

Trident Investment Management, LLC Opportunities Funds Commentary

March 31, 2009

Performance Discussion

Spring was in the air in March, at least as far as the equity markets were concerned. The S&P 500 was up 8.4% on the month, the MSCI Europe up 4.4% and the Nikkei up 7.2%. Intra-month, the numbers were even more impressive with the S&P 500 rallying an amazing 17.9% from the lows that it hit on March 09. The commodity markets also did well with most commodities, with the exception of gold, being up on the month. Oil rallied 11% to end at \$49.7 a barrel. Gold however, actually fell 2.4% to end at \$925 an ounce as the new euphoria prompted holders of gold to seek more risky alternatives to the metal. Remarkably, bond yields rallied with yields on the 10-year U.S. Treasury falling 0.4% to end at 2.7%. Credit also did well with most credit spreads tightening significantly (all figures in U.S. dollars).

Our funds suffered in March since most of our bets went against us, a trend that has continued into April. Our short positions in consumer discretionary stocks and credit went against us significantly as did our long positions in gold and gold stocks. We got a little help from our positions in short dated fixed income in Australia and Europe, but were hurt by our short positions in US treasuries, achieved through curve-steepener options. We believe that economic fundamentals are likely to re-assert themselves rather quickly. As such, while the current price action is disconcerting, the fundamental trends remain very much in place.

Market Outlook & Portfolio Strategy

The rampant bullishness of the second half of March was largely instigated by the actions of the central banks in the world's main bubble economies. The U.K.'s central bank announced that it would directly purchase up to £75 billion in U.K. Gilts, a gargantuan quantitative easing, especially when viewed in the context of the British economy's size. The U.S. Federal Reserve, not to be outdone, announced on March 18 that it would expand its balance sheet by purchasing up to \$300 billion of U.S. Treasury securities for the year and up to \$850 billion in mortgage backed and agency securities. The incremental \$1.15 trillion in purchases when added to already existing purchases will cause an expansion in the Fed's balance sheet for the year by \$1.75 trillion, a staggeringly large amount. The central banks' move to quantitative easing is something we have long anticipated because the borrowing requirement in both countries is simply too large to be financed by private capital alone. In the US for example, the Treasury needs over \$2.2 trillion this year, an amount that exceeds the aggregate surplus savings of the world for the year. The printing press therefore is the only mechanism to ensure that the debt can ultimately be sold without a dramatic spike in interest rates. Unfortunately, by embarking on these actions, the U.S. particularly is entering dangerous territory. As the prime reserve currency, the U.S. dollar is the unit of account for most international trade while also being the currency of choice for most exporting countries' surpluses. A quantitative easing in this context makes the U.S. dollar extremely vulnerable to changes in global sentiment – enough concern about its reserve status could prompt a disorderly exodus from

the currency resulting in a global bond market and currency crisis that will very quickly change the very fabric of global finance.

The actions of the central banks led, in turn, to the view that the global economies had hit bottom and that the “green shoots of recovery” were visible. To support this position, market participants pointed to a set of purchasing manager surveys both in the U.S. and overseas as well as some selected housing data that had come in “better than expectations”. The market rallies that followed were led largely by consumer discretionary and financial companies, followed by industrial commodities. Credit markets also rallied with most participants convincing themselves that the worst had passed. Gold and gold stocks suffered despite the quantitative easing because of the general stampede out of safe investment havens.

The market euphoria seems misplaced when one bothers to examine the facts. Consider the national income identity so familiar from classes in introductory macroeconomics:

Y = C + I + G + (X-M) where		
	Variable	% of U.S. National Income
National Income	Y	100.00%
Consumption	C	70.4%
Private Investment	I	15.4%
Government Expenditure and Investments	G	19.4%
Exports	X	12.0%
Import	M	17.2%

In the U.S. currently, the consumer is facing significant headwinds in terms of still falling home prices, tight credit conditions with credit card limits in particular being tightened dramatically, and a very poor employment outlook. There is no doubt that unemployment will continue to rise over the next several quarters to well over 10% given current trends. Moreover, much of the consumption over the last few years has come from consumers borrowing against appreciating home values, and many of the jobs (some estimates put the figures as high as 55%) were created by catering to strong housing and consumption. Barring a dramatic improvement in the labor market which is highly unlikely, no sustainable recovery or even stabilization in consumption is possible in the near term. On the investment side, about 8.1% (or over 50% of the total of 15.4%) is made up of investments in structures, both commercial and residential. Given the glut of commercial and residential property today, one can hardly expect a sustainable recovery before 2010 on that front. Non-structural investment is unlikely to increase dramatically given the exceptionally high levels of excess capacity we already have. Since low interest rates improve growth primarily through increased

investments, this would suggest that the Fed’s keeping interest rates low is unlikely to be of much help – after all, even with zero interest rates, one needs to be able to invest and generate future positive returns, a difficult task in the current environment. Looking at exports and imports, we have already seen a decline in the U.S. trade deficit as both imports and exports have declined with the former falling more. However, the economies of the US’ trading partners have slowed down more than that of the U.S. suggesting that any significant contribution to growth from net trade (X-M) is unlikely. But this means that we are left with only one real source for growth going forward – the government. The Obama administration’s focus on fiscal stimulus thus, does make sense.

