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Trident Investment Management, LLC
Opportunities Funds Commentary

October 31, 2008

MONTHLY UPDATE

Performance Discussion

October 2008 was truly a month for the history books. The global equity markets had a horrendous month with the S&P 500 index down 19.80%, the MSCI Europe Index down 13.03% and the Nikkei down 23.83%. Intra-month, the results were even worse. The S&P was down as much as 27.22% during the month, and the Nikkei hit a 26 year low at the same time. Commodities suffered with oil being down 32.37% to end at $67.81 a barrel and copper down 36.47%. Gold did relatively better being down just 18.46%. Credit spreads, and in particular, emerging market spreads, continued to widen as investors started to worry about growth. The only ray of hope was a major rally in sovereign bonds in the developed world, thanks to significant rate cuts by the central banks. The U.S. 2-year Treasury yield fell 0.41% to end at 1.552% and that in Australia fell .81% to end at 4.29% (all figures in U.S. dollars).

The difficult markets were accompanied by some of the worst performance we have yet seen from the fund management industry. Most investment vehicles, and hedge funds in particular, were down in excess of 10% just in October. Investor redemptions created a climate of forced selling and this coupled with the difficulties faced by market makers meant exceptional market volatility with a perceptible lack of liquidity.

Despite the environment, our funds were up meaningfully in October. Our long positions in short-dated fixed income were the primary driver of our performance. Our short credit positions also helped, but our equity positions did not contribute materially to our results. Our performance has come despite the fact that we reduced our risk exposure significantly in September anticipating the exceptional volatility that has since followed.

We feel that conditions now warrant prudence. The turmoil is far from over and a substantial shift in global macro policymaking is imminent. That said, we are finally becoming constructive about financial asset valuations. For the first time in years, we can actually find bargains, especially in equities and some higher-yielding bonds. An investor with a time-horizon of two years or more is sure to be rewarded handsomely for taking risk. However, we believe strongly that patience in building up our long-term positions is essential given the near-term volatility.

Market Outlook & Portfolio Strategy

The market declines in October were fuelled in large part by mounting concerns about the global economy. Commodities and commodity-focused stocks declined precipitously, as did the emerging markets which tend to be correlated to the commodity complex. Policymakers, however, have taken truly heroic steps globally to bail out their financial systems. Paradoxically, thus, we have an environment where numerous high-quality industrial companies are trading at depressed valuations, while financial zombies, especially in the U.S., whose survival is in question are continuing to be favoured.

The Treasury Plan (Troubled Asset Relief Program or TARP) for bailing out the financial system took a significant twist in October. The plan was sold to lawmakers as a fund for purchasing troubled assets at elevated, "hold-to-maturity" prices from financial firms, thus allowing for a sneak capital injection to these companies. The plan also gave the Treasury secretary virtually unchecked powers to do whatever else was necessary with the funds allocated to stabilize the financial system. The original concept of buying assets was abandoned almost as soon as the bill was passed by Congress. The Treasury decided instead to focus on a direct capital injection to banks and other financial firms with this capital taking the form of preferred stock. Nine of the largest U.S. financial institutions received a total of $125 billion in injections from this plan, with a number of others expected to receive the remaining $125 billion authorized in the first tranche of the effort. The Treasury has been less than clear on exactly which firms are eligible for these

bailout funds. As such, numerous quasi banking institutions, insurance companies and the like are all queuing up to be served, with each representing to the government that they are of "systemic importance".

The implementation of the TARP so far suggests that U.S. policymakers have taken leave of their senses. The capital injected has been at the preferred stock level and as such is junior to all debt instruments of these companies. Since some of the firms receiving funds are leveraged more than 20 to 1, injections at the stock level put taxpayers at serious risk. The bondholders in most of these firms have failed to exercise any diligence in lending but, thanks to the Treasury, are not being required to share in any of the potential pain. Moreover, the Treasury has not insisted on any oversight of recipient firms' day-to-day operations despite the colossal leverage involved in most of them. While the funds ostensibly were to be used to get credit flowing again in the real economy, most of the recipients have indicated that they intend to use them to shore up their balance sheets and make acquisitions. And even worse, there has been no attempt made yet to rein in compensation at these firms – the financial companies receiving the first $125 billion have in fact earmarked about $108 billion for bonus payments for 2008! The pig-people in Wall Street are feeding at the taxpayer trough without any decorum. They differ from their animal cousins only in that the animals have far superior ethics.

