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MONTHLY UPDATE

Trident Investment Management, LLC
Opportunities Funds Commentary

May 31, 2009

Performance Discussion

Equity markets continued their rally from April in May. The S&P 500 Index was up 4.7%, the MSCI Europe Index was up 3% and the Nikkei was up 7.9%. Commodities rallied strongly also, with oil up 29.7% to end at $66.3 a barrel and gold up 10.3% to end at $978.8 an ounce. The credit markets also tightened with spreads on the worst credits coming in significantly. The major casualty during the month was the U.S. Treasury market where 10-year yields rose by 0.3% to end at 3.5%. The U.S. yield curve also steepened significantly with the spread between the 2-year and 10-year rates rising 0.3% to 2.5% (all figures in U.S. dollars).

May more than reversed two months of poor performance in our funds as most of our largest positions performed well. Our longs in gold and gold stocks and in some other commodities such as oil all worked well. Our long equity positions in Canada and Japan also performed well. Our bearish views on the U.S. bond market taken through 2-year – 10-year curve steepeners also kicked in. We continued to get hurt however, by our short positions in credit – though not as much as in April.

We also made a few alterations to our portfolio on the month. We cut back on our long positions in short-dated fixed income in Australia, the U.K. and Europe and initiated positions further out on the yield curve in Australia. We also started adding to our short positions in credit since the rally of the last two months is providing us with exceptional entry levels.

Market Outlook & Portfolio Strategy

The market action in May was in part prompted by economic news that participants felt was "better than expected" confirming that the green shoots of economic recovery were everywhere. There is some justification for this conclusion in Asia and the developing world where there was a virtual collapse in economic activity in late 2008. However, the news is not as good in the developed world, and especially in the U.S. The U.S. data that suggest a recovery are largely purchasing manager and consumer survey results which are highly prone to sentiment. For example, U.S. consumer confidence data surprised dramatically to the upside, but a closer examination of the data paints a less rosy picture. Consumers have become more optimistic about the future, but remain concerned about their present situations. They do not intend to purchase more houses, cars or durable goods given their limited circumstances, but paradoxically, believe things should get better a few months out perhaps because of the increasingly optimistic media reports about economic recovery. Unfortunately, such a triumph of hope over reality does little to spur sustainable economic growth. The U.S. consumer today still faces a hostile environment with unemployment at 9.4% and rising, home prices falling and credit being tight. While optimism in these conditions is laudable, it should be remembered that one cannot spend confidence.

Another factor that led to market euphoria in May was the release of the results from the stress tests conducted by the U.S. regulators on the banking system. The stress tests suggested that the largest banks needed about $75 billion in additional equity capital to weather even a pessimistic scenario for the U.S. economy – a sum that was far smaller than markets had expected. Many banks moved swiftly to raise the

required capital with market participants being only too happy to snap up these "cheap" stock issues. We have argued before in our letters that the stress tests were largely a cosmetic exercise designed to convince the public that the banks were solvent when, in fact, they are not. The scenarios assumed in the tests were too benign with even the pessimistic scenario assumed being better than current economic conditions. Also, when it came to off-balance-sheet items, derivatives and other toxic instruments which were at the heart of the credit crisis, the banks were allowed to value their own portfolios with what appears to have been only broad direction from the regulators. Even worse, the firms were allowed to negotiate with the regulators in regard to the additional capital that the tests suggested they needed by appealing to future earnings and the like to reduce the requirement for more capital. Thus, the stress tests used questionable hypotheses and a flawed implementation methodology to generate conclusions that could be argued until a desired result was obtained. Put differently, the banks taking stress tests could be likened to a student who is given a take-home examination that he grades himself with some grading guidelines from the teacher. Unfortunately, our student completely failed this exam, but then negotiated with his teacher to get a passing grade based on how hard he intends to work in the future.

The capital raising by the banks following the stress tests has resulted in several of them clamoring to repay the Troubled Asset Relief Program (TARP) funds that they were provided late last year. It is important to note that virtually all the TARP recipients also subsequently raised debt, guaranteed by the Federal Deposit Insurance Commission (FDIC), and the amounts raised were typically more than the TARP funds injected. In fact, many of the firms will be using these FDIC funds to pay back the TARP advances. Moreover, even if all the government funds are repaid, markets rightly believe that the TARP recipients will continue to get government support were problems to recur. Thus, the taxpayer remains at considerable risk even if the TARP funds are repaid, both from the explicit guarantee of the FDIC debt and from the implicit certainty of more bailouts if needed.

The repayment of the TARP funds obscures the more important issue of why the government even embarked on the program in the first place. The TARP funds were designed to deal with toxic assets in the financial system but then morphed into a direct injection of capital into these firms. It was expected that the latter course of action would put the financial companies on a healthy footing. However, few would argue, stress tests results notwithstanding, that the system is safe. Even the supposedly "healthy" firms remain exceptionally leveraged and continue to face very challenging market conditions. No new regulatory framework has been put in place to limit risk-taking by the financial companies and in fact, those firms that were too-big-to-fail are now even bigger and certainly too big to regulate. Toxic assets have not been jettisoned from the balance sheets of these companies and in fact, have not even been addressed. In a retrograde step, the accounting rules have been changed to allow for greater obfuscation in reporting and almost certainly more fraud by our financial swindlers. It is fair to say that the TARP has not really achieved any of its longer-term objectives. The only reason for firms wanting to pay back TARP funds is to avoid any constraints on compensation payable to their top executives – after all, unbounded profits and compensation for managements with losses borne entirely by taxpayers is a model that Wall Street just adores.

