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MONTHLY UPDATE

Trident Investment Management, LLC
Opportunities Funds Commentary

June 30, 2010

Performance Discussion

June appeared to be a continuation of May where markets were concerned. The S&P 500 was down 5.4%, the MSCI Europe Index was down 0.8% and the Nikkei down 4.0%. Gold was up 2.1% to end at $1,242 an ounce, while oil was also up 2.2% to end at $75.63 a barrel. The fixed-income markets rallied in this climate of fear with the 10-year U.S. Treasury rallying 35.4 basis points to end at 2.93%. The credit markets sold off fractionally as well on the month (all figures in U.S dollars).

Our funds finished up in June. Our long positions in Australian fixed income contributed to most of our performance followed by our longs in gold and shorts on equity indices. We also had some gains in credit. Our losses came largely from our yield curve steepeners. We were relatively quiet on the month and are waiting for some pullbacks to add to our already significant long positions in global fixed income.

Market Outlook and Portfolio Strategy

Markets appear to be in a limbo as of now. On the one hand, the economic news has gotten significantly worse of late suggesting that numerous regions of the world may be slowing down. On the other hand, most observers are optimistic arguing that growth should accelerate after a brief leveling off and that markets are already pricing a more pessimistic outcome than is warranted. Most also believe that U.S. policymakers in particular will rush in with further stimulus to deal with any potential growth slowdown that might materialize. In fact, speculation has already increased on the potential for more U.S. fiscal expenditure and even more quantitative easing by the U.S. Federal Reserve. Despite the market debate, policymakers seem mired in issues that will do little to address the current growth malaise. In particular, the U.S. is focused on a comprehensive, new financial reform bill that aims to rein its financial institutions and ensure that a repeat of the Lehman collapse will prove less disruptive. Even worse, a major oil spill in the Gulf of Mexico from an underwater well drilled by British Petroleum (BP) has proved the worst such accident in U.S. history, requiring enormous resources both from government and the oil industry to deal with. The summer doldrums seem truly upon us!

The legislation to reform the U.S. financial sector has taken center stage over the last several weeks with numerous compromises being discussed to make it more palatable to all interest groups in our plutocratic government. Unfortunately, the Bill, as drafted, ignores virtually all the fundamental reasons for the financial crises of 2007-2008, and should be viewed more as a triumph of unnecessary politics to the detriment of the nation. We consider what a financial reform bill should have focused on in greater detail below and then discuss why the current framework falls far short. We believe that the U.S. government is engaging in political theater for the benefit of its least informed domestic constituents without really making the hard choices to provide a stable foundation for growth.

The Role of the Financial System

Much of what goes on in the U.S. financial system today is taken for granted with little discussion being focused on what exactly the system is supposed to do. The financial system in the U.S., or for that matter in any country, can be viewed as having three major functions:

1) To provide a framework to deal with the transactions that occur in the economy. This is purely a convenience function that involves record-keeping of individual deposits in the system and dispensing or transferring the same, as desired, to support payments and receipts.
2) To serve as a conduit that brings together the providers and users of capital. This is perhaps the single most important task that the financial system is charged with. Any economy has savers who wish to earn a return on their savings, as well as entrepreneurs and businesses that can put these savings to productive use. Channeling funds between these groups allows society to use its resources most effectively, and if done correctly, contributes to an increase in collective welfare.

3) To permit the sharing of risk across society. We distinguish this role from that above in that sharing of risk does not require a provider and a user of funds per se. Thus, a farmer who grows corn and needs to hedge some portion of his crop against wild swings in prices when his crop is harvested can use the commodities futures markets to manage his risk to an acceptable level. Again, a member of society who has savings and is prepared to defer his consumption for several years might contemplate longer-term investments, while a similarly placed individual with a shorter horizon might prefer shorter dated opportunities. The financial system can provide such participants the instruments needed to deal with their respective risk preferences.