The problem with government expenditure of course, is the age-old question of who will pay for it. Almost all of the world’s developed countries have automatic fiscal stabilizers such as unemployment insurance that kick in during periods of recession. As such, government expenditures increase during recessions even as tax receipts decline, virtually guaranteeing deficit expenditure at the margin. However, even before the current economic downturn started, most countries, with some exceptions such as Canada and Russia, were running deficits. Incurring huge fiscal deficits to generate growth would be tantamount to trying to spend one’s way out of debt with even more debt. If a country were to embark on such a risky, if not wrongheaded strategy, at the very minimum it would need to target its expenditures carefully so that it can create sustainable long-term growth that will generate the surpluses necessary to at least pay the interest on the deficits incurred. Unfortunately, the bubble economies today have adopted myopic policies that will almost guarantee future disaster.

The U.S. public debt situation is not as healthy as one might expect. The total national US debt (which includes public and intra-governmental debt but excludes future social security and medicare obligations) is about \$11 trillion or about 80% of GDP. However, the private sector has amassed record levels of debt over the last few years. In fact, the ratio of total credit to GDP in the U.S. exceeds 350% which is about the largest such ratio in history for any country in the world. At the end of 2008, total financial sector debt exceeded 120% of GDP, a sharp shift from 1958 for example when it was just 6% of GDP. Consumer debt at the end of 2008 was about 97% of GDP. By guaranteeing financial sector debt implicitly through the Federal Reserve, and by its bailouts of Fannie Mae and Freddie Mac, the U.S. government has rapidly increased its effective debt obligations to over 150% of GDP by some measures. And the country continues to pile on more debt. Even without the costs of the financial bailouts, the deficit in 2009 would have risen to over 6% of GDP due to automatic fiscal stabilizers. Factoring in the bailout expenditures (and these relate now to capital injections, not guarantees) and the Obama stimulus plan, we are staring at a deficit of over 12% of GDP for 2009 and very likely deficits well in excess of \$1 trillion a year (over 7% of GDP) for years to come. Thus, at least for the medium term, the U.S. will be significantly boosting its debt levels, and there is no real plan to reduce debt eventually or generate the surpluses needed to even service the debt.

An optimist could argue that the world will continue to finance the U.S. debt at attractive interest rates and that the high debt burden taken on will remain eminently serviceable. Such a statement presumes though that the government can allocate the proceeds of the debt productively (to generate a “return” that at least matches debt service) which requires quite a stretch of the imagination. While that might perhaps be possible with just true public sector debt, even if incurred to support the consumer through tax cuts and the like, it will not be true if the U.S. continues with its open-ended support for public-sector guarantees for the financial system. The problem with the financial system’s debt is that much of it was incurred to purchase assets at inflated prices so that a good portion of this debt surely cannot be repaid. Any assumption of such debt through financial guarantees thus, would represent a straight transfer of wealth from taxpayers to creditors of the financial institutions to make them whole on their bad investments. Such transfers do not represent productive uses of capital and will inevitably put the country on a path of ever-increasing debt. The bigger the bailouts and the larger the losses due to asset markdowns, the more certain it is that the debt burden so incurred will become unserviceable. The other problem with such bailouts is that the funds used for this purpose simply cannot revive growth for the medium term. However, if the bailout funds do not revive growth, the losses incurred on them will simply become larger because the financial system is sure to suffer more with an ever-weakening economy.

The financial media and the administration have argued that there is no alternative but to fix the financial system and portray naysayers of their plans as being people who just do not understand the risks. However, these arguments subtly transform the true debate which is not about whether the financial system needs to be fixed, but how it needs to be fixed and at what cost to the taxpayer. There is a high probability of significant taxpayer losses from the policies adopted for the financial system so far but yet policymakers are hard at work denying these more-than-apparent risks. As more details of the new policies the government is going to implement surface, we are struck by just how transparently these measures cater to the financial elites at the expense of the taxpayer and just how staggering the potential taxpayer losses can be.

The Public Private Investment Partnership (PPIP) program proposed by Treasury Secretary Geithner during February which we had discussed last month in our letter, has taken some new twists, which make it even more unconscionable. The banks themselves are likely to be big participants in this program. Moreover, the Treasury appears to be considering limiting participation in the program to larger investors who “have a demonstrated track record of purchasing legacy assets”. This is another way of saying that only the largest investors who already have a dismal record of investing in rubbish assets (such as the problem banks themselves), and thus an incentive to prop up the valuations of the same will be allowed to participate. Limiting the program in this fashion is almost certain to make the program even worse than it might be in theory and make taxpayer losses almost certain. We take up a simpleminded analysis of why this might happen below.

