

Trident Investment Management, LLC Opportunities Funds Commentary

June 30, 2008

Performance Summary

June was one of the worst months in equity markets in recent memory and especially for financial stocks. The S&P was down 8.4% on the month, the MSCI Europe Index down 9% and the Nikkei down 5.9%. The decline in markets was aided by a huge move in oil prices with WTI crude rallying 9.8% to end at a staggering \$140 a barrel, a new high. Gold also rallied rising 4.1% to end at \$928.3 an ounce. Despite the huge commodity price moves, Treasuries rallied with yields on the 10-year U.S. Treasury falling 0.1% to end the month at 4.0%. Credit markets suffered, with spreads on many of the problem credits moving to new highs. The U.S. dollar weakened slightly depreciating 0.6% on the month (all figures in U.S. dollars).

We had a very strong month in June with virtually all our positions going in our favour. Our credit shorts, especially in the bond and mortgage insurers contributed substantially to our profits. Our equity shorts in financials and retailers also helped our performance as did our longs in gold and gold stocks. Our fixed-income options positions were among the only ones that did not contribute to our gains. Over the month we have added to our short positions both in credit and in equities with the bulk of our new positions being focused on consumer sensitive companies. With oil at current levels, inflation overall surging, and the housing market still in free-fall, there is little hope for global consumers moving into the second half of the year.

Market Outlook & Portfolio Strategy

The view that the worst was behind us after the Fed's bailout of Bear Stearns in March, was called into question in June as most markets sunk to their year lows. The housing market remained under pressure as inventories continued to mount and delinquencies in mortgage loans of all types increased. The subprime problems have migrated to other mortgage classes such as Alt-A loans, Home Equity Lines of Credit (HELOCs) and even prime loans. The stretched consumer who was supposed to be saved by tax rebate checks got a new blow in the form of rapidly rising oil and food prices. In fact, so steep has been the rise in the price of oil that the entire tax rebate so far, appears to be going to just paying for higher gasoline prices. Not surprisingly, consumer confidence is hitting multi-decade, if not all time lows. Credit card defaults have risen dramatically, even as sales of big-ticket items such as automobiles have plummeted.

Current conditions put the Fed and most other central banks in a difficult position. High oil and commodity prices are rippling through the global economy and pushing inflation to multi-year highs. However, global interest rates are well below the true rate of inflation so that real interest rates are negative. This in turn encourages consumption and the purchase of hard assets, boosting commodity demand and prices further. Much tighter monetary policy is therefore required to quell these inflationary pressures. However, with the high degree of leverage in the global financial system and the serious credit problems that have surfaced already in a time of negative real rates, any rate hike could trigger even more financial difficulties. The credit crunch that would result could intensify any economic slowdown that might occur and create a serious global recession. Thus, the policy choices faced by central banks are hardly palatable – raise rates and risk triggering a financial meltdown, or lower rates and usher in years of very high inflation.

In terms of pure economic theory, the case for fighting inflation in the short run at the expense of growth is weak. A significant economic contraction is unambiguously bad because virtually everyone suffers due to the lost output whereas growth with high inflation does not pose this problem. However, inflation, when unanticipated, benefits borrowers at the expense of lenders. If inflation remains high for an extended period it discourages saving resulting in higher real interest rates, less investment and a lowering of longer-term growth rates. When a government adopts policies of deliberately inflating away its debt by creating unanticipated inflation, it can quickly destroy its credibility with savers and create hyperinflation. The Latin American experience of the 1970s and 1980s provides numerous examples of such situations. Savers in these circumstances understand the risks of loss from inflation and demand

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impossibly high real interest rates which often results in expropriation of private savings by the government and capital flight, ultimately ending with some form of economic collapse.

While it is clear that high inflation leading to hyperinflation is not desirable, it is equally clear that low inflation in itself is not a panacea. For example, the U.S., which claims officially to have had very low inflation over the last few years, has a savings rate which is low to negative. Despite supposedly low inflation, the U.S. is the largest debtor country in the world. Countries such as China with much higher inflation rates enjoy much higher savings rates than the U.S.