The financial system has no independent reason to exist in a society other than for the reasons described above. Any profits that are made by financial firms must be measured in the context of how well and at what cost they provide the above services. Thus, a financial system that is profitable but yet produces huge, costly distortions in the real economy is not desirable, nor is one that is often unprofitable requiring constant injections of funds from society. The critical point to note is that any financial regulatory framework has to be set up to make the system meet the needs of society first.

Evaluating the Financial System

Most observers would conclude that the global financial system provides the transactional functions very efficiently. Virtually all major cities have well-developed domestic and international banks. Deposits and withdrawals of funds, the writing of checks and the existence of Automated Teller Machines are all factors that most of us take for granted these days. Technology and global coordination have ensured that the basic transactions of banking are done more efficiently today than at any other time in human history.

The record of the financial system, where it comes to serving as an efficient conduit of funds from savers to users of capital, is decidedly mixed. The financial intermediaries and the capital markets in conjunction have allowed capital to be raised on a scale never before contemplated. Some capital raising is, of course, essential for the economy. However, a good part of the capital raised by our financial system over the last three decades has arguably worked to the public's detriment as we discuss below. This would suggest that a more tightly regulated and smaller financial system might actually prove better for society.

Consider for example the securitization boom of the 1980s. The Collateralized Mortgage Obligation (CMO) was expressly designed to allow bankrupt thrift institutions to raise funds from underwater mortgage assets by pledging them as security against bonds issued. The CMO transaction was treated as a financing rather than a sale of the underlying assets and thus permitted thrifts to defer recognizing huge losses that they might have on an outright sale. By raising cash from the CMO, the thrift was given a new lease on life – the funds raised could be deployed in high return (which meant also very high risk) investments that could potentially save the bankrupt thrift. Not surprisingly, Wall Street hastened to provide a host of rubbish assets such as junk bonds to permit these funds to be deployed "efficiently". The results were all too predictable – by the end of the 1980s most of these thrifts were in dire straits and virtually all of them had to be wound down at considerable taxpayer expense.

The true cost was not even in the losses suffered by the thrifts. The junk bond boom of the 1980s allowed a reshaping of corporate America where debt could be used to take over relatively unlevered companies. A new group of corporate raiders (all financially driven) took control of many of the icons of American industry using mountains of debt, and proceeded to sell off assets, raid employee pension plans and fire employees, all in the name of efficiency and short-term earnings. While the raiders made out handsomely, the majority of Americans lost out. Job security, medical insurance and a guaranteed pension could no longer be taken for granted. Income distribution steadily became even more unequal with corporate chieftains moving from making about 40X the average employee's salary to about 400X today.

The CMO and junk bond booms of the 1980s showed some major failings in the regulation of the financial system. Had regulators shut down the thrift institutions that had been bankrupted by the high interest rates of the late 1970s, the CMO market may not have taken on the significance that it did. Since thrift deposits were taxpayer insured, the firms were able to take huge risks when already bankrupt thanks to the cash raised from CMO transactions, and become a repository for

every questionable bond created by Wall Street. And the bill for all this was paid by the public. When weighed against the ultimate social costs, the so-called benefits of the CMO market become questionable at best.

The dot-com bubble of 1999-2000 was another classic example of the financial system failing at its conduit function. There is no doubt that huge amounts were channeled from savers to users of capital during this period as every questionable internet idea received funding. When the investment bubble so created collapsed, the global economy plunged into a painful recession. Emergence from this recession was not possible with conventional policy and was in fact engendered by creating yet another bubble, this time in real estate. The global real estate bubble (again abetted by the financial system) produced an illusion of prosperity and to do so, had to overcome the effects of the previous bubble's collapse, meaning that it had to be substantially bigger than the technology bubble. Unfortunately, when the real estate bubble burst in 2007, the cost to society was an even bigger crisis, with more pain.