Even if the TARP's implementation details were addressed, its philosophy is fatally flawed. At its core, the TARP believes that shoring up the financial system with taxpayer funds while retaining most of the current management in these firms should work to fix the current U.S. credit crisis. One of the stated goals of the TARP was to ensure that the taxpayer funds be used by the financial firms to bolster new lending. Unfortunately, the problem the U.S. faces today is one of too much leverage with a financial system that is virtually bankrupt. Moreover, the consequences of leverage have permeated through all sectors of the real economy to the point where a painful retrenchment can no longer be avoided. As such, any government plan should force a deleveraging of the financial system in an orderly fashion while using the bulk of the funds to stabilize the real economy. It should not provide additional capital for unchecked speculative lending by demonstrably incompetent managements. So while the TARP might appear to be a private sector "solution" with some public-sector assistance, it represents the worst form of crony capitalism. We consider the fragile nature of the U.S. financial system and the linkages to the real economy in greater detail below.

According to bank capital rules established by the Bank for International Settlements (BIS), a bank is required to have a capital adequacy ratio of at least 8%. The computation of the capital adequacy ratio is rather complex and requires assigning risk weights to the various assets the bank holds, with some requiring no capital (risk weight of 0%) and others requiring more than 8% (such as speculative loans with a risk weight of 150% requiring 12% capital). Determining the amount of capital the bank has is also convoluted, but for purposes of our discussion we can just view the capital as being the amount of equity in its balance sheet. A gross approximation of the BIS rules would suggest that a bank has to limit its leverage (or total risk assets) to a maximum of 12.5X its equity (100/8).

Most banks in the U.S. are leveraged about 10 to 1 just on balance sheet assets. The balance sheet assets do not include off-balance-sheet vehicles such as credit default swaps, credit lines, structured investment vehicles and the like to which many of the larger banks have considerable exposure. According to the Federal Reserve Bulletin of October 2008, the U.S. commercial banks hold only 16% of balance sheet assets in very safe investments (10% in Treasuries, 3% in cash and 3% in secured repurchase agreements). Thus, fully 84% of assets are in risky holdings with over 45% being held in real-estate assets. If we give the risk assets a BIS risk-weighting of 100%, requiring that 8% capital be held against them, the banking system needs capital of at least 6.72% of assets (8% of 84%). The residual (or assets less liabilities for U.S. commercial banks), which for now, we will view as capital, represents 10.69% of the balance sheet. Superficially this might suggest that the banking system in the U.S. is in good shape because it still has "excess capital". However, the reality is far worse. Real estate assets overall have dropped at least 10% in market price. Were we to assume that markets are even close to being right on potential losses, which is reasonable given that home prices are already down 20% or more from peak, the banks could lose over 4.5% of assets just on real estate, wiping out our computed excess capital.

Banks therefore are being hit with a double whammy – or a mark-to-market basis which almost certainly reflects reality, their capital is being eroded, even as overall economic risks have picked up dramatically requiring that they have more capital than normal. Thus, even in a superficial, balance-sheet sense, the banking system in the US needs more capital.