The central banks are not all of the same mindset in evaluating their policy choices. The Bundesbank of Germany and now the European Central Bank are more inclined to view inflation as a serious threat. The Germans understand the perils of high inflation that could lead to hyperinflation, given their experience with the Weimar republic. The inflationary conditions of the 1930s contributed in no small measure to the rise of the Nazi party and the subsequent devastation of Europe. The U.S., over the same period, was combating the Great Depression with unemployment, deflation and bread-lines. As such, the Fed is generally more concerned about growth rather than inflation. The emerging markets as a group tend to be much less concerned about inflation, except perhaps in Latin America. Relatively high inflation is the norm in most developing countries and the only time this may result in draconian policy action is when rising prices create social unrest. Few developing country central banks share the Bundesbank mentality. We believe strongly that most of the global central banks will continue to talk tough, but do little else to combat inflation given the huge risks that significant rate hikes would pose. The world is inexorably on the path to stagflation – a combination of weak growth with high inflation. Unfortunately, stagflation also implies much higher longer-term, nominal interest rates because of higher inflation.

A significant part of U.S. bank balance sheets are made up of fixed rate mortgage loans where the borrower has a prepayment option. With higher nominal, long-term rates, the banks lose both from the direct effect of a higher discount factor, as well as from a stretching out of the term of the loan as borrowers stop prepaying. Moreover, slow growth dramatically increases credit losses especially when the underlying collateral for the loans also declines in value as is currently the case with housing in the U.S. The presence of inflation however, means that the credit losses will be considerably less than might have been the case with deflation. So, while stagflation may not be as painful as deflation, it will nevertheless create significant losses for the financial system.

The financial system in the developed world is ill-equipped to deal with the major losses that might arise from a global stagflationary slowdown. The banks have already suffered in the last year due to the bursting of the global credit and real estate bubbles. The capital raising that they have done so far, while significant, has done little to replace the hits they have already taken and are still taking to their equity. Moreover, while raising capital, the institutions propagated the myth that there would be no more losses – and the losses since have been staggering. June was a particularly bad month that has meant even more losses for the financial system and further erosion in its capital base. Investors in recent capital injections to the banks are already nursing huge losses and are unwilling to participate in future capital transactions. With capital increasingly hard to come by, the only choice left to the financial sector is to reduce leverage to allow for the reduced capital levels. The problem with deleveraging though is that it is more easily said than done.

In stable markets with transparent asset values, reducing leverage in the financial system is extremely difficult. With markets suffering a crisis of confidence due to a wildly mispriced alphabet soup of credit instruments, dramatically reducing leverage without massive hits to asset prices is virtually impossible. Unfortunately, the bigger the hits to asset prices, the greater the losses to the financial firms and the greater the hits to their capital. As such, most financial firms have talked of reducing leverage but have not done so convincingly because they cannot. Many of them have sold their best and most liquid assets at close to fair values, while retaining the most toxic on their books and increasingly marking these holdings using Level 3 valuations that do not require acknowledgement of their losses. A consequence of this is that

the financial system’s ability to take on any risk whatsoever has been sharply diminished. Not surprisingly, markets for most higher-risk instruments in June virtually ground to a halt. Markets for high- yield corporate bonds, convertibles and even relatively higher-grade (A or below) corporate debt have simply frozen up in a fashion reminiscent of 1998 at the height of the Long Term Capital Management (LTCM) crisis. Unfortunately, there is nothing the central banks can really do to forestall this, short of opening up a new leveraged bank themselves.

The crisis in the financial system can pass only when the firms are once again adequately capitalized with all their losses being fully recognized. The only way investors can be convinced to provide the huge amounts of equity capital that the financial system needs is if they are certain that they are being presented with a complete and realistic picture of a firm’s condition. However, regulators have done little to force such transparency. In fact, they have acted to provide lifelines to ailing institutions without even requiring the dismissal of their incompetent and/or crooked management teams and boards of directors. Amazingly, even stockholders have not asked the hard questions of managements. After all, the managers in the financial system were, as a group, paid staggering sums of money for their incomparable wisdom and experience but have proved blatantly incompetent at managing the business. While there have been some recent high-profile resignations or dismissals, they have always been with handsome payouts that send the message that incompetence and fraud are more profitable today than ever before. The management changes so far have been cosmetic – the leading incompetents are still very much in charge.

Our point would be better made with an example. The poster child for what currently ails the banking system is, of course, Citigroup. The firm with its wide range of businesses was in large part the realization of a dream for a financial services supermarket by its former chairman, Sanford Weill. The supermarket model has been touted repeatedly in the U.S. most notably in the 1960s with a conglomerate creation boom. Experience has shown that the promised synergies from the creation of a conglomerate rarely materialize. In fact, Mr. Weill surely knew that because he tried the same experiment while president of American Express and that was an expensive mistake that took years to undo and nearly destroyed the firm’s charge card and travel franchise. But when Citigroup was being formed, these considerations did not matter – the promises were all that did.