Turning now to the role of risk sharing, the track record of our financial system, when measured against the costs to society, has been quite mixed. There is no doubt that our financial institutions have created many risk-sharing vehicles. Market participants have access to a dizzying array of options, forwards, futures and other exotic derivatives to hedge out virtually every conceivable risk factor. Yet, most of the instruments were already available to us even as early as 1980. In fact, the only real development since then has been the advent of a host of exotic instruments explicitly designed to foster speculation and hide risk.

Consider for example the market for the Collateralized Debt Obligation (CDO). The CDO essentially represents broad exposure to a portfolio of bonds, and the biggest purchasers of the same were actually bond market participants such as bond funds and insurance companies. These institutions were supposed to channel their capital to high quality bond opportunities, but instead chose to invest in opaque financial structures whose inner workings they little understood. The imprimatur of a AAA credit rating from the ratings agencies, which themselves did not analyze the instruments in question fully, allowed for a multi-trillion dollar fantasy market where investors who did not know what they were buying, did so on the basis of ratings from analysts who did not do any real analysis, and from institutions which worked hard to make the instruments in question as opaque as possible. The genius in the CDO boom was that what were obviously rubbish securities were transformed with financial alchemy into incomprehensible investments that were of unimpeachably high quality thanks to the ratings agencies. Paradoxically, thus, the financial market participants that were the most risk averse (the pension plans, money market funds etc.) ended up with the largest risks without quite realizing that they were taking them on in the first place. So, when it comes to the risk-sharing function, the financial system has evolved now to the point where the whole concept of risk-sharing has been turned on its head.

In the final assessment, our financial system has proved more than capable when it comes to the purely transactional part of finance. But it has failed miserably in its conduit function by engendering huge and repeated misallocations of capital, the losses from which society has had to bear. It has also been over-zealous in its risk-sharing function by "innovating" to such an extent that the true risks are unfathomable, and the subsequent collapse has meant that the costs to society have far outweighed the supposed benefit of such sophisticated risk-sharing in the first place. As such, the system today begs for radical reform.

Re-Regulating the Financial System

The financial system, as even our brief discussion above suggests, has evolved in a fashion that is not quite optimal for society over the last several years. The crisis of 2007-2008 has essentially bankrupted the system while imposing a huge cost on the taxpayer. The philosophical thrust of new regulation therefore, has to be on ensuring that the system performs its functions for society properly, and not on retaining the status quo. In particular, the regulation of both the conduit and risk-sharing functions of the financial system can and should be much improved.

The critical issue in the conduit function is to what extent financial firms can be allowed to become providers of capital in their own right, given that the taxpayer provides a backstop for the transactional functions that the system performs. That is, the existence of deposit insurance, access to discount window borrowing from the central bank

and other Fed programs provides the banks with subsidized funding, which investment funds and other private entities do not enjoy. With such access and the ability to take on leverage, banks have a tendency to take on huge risk for profit when times are good, only to leave the taxpayer footing the bill when conditions change. There is a built-in tendency for financial institutions to grow larger – the bigger a firm gets, the more it merits a taxpayer backstop becoming "too big to fail". Thus, the holy grail of a banking institution has been to get large enough to have its losses socialized, while of course keeping its gains privatized.

A number of approaches, which could work alone or in conjunction, can be considered to improve the conduit function and reduce taxpayer risk. One approach would be to significantly limit any risk-taking by taxpayer-backed institutions outside of the standard lending and transactions functions – this was the original intent of the so-called Volcker rule (proposed by former Fed Chairman, Paul Volcker) that asked for banks to split out their proprietary trading and other risk businesses to a separate entity. Another method is to force a dramatic increase in capital requirements for the financial firms so that all risk taking is with a majority of private (rather than taxpayer) money. In addition, there has to be some structural impediment to an unbounded increase in institutional size – possibly involving even more significant capital requirements or hard balance sheet limits.