When all risk assets are measured appropriately many of the larger commercial banks are considerably more risky than their balance-sheet leverage ratios would suggest. In fact, many of the losses so far have come from off-balance sheet items on which the banks have provided very poor disclosure. Unfortunately, even the balance sheet leverage of the largest banks is very high. For example, Citigroup has total book equity of just $126 billion but total assets of $2,050 trillion, which means balance sheet leverage of 16.3X. JP Morgan has leverage of 15.4X. When the off-balance-sheet items are factored in, it is likely that the leverage ratios for these large banks exceed 20X. The brokerage houses are levered on balance sheet anywhere from 15X to 25X, and with off-balance-sheet exposures, this ratio may approach 50X. The problem with so much leverage is that the firms have little ability to weather a downturn in asset prices or quality. A leverage ratio of 20X can cushion an asset price decline of only 5% before equity is totally wiped out. Given the systemic decline in financial asset prices globally, one has to come to the sobering conclusion that the US financial system, and very likely that in the UK, Australia and parts of Europe, is close to being bankrupt if not already so. If the global economy weakens significantly, the financial problems are only going to get worse. A run on the financial system thus, is hardly a panic reaction by markets – it is a rational reflection of reality, and it is precisely for this reason that policymakers have had to undertake bailouts at the scale that they have so far.

While our analysis above reflects the conditions in the financial system, especially in the U.S., one could argue that the TARP has enough assets at $700 billion to permit at least a stabilization of the banking system, and prevent a wholesale credit contraction in the real economy. Unfortunately, a stabilization is simply not enough to stop the slide that has just started in the real economy. The US economy as a whole has been driven by financial engineering to a degree that few can appreciate, leaving it extraordinarily vulnerable to any slowdown of credit extension, even to "normal" levels. The simple examples below will illustrate our point.

Consider an individual who has bought a car for $100 with a loan for the same amount at an interest rate of 10%. Assume that the amount the borrower can reasonably earn in income for interest payments is just $5, so that he cannot pay the full $10 of interest due on the loan each year. In a normal financial environment, the borrower would default after the first year on his payment and the car would be repossessed. However, in the Greenspan-bizarro environment of 2001-2006, our borrower was not in fact, shut down. He was able to trade in his less valuable car towards a new one with a so-called "upside down" loan. That is, he would trade in his car (now worth $85 in the used car marketplace) for a new car costing $100, and could get a loan for $120 reflecting the new car's cost plus the unpaid interest ($5) and depreciation ($15) on the old car. The friendly bank that financed these loans just adored our borrower. Not only did he "pay" 10% interest on his car each year, but the transaction fees on every new upside-down transaction he did, added to the bank's profits. The $5 of interest that he could not pay was counted as part of bank earnings and capital because it was paid out of the new $120 loan. And the new, larger loan was put on the books as a "safe" loan, even though there is a built-in collateral shortfall of $20 in it given that the new car is worth only $100. Such loans were made in the hundreds of billions in the US. The question that should reasonably be asked is which banks would make such loans. And this is where the real economy part of the problem comes in.

Consider a firm (call it Lemon) that manufactures cars in the U.S. costing $90, and sells them at $100. The firm employs 10 people, so that the profit generated per employee is $1. Assume now that a new company (call it Peach) opens a new factory (also with 10 employees) to build cars in the U.S. Peach is more efficient than Lemon and so can make cars at just $80 in the U.S. It manufactures as many cars as Lemon does and sells them for $90. Now, Lemon is in trouble because it cannot make a profit at a $90 selling price. Even worse, since twice as many cars are available for sale, prices per car might drop below $90 forcing Lemon into a loss. So, Lemon is facing a fight for survival.

The solution to Lemon's problem was quite easy in the financial environment of the last few years. Lemon expanded the market for cars by finding borrowers who could never have afforded a $90 car. To do so, the company provided financing to any and all to purchase their $90 car. The business of making the car would still not generate a profit, but thanks to the financing provided by Lemon's financial subsidiary, the firm would be able to book a profit of say $15 on the loan transaction. Thus, Lemon while doing nothing differently in its core manufacturing business is making $15 of total profit per car! Look at the virtuous cycle that this creates. The now highly profitable Lemon expands both its car production as well as its financing operation. Many more cars are being sold which means more car dealers, service centers and the like all of which boost employment. And employee productivity in the car industry soars thanks to the higher profits. In fact, Lemon's foray into financing is so successful that it expands its financing operation to include mortgages, personal loans and the like – after all this is free profit. And while Lemon's financial subsidiary itself is not regulated, the regulated banking system sees the huge profits it generates and is only too happy to lend aggressively to this entity so it can work its financial alchemy. If Lemon's loans are securitized and sold to the public, the constant refinancing will mean, at least in the short term, few defaults, and exceptional returns which in turn will beget even more of a lending mania. Lemon's financial risk thus, has become the banking system's problem too.