The creation of Citigroup as it is today would not also have been possible without regulatory help. The Glass Steagall Act of 1933 created federal deposit insurance in the U.S. and explicitly prohibited mergers between banks and other financial firms such as brokerage or insurance companies so that the insured bank’s risk was manageable. By 1998 when Travelers Group that owned Salomon Brothers, the brokerage, made a bid for Citicorp (the bank), the risks to banks from owning brokerages were more than apparent to regulators. The LTCM crisis of July/August 1998 underscored the risks to having overly large financial institutions – the Fed was forced to intervene here to save the global financial system because of uncontrolled and irresponsible lending by banks and brokers to a high-risk hedge fund. Despite the obvious failure of regulation to prevent excessive risk taking by publicly insured banks even in 1998, then Fed Chairman Alan Greenspan supported the relaxation of the Glass Steagall Act and formally approved the merger of Citicorp and Travelers to create Citigroup on September 23, 1998. The Clinton administration with Treasury Secretary Robert Rubin pushed for an actual repeal of many of the onerous provisions of the Glass Steagall Act with some urgency in 1999 to ensure that the newly created Citigroup would not have to comply with its requirements. On October 22, 1999 a deal was announced to repeal the Act with both houses of Congress approving the final version of the bill on November 4. Just days after, Robert Rubin joined Citigroup.

The new Citigroup under the leadership of Sanford Weill and his able lieutenants was hardly the well-run bank it was purported to be by all of the cheering Wall Street intelligentsia. The bank was riddled with internal conflicts of interest, if not outright fraud. One particularly visible example was the situation with Jack Grubman, the firm’s star telecommunications analyst. Grubman put out glowing reports about Worldcom and related companies long after others

advised caution – these firms were ultimately forced into bankruptcy. Citigroup of course, earned hefty fees from the transactions that these companies constantly executed. Grubman, who rarely saw a telecommunications company he did not like, actually did not believe in AT&T’s business model. He was persuaded by his superior, Mr. Weill, to take a “fresh look” at AT&T which was then run by chief executive C. Michael Armstrong. Mr. Armstrong was then, and still is on the board of directors of Citigroup. Jack Grubman upgraded his recommendation on AT&T after his fresh look, and in his memo about AT&T to Weill requested the latter’s help in getting his children into an exclusive New York private pre-school which the latter was only too glad to do. It appears that Weill at the time was engaged in a boardroom battle with co-CEO of Citigroup, John Reed, and needed Armstrong’s support for Reed’s ouster.

To add insult to injury, Citigroup was a key player in the Enron scandal where it averaged one deal a month with the firm from 1997 till bankruptcy, a remarkable record. Citi was accused of structuring deals that were intended to inflate Enron’s profits. It vehemently denied the charges but nevertheless paid out almost \$2 billion to Enron shareholders. Unfortunately, a big lawsuit relating to Enron – the so-called “Mega Claims” suit – is still pending. Enron’s bankruptcy examiner concluded that Citi helped Enron “produce materially false misleading statements”. If all this is not enough, the great Mr. Rubin himself was persuaded to contact the Treasury in 2001 with a request for them to perhaps intervene with the ratings agencies to delay a downgrade of Enron that would lead to its bankruptcy.

But wait, there is more! In 2004, Japan’s market watchdog, the FSA, ordered Citigroup to shut down its private banking operations in the country on the grounds that it had found “all sorts of unscrupulous violations” at the firm. The FSA said in broad terms, that the firm operated in an environment where profits were given undue importance by the bank’s headquarters, and as such it had constructed a system that evaded the laws and regulations of Japan. A powerful statement indeed!

The last few chapters of the Citi story are especially relevant today. Sandy Weill gave up the reins of CEO in 2003 and as Chairman of the Board in 2006, both to Chuck Prince. Mr. Prince continued to be assisted on strategy by the remainder of the Weill team, most notably Mr. Rubin. Unfortunately, the strategic advice he received appears to have been rotten. While the details are sketchy, it seems that in 2005 Mr. Rubin pushed the bank to increase its activity in high-growth areas like structured credit which was the worst possible time for such an expansion.