In dealing with the risk-sharing function of the financial system, the thrust of regulation should be simple and focused – firms should be required to provide a greater level of transparency for products they create, rate or sell. Also, institutions should be held much more accountable so that there is a huge and immediate penalty for misrepresentation or fraud from the regulator rather than from the courts which tend to move much more slowly and lack the necessary domain expertise.

Given the importance of proper regulation, having a truly independent regulator whose decisions are transparent and open to audit is a critical requirement for any financial reform. In fact, the existing regulatory framework for the financial system that has been in place since the 1930s should have proved more than adequate as long as regulators were zealous in protecting the public interest. Unfortunately, the U.S. regulators as a group could well have been financial system lobbyists in the period leading up to 2007.

The Dodd Frank Bill

The U.S. financial regulatory reform, now being passed as the Dodd-Frank bill, acknowledges many of the issues we have raised above, but deftly avoids any significant regulatory changes in the short run. In fact, it defers many of the changes to various committees that are to be set up for the purpose of drafting new regulations.

The regulator that seems to have increased its influence significantly through the Bill is the Federal Reserve, whose almost criminal incompetence in the 2004-2006 period was largely responsible for the financial crisis that followed. A move in Congress to audit the Fed's decisions was severely watered down in the Bill.

Where it comes to the conduit function of the financial system, the Bill does not fully address the issues. To its credit, it at least makes an attempt to deal with some of the existing problems, while leaving the door open for future measures. In particular, it seeks to limit proprietary trading and bank sponsorship of hedge funds and private equity funds. These provisions are not as exhaustive as those proposed by Paul Volcker in his initial statement of the Volcker Rule, but viewed charitably, one might argue that this is a good start. Also, the Bill requires that certain risky derivatives be moved to exchanges, although it is unclear that this measure has any teeth since virtually all of the usual derivatives were exempted from this requirement. While the Bill does little to break up overly large financial firms, it managed to retain the Kanjorski Amendment which gives a Financial Stability Oversight Council that is to be set up, the authority to break up large firms that pose a "grave threat" to the system's stability. Of course, none of the current behemoth firms, all of which pose grave risks to stability in our view, are to be broken up now. Finally, the Bill provides the government the right to liquidate large firms in the event of a Lehman style failure. The Bill does not take the obvious step of boosting capital requirements. A more conspicuous problem is that it totally avoids dealing with the two behemoths of American finance, Fannie Mae and Freddie Mac, which are arguably the firms most in need of proper regulation.

On the risk-sharing front, the Bill sets up a consumer protection office, to operate within the Fed that will have the power to write and enforce rules over various financial products. Arguably, this agency might work for greater clarity in the financial instruments created. Also, the move of some derivatives to exchanges as discussed above should increase their transparency. Finally, there are some provisions requiring lenders to retain some of the risk of loans they make, so that they cannot make what are essentially fraudulent loans that are quickly sold to the public. Unfortunately, the Bill does not actually require financial system participants to act as fiduciaries in dealing with their customers, a strange omission since the financial system is ultimately about intermediation. The door was left open for the SEC to study this matter and propose new rules for the same in the future.

As things stand, the Bill does not move to increase transparency in financial reporting for the firms in the financial system, nor does it provide any new mechanisms for the public to hold financial firms accountable. In fact, it is not clear that even the regulators have much more authority than they do already except perhaps in the limited dimension of winding down complex firms like Lehman.

So, where does the Dodd-Frank bill leave us? It might perhaps represent a start to greater regulation of the financial system, but it is not a transformational law that is going to put the system on a firm footing for the future. Even worse, the few meaningful changes to regulation that have been introduced have been delayed with ultimate implementation left to various regulatory committees. And of course, it completely sidesteps the regulation of Fannie Mae, Freddie Mac and dealing with the entire housing market problem which were among the most important factors leading up to the 2007-2008 crisis.