With so much taxpayer money and contingent risk at issue, it is truly amazing that the US government has caved into financial lobby and has moved to allow numerous firms to pay back their TARP funds. Many of these firms were technically bankrupt several times over just a few months ago, and still

remain bankrupt by any objective measure of their solvency. A cynical view of the government's action is that it represents crony capitalism in its more ugly form with the financial oligarchs having taken control of the political apparatus. The taxpayer is being put at greater risk to ensure that favored financial managements can continue to take huge risks with their attendant payouts. A more charitable take on the government's actions is that they believe that unshackling the TARP firms and creating an illusion of normality would spur more lending, an important requirement, in their view, for any economic recovery. Unfortunately, more lending simply cannot be the answer – we analyze below why it is going to be virtually impossible for the U.S. to spend its way out of debt.

The US has a massive structural problem of too much debt. The level of government debt in the country is extremely high when the costs of entitlements such as Social Security and Medicare, and guarantees for Fannie Mae and other financial institutions are considered. Numerous observers have argued, however, that only the actual debt held by the public matters and that by such measures the U.S.' debt levels are no worse than those seen in other developed nations. While such a debate might be possible where it comes to government debt, there can be no dispute where it comes to total debt in the U.S. accumulated by both the private and public sectors. According to the most recent data from the Federal Reserve, the ratio of total Credit Market Debt in the U.S. to GDP exceeds 370%, a record for any nation and a ratio we have highlighted many times before. Even worse, the total credit market debt excludes government debt held by agencies of the government itself. If the government debt held by other arms of the government were included, the ratio would exceed 400%. Also, the debt implied by future payments for entitlements such as Medicare, are not treated as debt at all. These figures are in fact provided by the Treasury in its annual U.S. report. If these were viewed as debt by the Fed the total debt to GDP ratio would exceed 650%.

We can perform a simple stress test using the above credit market debt to GDP ratio for the U.S. economy that will allow us to assess some of the major problems the country faces. By necessity, our test will require a number of assumptions, but the results are nonetheless illustrative and considerably more robust than those conducted by the Treasury on the financial system. The first assumption that we will make is that the debt pays interest at a fixed, nominal rate thus excluding the complexities of floating rate and inflation-indexed instruments and other hybrid instruments such as pay-in-kind bonds. Next we assume that the holders of a given debt instrument are not simultaneously the creditors. That is, the creditor is not lending directly to himself using this "debt" and as such has an expectation of being paid principal and interest. This assumption can be contested on the grounds that in the U.S. the bulk of credit market debt is owed by the country to itself. However, by making this assumption we are implicitly separating the borrowers and lenders within the country into two distinct classes with a view to understanding the dynamics of the debt.

Now let us look at the debt in the context of overall GDP growth. Assume that:

g = annual growth rate of nominal GDP.

r = annual nominal interest rate on debt.

D = Total Credit Market Debt / GDP

The total annual interest that will accrue on the credit market debt then will be (D * GDP) * r. The incremental earnings generated by GDP growth on the year will be (GDP * g). Assume that all the GDP growth goes to pay down debt. Then, it can be shown that the GDP growth rate has to be at least rD/(1+D) if the Debt to GDP ratio is not to increase on the year. A growth rate lower than this will mean an increase in the Debt to GDP ratio, and vice versa.

The exercise above becomes interesting when we plug in the appropriate numbers for the U.S. economy. As of the fourth quarter of 2008, the ratio of Total Credit Market Debt to GDP is about 370%, or D = 370%. The weighted average interest rate paid on U.S. Treasury debt as of May 2009 is 3.5%. Given that private sector debt in general carries higher interest rates than Treasury debt, a reasonable assumption is that the minimum rate on all credit market debt is at least 3.5% which means r = 3.5%. With these figures, the minimum rate of nominal GDP growth necessary to stabilize the debt to GDP ratio would be about 2.8% assuming that all of the increase in GDP goes to servicing debt. Reducing debt ratios with a level of GDP growth below this threshold would not be possible without defaults.

The scary part of these calculations however, comes when we consider what would happen to debt levels if the expected growth in nominal GDP did not materialize. We can show that for every 1% that growth falls below the steady state level of 2.8%, the debt/GDP ratio would rise by almost 5% of GDP. In fact, if nominal growth came in at 1% which is hardly unreasonable given current conditions, our debt levels would rise by over 8% to 378% of GDP. Even worse, if the 1% nominal growth were attained with a fiscal deficit of 13%, the debt level would rise by over 21% of GDP to 392%! And lest there be any confusion about the magnitudes, 21% of GDP would be about $3 trillion of new debt. The debt levels get dramatically worse if higher rates of interest such as 5% are assumed. And the entire analysis presumes that we are only going to service the debt – no attempt is being whatsoever to pay it down.

