong gains in the previous month, going against us. The rally in the S&P was driven largely by financials and retailers, which made up the bulk of our shorts. Our long positions in gold and gold stocks hurt us as the group fell. Finally, even our credit positions went against us in response to improved sentiment in equities. Our long fixed-income positions were among the only ones that did not go against us on the month. We have trimmed our financial short exposure in response to events, but by and large, have remained in our core positions, especially in credit. We expect more weakness in gold and to add to our long positions in the near future.

Market Outlook & Portfolio Strategy

The news in July was considerably worse than we had expected. The shaky situations of U.S. Government Sponsored Enterprises (GSEs), Fannie Mae and Freddie Mac, became the focus of the markets with reports that questioned their solvency. In a letter a couple of months ago, we highlighted the problems with the GSEs, which operate currently with leverage ratios (total assets/equity) of anywhere from 20 to more than 80 times depending on how one chooses to look at their off-balance sheet risks. The markets finally began to focus on their “fair-value” balance sheets which use market metrics to determine the values of assets they hold. While there is considerable wiggle room in these computations and both companies tend to use the most aggressive (high) market values they can for assets. What is clear is that both Fannie and Freddie are operating with negative net worth. That is, their equity has been completely wiped out by asset impairments. Both companies have negative equity positions of over US$5 billion each. Even though the GSEs are technically bankrupt when their assets are marked to market, they still jointly guarantee over US$4.7 trillion of mortgage securities, even as they also hold over a US$1.7 trillion in securities on their books.

If that was not enough, Indymac, a California thrift that had been over zealous in the mortgage business, failed and was seized by Federal regulators in mid-July. Indymac had over US$32 billion in assets and paying off its guaranteed depositors is going to cost the Federal

Deposit Insurance Commission (FDIC) between US$4 and US$8 billion. The FDIC's deposit insurance fund is only US$53 billion, and this one failure will wipe out about 10% of the fund. Indymac had been troubled for months because of its focus on low or no documentation Alt-A loans, which have become the toxic asset class this year. Indymac's failure raises some scary questions. According to its Quarterly Banking Profile, the FDIC estimates that total insured deposits in the U.S. banking system were US$4.43 trillion at the end of the first quarter. At the same time, the total deposits totaled about US$6.85 trillion. Thus the FDIC is operating with around a $50 billion cushion to insure $4.43 trillion in deposits. Also, in the shaky banking environment of today, fully US$2.42 trillion of deposits are not insured at all. The risk of a full scale run on U.S. banks, especially by the uninsured depositors, is all too real.

The FDIC expects more bank failures. It maintains a list of problem banks, and surprisingly, Indymac was not on the list until about a month before its closure. Given the expected drain on resources, the FDIC is already contemplating an increase in deposit insurance premiums for member banks. Unfortunately, this does little to fix the ones that are already in trouble, and there probably are several. The deposit insurance fund even with higher premiums may not be adequate if the current banking losses continue. There is considerable systemic risk when it comes to insured deposits.

Given that GSE credits are generally viewed as having a U.S. government guarantee, the problems that surfaced in July was something akin to a nuclear missile in the financial space. The banks, which were already struggling with large losses on their asset holdings and significant erosion in their capital, had to contend with more writedowns in asset values. Poor equity and credit market sentiment meant that raising additional capital would imply massive dilution to existing stockholders, if it could be done at all. Most importantly, additional capital would do little for the banks if asset markets did not stabilize. These factors resulted in a freefall in financial stocks over the first half of July and policymakers felt impelled to act to limit a full-blown financial crisis. Unfortunately, in a pattern that has been repeated many times over the last several months, the policies proposed and partially implemented so far, do little to fix the underlying issues facing the financial system.

Even a conservative estimate of banking assets would put them at over 10x equity. Brokers and GSEs are even more leveraged. Even a 10% decline in asset values would mean that the system's capital would be entirely wiped out. Any approach to shoring up the financial system has to involve creating conditions that will stabilize or increase asset values. But doing so will require policymakers to target something more tangible than market sentiment. Problems in the housing market are real – issues of over-supply and inadequate demand. Significant measures adopted to boost demand or reduce supply might help in boosting asset prices. But values of a significant fraction of many banks' assets cannot be helped so easily. Much of Wall

Street made silk purses out of sows' ears by using securitized obfuscation coupled with some good old-fashioned fraud. Unfortunately, one cannot stabilize the value of sow ears at silk purse levels, or for that matter at any level, once the true nature of the product is apparent. What's needed is a hardnosed regulator who identifies the porcine parts as such, so that some concept of true value can be arrived at. Put differently, a necessary precondition for asset price stabilization is that one understands all the details of the asset in question, so that some concept of fair value can be arrived at. Unfortunately, virtually all the policies proposed or implemented so far totally have ignored this requirement.

An example of shortsighted policy was the response to the huge problems with the GSEs, which have been more than apparent for months, if not years. The negative fair value balance sheet of these firms is a matter of public record. When markets finally reacted to these truths, U.S. Treasury Secretary Hank Paulson responded by asking Congress for the authority to inject an unlimited amount of capital on terms to be determined by him to stabilize these institutions and allow them to operate in their current form. A Congress that is in full election-year mode wasted little time in giving Mr. Paulson carte blanche. While this authority is coupled with the requirement to establish better regulation of the entities, the worrisome part is that it does not fundamentally alter the mandate or the operating structure of the failed institutions. Paulson suggested that all debt of these firms be guaranteed by the government without spelling out the exact terms.