The brilliant strategic plans continued. Citigroup on April 13, 2007 (when the subprime crisis was in full swing) agreed to purchase Old Lane Partners. The latter was a hedge fund firm started by a group of Morgan Stanley managers led by Vikram Pandit. The managers of Old Lane had little to no investment experience and no track record as a firm. However, given investors’ obsession with perception rather than reality, the firm had no trouble raising \$4 billion in initial capital to manage. Of course, once the money had been obtained the performance was dismal. But that did not stop then-chief executive Chuck Prince, no doubt aided in this thinking by Mr. Rubin, from making a strategic acquisition of the firm for the princely sum of about \$800 million. Post purchase, Old Lane’s dismal performance continued. In June, Citi announced plans to close Old Lane just 14 months after its purchase. A longer history of Old Lane is not possible – the firm’s existence was only for a brief 26 months, and \$800 million!

Of course, Citi was hit on all sides when the real estate and credit crises started in 2007. Mr. Prince resigned in disgrace after a dismal third quarter in 2007. Amazingly, Mr. Rubin was not affected at all. In fact, he deflected all blame claiming he did not have an operational role in Citi. He must have had a strategic role of some kind then because he was one of the highest paid at the firm taking home much more than \$100 million in his time there. Presumably he was worth much more than that because a less competent strategist might have produced losses for the firm in the trillions perhaps rather than just in the billions as he did.

But the final chapter is what is most disgraceful. Mr. Rubin who was already the Chairman of the Executive Committee of Citi was elevated to being Chairman of the Board in November 2007. He hired Vikram Pandit (yes the same one of Old Lane fame) to take over the reins of chief executive. Presumably the latter’s skill at selling a lemon to Citi for \$800

million should have been the deciding factor for this appointment. After all, Mr. Pandit has no prior experience to speak of in classic banking, let alone with one as large as Citi. He has also barely worked at Citi, which is internally an exceptionally complex and global institution. Of course, the Board had no problems rubber-stamping Mr. Pandit's appointment since most Board members lack the industry knowledge to exercise proper oversight. I would wager that of the 14 members in Citi's board, less than five even understand the bank's financial statements!

Citigroup is among the world's largest banks and is definitely one that is too big to fail. As such, it is under constant public and regulatory scrutiny. As the above discussion should show, there was ample, if not overwhelming, evidence of problems at the firm well prior to 2007. Despite this, regulators and investors exercised little to no oversight of the bank and allowed it to operate unchecked, leading to the problems that it faces now. Unfortunately, while I have chosen to focus on Citi, the bank is by no means the worst off, nor is its management the least competent. Despite the errors made, I would have to admit that there are numerous large banks in the U.S. and overseas whose managements are much less capable. But if an investor of sound mind were presented with Citigroup today it all its glory with its complex balance sheet and rivers of red ink, how could he possibly feel comfortable about investing in the firm to shore up its capital base even though it is too big to fail? And if an investment in Citi is so unconvincing, how can one persuade a new group of more risk-averse investors to cough up the colossal amounts of capital that the U.S. financial companies in particular need? The U.S. financial system is looking at least as sickly as Japan's did in 1991 – we are going to take years to emerge from the current mess and the end result could well be the nationalization of vast swathes of the financial landscape. Hopefully, by that point, there should have been a radical management overhaul with the genius leaders of today no longer in charge.

The market declines in June led by banking and other financial stocks when viewed from our perspective are hardly irrational. Markets have finally begun to appreciate the scale of the problem in the financial system and do not see a ready solution. No bottom is yet in sight, no magic bullet can stem the bleeding and no savior is galloping to the rescue. A serious credit crunch is in full swing, especially in the U.S., with all of its attendant consequences. Not surprisingly, we have continued with our core bets. We remain short U.S. banks and other financials and their credits. We are staying long gold and have continued to short more consumer sensitive companies and their debt. We are probing uncharted territory in markets here – sentiment is terrible, the facts are worse and policymakers have so far proved powerless. There is one ray of sunshine though: the longer this state of affairs continues, the more opportunities we see for profit!

Performance Summary at June 30, 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)
14.2%	9.5%	22.1%	126.5%	48.4%	34.8%	21.3%	N/A	22.1%	14.5%

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)
13.9%	9.2%	15.4%	122.2%	49.7%	35.2%	18.4%	16.3%	15.4%	21.5%

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