Consider two banks A and B that have toxic assets on their books, which they purchased at \$100 and carry at a price of \$95 reflecting an impairment of \$5. Assume also that these assets trade at

a market price of \$30, which, according to our banks does not reflect the “true value” of these securities. Now, if Bank A decides to participate in the PPIP and puts up \$8.33 of capital, the Treasury will match this capital and put up \$8.33 as well. The entity created with the \$16.66 of capital will be able to buy toxic assets with leverage from the Federal Reserve of about 6X so that it can buy up to \$100 of assets. Now if bank A’s PPIP entity bids on bank B’s toxic assets, it might bid a super-aggressive \$90, a full \$60 above market prices. This would make no sense if the true value of the asset ultimately ends up being just \$30 – then bank A would certainly lose the \$8.33 it put up for the PPIP. But bank A might be perfectly willing to bid at that crazy level of \$90 if it were assured that bank B would bid the same price as well for the toxic asset bank A had on its books. Then, both banks A and B would sell their toxic assets to each other’s PPIP entities at effective prices of \$81.67 (\$90 less \$8.33) which would represent a massive gain relative to market prices of \$51.67 (\$81.67 less actual price of \$30). Unfortunately, the taxpayer comes out on the losing side of this scam being out of pocket \$51.67.

Limiting the PPIP program to those who have significant track records with toxic assets will virtually guarantee such transactions designed to impoverish the taxpayer. The reason for this is that anyone with toxic assets is an ultimate beneficiary of these transactions and will have a vested interest in propping up this market. While explicit collusion to prop up prices might be deemed illegal, such behavior will likely arise legally because of an economic concept called a repeated game. The way a repeated game would work in a situation with two PPIP entities controlled by two different banks would be as follows. Bank A’s entity buys \$1 of toxic assets at inflated prices from bank B. Seeing the first purchase, bank B might try its hand at a charitable purchase and have its own PPIP entity purchase assets from bank A at ludicrous prices too. This in turn will beget further purchases by bank A’s entity of more of B’s rubbish. Such repetitive behavior will quickly ensure that both banks get the message that “good” behavior (or inflated prices for asset purchase) will produce tangible rewards. There is no explicit agreement to make these purchases at inflated prices, but the fact is that they will occur at inflated prices anyway because it is in the self-interest of both participants to pay these prices.

Allowing other participants into the PPIP who do not have toxic assets at all and might insist on paying market prices for these assets would not solve the repeated game dilemma we would be in above. This is because these clean entities would essentially be shut out of the marketplace entirely. The banks would only sell to the PPIP firms that overpaid, and the rational participants in this arena would be forced either to join the banks’ club, which to them would make no economic sense, or leave the market entirely which is the more likely outcome. Such a result is all too possible and in fact, is borne out by recent history. Consider for example that any careful bank from 2004-2007 that avoided the toxic loans and derivatives just did not have the short-run profits that its incompetent counterparts generated. Any chief executive that presided over such a bank could not have retained his job for long. In our unregulated world of Ponzi finance and skewed incentives, incompetence and crime unfortunately beget copycat behaviour!

The entire political apparatus, especially in the U.S., appears to have been hijacked by the financial elite who actually caused the problems the country is facing. There are some obvious truths that are just being hidden from the public by the very regulators who are entrusted with the job of protecting the public interest. The largest firms in the financial system caused the disaster we are in today. If they are being bailed out because they are too big to fail, the simple reality is that they are also too big to exist as well. Instead of moving to break up these firms and force much tighter regulation on the new smaller firms, the government has worked to allow the firms to get even bigger and has essentially provided an explicit guarantee against failure while retaining the same crooked managements in these firms. The truly depressing element in all this is that the government did not have to do any of this if all it wanted to do was to make sure that the banking system provides its core functions to the economy – a sequence of bank failures supervised by the FDIC with accompanying creditor losses would have limited government costs while flushing out the incompetence and forcing transparency. By wasting scarce taxpayer resources on bailouts that are essentially unnecessary, if not even counterproductive for long-term stability, the U.S. is firmly on the path to explosive indebtedness and potential hyperinflation – the very solvency of the country will be in question given the current thrust of policy.

Our funds had a rough month in March and the bad performance has continued into April. Inebriated market participants are reveling with the Wizard of Oz, but unfortunately, we just see the man behind the curtain and cannot join in the festivities. When this bacchanalian party ends, we feel confident that we will remain standing.

Performance Summary at March 31, 2009

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)
-1.4%	2.2%	18.2%	31.6%	61.2%	39.5%	22.7%	N/A	2.2%	15.7%

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%	1.7%	17.2%	37.2%	66.9%	42.2%	22.6%	14.7%	1.7%	22.2%

Nothing herein should be read to constitute an offer or solicitation by Trident Investment Management, LLC or its principal to provide investment advisory services to any person or entity. This is not to be construed as a public offering of securities in any jurisdiction of Canada. The offering of units of the Trident Global Opportunities Fund are made pursuant to the Offering Memorandum only to those investors in jurisdictions of Canada who meet certain eligibility or minimum purchase requirements. Important information about the Funds, including a statement of the Fund's fundamental investment objective, is contained in the Offering Memorandum. Obtain a copy of the Offering Memorandum and read it carefully before making an investment decision. These Funds are for sophisticated investors only. ©CI Investments and the CI Investments design are registered trademarks of CI Investments Inc.