An explicit guarantee of the GSEs without outright nationalization is a recipe for disaster. Given low stock prices, stockholders and managements have every incentive to take risk that might boost their stock price. A conservative operation with full loss recognition will dilute the existing stockholders and certainly unseat the current management. However, prior to the Treasury's involvement, debtholders of the GSEs had an incentive to discipline the firms, and arguably may have already done so, had it not been for the implicit guarantee that the debt would be backed by the U.S. government. Paulson, by suggesting that the implicit guarantee be made explicit, further removes the burden of discipline from the debtholders. But then we would effectively have two gigantic hedge funds with over 50x leverage in the GSEs, whose debt is fully guaranteed by the U.S. Treasury and whose management is totally incentivized to pile on the risk. This is a recipe for disaster with the cost to the taxpayer sure to rise into the hundreds of billions. The Pollyannas in the government have estimated that the cost to the taxpayer will be no more than US$30 billion. But then, they were the same group that argued that the Iraq war would cost virtually nothing and that the sub-prime crisis was "contained".

Markets believed that the move by Paulson put a short-term floor under the GSEs, or at least under their debt instruments. Around the same time, the SEC imposed restrictions on short sales of a number of large financial institutions, essentially attempting to create a short-squeeze rally in their stocks. These measures were taken against a backdrop of sharply

worsening financial news. In fact, most financial firms reporting earnings disappointed and admitted that things were likely to get much worse in the medium term. But market participants demonstrated that, like Pavlov's dog, they could drool with every whiff of policy, however incompetent or unrealistic it might be. A major rally started mid-month in U.S financial stocks and quickly spread to retailers and other punished sectors. The rally was turbocharged with a significant rally in the U.S. dollar coupled with a decline in oil, gold and other commodities, which appear to have fallen based on concerns about global growth. Therefore, in the short space of about 36 hours, markets went from the depths of despair to what can only be described as euphoria – at least in the short term. Of course, a host of pundits immediately took the stage to argue how a bottom had been made in the markets, especially in the financial sector and the economy itself. In observing all this, I am reluctantly forced to concede that Pavlov's dog must have possessed a vastly superior intellect compared to our thundering market herd.

Despite colossal losses in every sector of the financial space, regulators and overseers have done little to address what we feel is the prerequisite for a permanent solution – force transparency in valuations, so that new capital-raising on fair terms is possible. This is clear when one considers the LIBOR market, which defines the rates at which banks lend to each other. LIBOR rates remain significantly above Treasury rates, despite all of the policy actions taken so far, suggesting that banks perceive considerable risk in lending even to other large banks. This suggests that conditions are far worse with the banks than they are willing to admit. It also represents a failure of the Federal Reserve which, in its capacity as bank regulator, should be forcing greater transparency in the system. With the banking system under such strain we remain in a very serious systemic crisis, which is going to take years to resolve. Numerous ancillary players like the credit and mortgage insurers cannot survive the current conditions for much longer and may already be technically bankrupt. In the face of incontrovertible evidence, the ratings agencies persist in rating these ancillary companies as being of investment grade, with ratings that are much higher than a high-grade well managed company with little debt. Insurance regulators for these companies appear to be equally willing to permit managements to stay on even though the interests of current policyholders would be best served by forcing these companies into a runoff mode, where they are prohibited from writing new policies.

What is truly lamentable, when one considers the behavior of the overseers, is that they are unwilling to acknowledge the facts, even when they are entirely obvious. Their credibility is in question because of their view that "markets are wrong" and that asset impairments are "temporary", even though they were touting the value of market-based valuations when times were better. Early last year there might have been some argument as to whether we were in a major financial crisis, but there is no doubt today. If we were to give the overseers the benefit of the doubt, the only conclusion one can draw from their behavior is that total transparency is simply not possible because the problem is too big. This would suggest that a true valuation of bank assets might result in the wholesale bankruptcy of most of the financial system and have

serious longer-term repercussions for the U.S. and global economies. Unfortunately, hiding the truth does not solve the problem either – it prolongs the capital market turmoil and will ultimately result in even bigger losses for the banks and taxpayers. The only way to prevent this would be to regulate the system more tightly. In practice this would mean effectively nationalizing the banks and dealing with their problems over time. This was the Japanese solution of the 1990s. It appears that we are slowly slipping into that, despite the fact that the U.S. was among Japan's most vocal critics.

July's volatile markets highlight the struggle between hope and reason. Policymakers feel the desperate urge to unleash hope, while stifling reason, but their actions serve only to delay the ultimate resolution to the crisis that continues to grip the financial system and the markets. We have trimmed some of our financial shorts expecting the rallies to continue for some time, but have retained the bulk of our shorts in the U.S. retail and consumer sectors. We also retain our long positions in gold and gold stocks, U.S. consumer defensives and in short-dated fixed income instruments outside the U.S. Finally, we continue to be aggressively short credit, expecting no near-term improvement. We expect that our positioning might hurt us for some weeks to come, as hope triumphs over reason. We are waiting for reason to return.

Performance Summary at July 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)
-2.5%	12.7%	13.9%	80.4%	47.2%	33.3%	21.1%	N/A	19.1%	14.0%

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%	13.6%	12.6%	78.4%	49.7%	34.6%	17.4%	15.1%	14.4%	21.2%

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