The real irony here is that in an environment where the financial system is bankrupt and in need of over $12 trillion in Federal guarantees just to stay afloat, the lawmakers cannot pass a stiff regulatory bill after 18 months of discussion. In fact, this Bill underscores that the political system today resembles a financial plutocracy with the former czars of finance themselves writing the legislation to ensure their continued prominence and power. Considering that it was incompetent, if not venal, regulation and unchecked financial speculation that led to the last crisis, this Bill is a bitter pill for the American public to swallow.

In sum the Dodd-Frank Bill is well-intentioned but does not go the distance. It creates a vast new regulatory bureaucracy with little oversight and transparency to deal with the financial system. These regulators do not appear to be accountable even to Congress, let alone the public. As such, the success of this Bill will largely depend on the dynamism of the individuals chosen to be the regulators. Based on our recent history, this does not make us feel optimistic. This legislation is unlikely to make the financial system safer or force it to serve the public interest better.

What does this mean for financial markets?

We have focused on the Dodd Frank bill above because there has been a market perception that the uncertainties surrounding regulation have been responsible in part for the overall malaise in bank lending and by extension the overall economy. In fact, the Obama administration has focused on bank regulation much more than job creation which suggests that it perhaps shares the same sentiment as the markets do. Yet, the new financial regulatory bill is not a panacea. In fact, we believe that it will expose more strains in the financial system in the short run.

The Bill does not address what really ails the financial system at the current time which is the overhang of bad loans from the lending decisions made during the real estate bubble. The U.S. job market is still in trouble, consumer incomes are still not growing appreciably, the housing market has started another leg down and we have not established a foundation for growth. As such, the core lending business is likely to remain poor for the financial system. In fact, even in the heady days of 2005-2006, the banks resorted to creative loans such as Option ARMs and Alt-As (or liar loans) to broaden the universe of borrowers – the existing pool of borrowers of 2004 was simply not enough to boost revenues appreciably. The CDO market arose directly from the fact that these rubbish loans needed to be securitized and sold.

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Limiting the scope of financial system activities or increasing regulation will create problems for the member firms. With the collapse in the loan markets, and possibly increased scrutiny of new loan products from regulators, banks should have a tough time with loan growth. The capital markets activities that buttressed what were weak lending results will almost certainly be limited, at least over time. On the risk sharing front, the public has lost faith in the alphabet soup of derivative products – any attempt to simplify these products and make them more palatable to the investment community as a whole will mean more overall transparency and lower overall rents to the financial system. All this suggests that there should be severe problems with longer-term earnings growth for banks. Most of them are already capital-shy and desperately need good earnings to buttress their meager capital. The new regulations thus, might help intensify the current credit crunch.

Faced with weakening global activity, crippled financial institutions, especially in the developed world, and hugely indebted governments, the continuation of a credit crunch should only increase the strains on the global economy. We anticipate continued market volatility and importantly declining liquidity as more of the investing public stays on the sidelines in what is a painful and uncertain environment. We have seen such conditions before in Japan where both bank lending and capital market transaction volumes declined and continued to do so for almost two decades. The problem with the current situation is that any unexpected bad news could trigger a meltdown with a resultant evaporation of liquidity. We feel strongly that we are nearing some kind of crisis with a multitude of potential flash points for the same.

Conclusion

We have done very little to our portfolio over the last month and believe the current environment warrants caution. We have increased our options positions in global fixed income significantly over the last few months and are poised to profit both from an increase in volatility as well as a more significant move down in equity and credit markets, which we expect. Things are playing out in the global economy increasingly as we had expected. We expect our portfolio to perform when markets begin to price in the current reality.

Performance Summary at June 30, 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)
1.3%	2.1%	-1.0%	-5.8%	5.9%	36.4%	22.4%	N/A	-1.0%	12.6%

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)
1.2%	1.9%	-1.1%	-5.2%	8.4%	37.7%	23.8%	7.3%	-1.1%	19.7%

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