It is true that we are making numerous assumptions in reaching the conclusions above. But where it comes to the debt levels themselves, we have understated the problem. As pointed out earlier, when all U.S. government obligations, including those for entitlements are considered, the total debt to GDP ratio rises to over 650%! Even worse, if we factor in the unfunded pension obligations of the corporate sector and the guarantees of the same provided by the Pension Benefit Guaranty Corporation, we have an additional layer of debt that can be added on to these already inflated levels. However, the important point to note is that just a few years of weak nominal growth, even without fiscal deficits will lead to levels of public and/or private sector debt that cannot even be serviced. As such, it is not hard to understand why the Fed today is really trying to create inflation and thus higher levels of nominal growth despite any pronouncements to the contrary. Huge debt levels with deflation are a prescription for debt defaults, and the numbers above should convince anyone that in such an environment the amounts defaulted on will surely be more massive than at any other time in history. Short of outright default, a workable solution might be to create some inflation while simultaneously acting to reduce debt. But U.S. policy so far has focused on huge deficit expenditures that will dramatically increase debt levels while delivering questionable growth benefits. Such a policy mix is, at best, a huge gamble, and at worst a massive disaster in the making.

In a nation with so much debt, one would expect that the rights of debtholders would be of paramount importance to the policymakers. The usual argument made about why the U.S. debt levels are not worrisome is that a significant portion of the debt is actually securitized and as such, not risky. Unfortunately, the presence of collateral does not imply the ability to service the debt and our analysis

above was focused on the latter. Moreover, the political climate is such that it is no longer clear what rights debtholders really have. The Chrysler bankruptcy has brought these issues into the spotlight.

In the Chrysler case, a number of bondholders had claims secured by Chrysler assets. The U.S. government supported a plan for the firm to emerge from bankruptcy with its assets transferred to a new company. The new firm would be managed by Fiat , the Italian automaker, which would initially receive 20% of the new company with the governments of the U.S. and Canada getting 9.8% and 2.5% respectively, and the United Auto Workers retiree medical fund owning the remaining 67.7%. In return for the transfer of assets from the old Chrysler to the new company, the secured debtholders would receive 29 cents on the dollar for their debt. On the other hand, the UAW health-care trust which had an unsecured claim would get both the large equity stake as well as a note from the new company for 40% of their debt's value. One could reasonably conclude that the UAW was treated better than the secured debtholders in the bankruptcy despite their junior status. When the secured creditors, many of whom were TARP fund recipients, objected, the Administration expressed its disapproval of their behavior in no uncertain terms berating them as "speculators". Not surprisingly, most of the creditors caved in to the government's demands, at least in part because they were beholden to the government through the TARP. While we do not want to opine on whether the secured creditors received a bad deal or not, the fact remains that the existence of collateral for debt does not guarantee access to it. If anything, the Chrysler experience underscores the fact that getting repaid even on secured debt may become a charged, political issue rather than a straightforward and impartial bankruptcy proceeding. Capitalism's most fundamental requirement is the existence of clearly defined property rights, and this is particularly important in the current situation where the U.S. is literally drowning in debt. It is unfortunate that the U.S. government has decided at this juncture to pursue policies that might make debtholders question these basics.

In sum then, the world does not seem to be a better place despite the euphoria of the last several weeks. The banks are still wards of the state even if they get to repay TARP funds soon. Even worse, the banks if they lend, are only going to add to the massive U.S. debt. The government, by embarking on a program of deficit financed expenditures, is going to do even more to create a parabolic expansion of debt. And finally, the Chrysler experience should give pause to anyone who thinks getting repaid, even on secured debt, is going to be easy. The events of the last few weeks make me feel that all those pundits who are rejoicing about the "green shoots of recovery" just have not figured out yet that they are looking at a patch of AstroTurf – perhaps their time would be better spent, like John Lennon, watching the wheels of the debt steamroller bearing down upon them.

Our positions have not changed very much over the month. We have reoriented most of our long positions in fixed income away from short-dated instruments, which we anticipate might suffer as hopes of recovery continue to mount, to longer-dated instruments, which now provide excellent value. As before, our positions are concentrated in Australia and Europe. We have also started to add more aggressively to our short positions in credit – we believe that the expected recovery will be tepid at best and will result in more credit problems down the road. We retain our bearish stance on long-term U.S.

yields and are also using every opportunity to add to our short positions. Our instruments of choice are the curve caps, which are essentially curve steepener options.

Markets have done enough to wreck investor portfolios over the last few years, and the news overall still is terrible. Amazingly, most market participants are so optimistic that we are seeing asset valuations driven to extremes by hope. We are excited at the prospect of profiting from the return to reality.

Performance Summary at May 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)
6.5%	1.8%	7.4%	41.7%	71.2%	37.3%	24.4%	N/A	5.6%	15.8%

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)
6.7%	2.3%	7.0%	48.2%	75.2%	40.0%	24.9%	14.4%	5.3%	22.2%

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