The distortions caused by financial engineering in the real economy are legion. Spurred by the financing profits, since Lemon expanded production, car prices may drop to $85 or lower given the huge supply of new cars. Then, Lemon loses more money in manufacturing every car and its financing arm has to generate even more profits to make the firm overall look good. Lemon in fact, will do any kind of upside-down lending against cars it makes because it really has no choice – it has committed itself to continued growth in lending to pursue the inherently unprofitable business of manufacturing cars. If Lemon now is unable to borrow to provide financing to its customers, the consequence is not just a few risky customers being denied loans. Since so much car demand was artificially created by Lemon due to creative financing and supply grew to meet this demand, the car industry would face a ballooning of inventories and a collapse in prices. Lemon will be quickly forced into bankruptcy as might many other companies in its supply chain, and the loss in jobs and confidence could lead to further declines in demand. Even Peach, which conducted its business more conservatively, would be affected very negatively by this.

If the above example sounds depressingly familiar, it is because it mirrors reality. The U.S. automakers, General Motors and Ford, are today in the position of Lemon and face bankruptcy. The huge amounts of debt that they have issued are going bad at an alarming rate – both their financing arms, GMAC and Ford Motor Credit, are almost surely bankrupt. The consequences to the real economy from their bankruptcy are seismic, but the problem is that one cannot "stabilize" this situation without letting it run its normal course – any attempt to do so would be doomed to failure.

Our example takes an even more interesting turn if Peach actually produced cars overseas at a low cost of say $70 per car, rather than in the U.S. Lemon might decide to one-up Peach by outsourcing its own production overseas while retaining its financing and distribution arms in the U.S., possibly relocating all its manufacturing employees to these divisions. Suddenly we have a situation where no one produces cars in the U.S., but we have a highly profitable auto industry whose sole job is to sell and finance automobiles made elsewhere. In fact, if Lemon plays its cards right, its manufacturing partner overseas may even provide the vendor financing to it with a view to selling more cars. This makes for another virtuous cycle. If overseas cars could be purchased for $70 (with cheap vendor financing) and sold at $80 (much lower price than before), with a reduced financing profit of $10 (rather than $15 before), we would still make $20 per car sold – record profits! In fact, our employees would now all be salespeople with relatively cushy jobs without any of the heavy lifting required in manufacturing. Productivity would soar, cost of cars would fall as would inflation and since the workers now do not make anything but loans and car sales, their livelihood would depend on the continuation of this new paradigm. Of course, since the domestics are just consuming and providing financial services that their overseas partners do not require, an inevitable result of this will be that the overseas producers will accumulate more and more claims on the domestics and soon become their largest creditors. This is an even bigger macroeconomic problem.

If this virtuous cycle goes into reverse, it takes down both the domestic and overseas economies, not to mention wiping out the values of huge amounts of financial claims.

The latter example is not applicable to the U.S. automakers but to the U.S. retailers. Wal-Mart in the U.S. simply imports low cost goods from countries like China to sell to the U.S. consumer. The more that Wal-Mart sells low cost Chinese goods in the U.S., the more profitable it gets and the more productive its employees get. In fact, its employees do nothing but provide sales services to its domestic purchasers of foreign goods and their incomes are entirely dependent on continued sales. The Wal-Mart situation is applicable to virtually all the U.S. retailers, and to numerous other parts of the U.S. economy. The continued huge U.S. trade deficit can be directly traced to the growth of this "post-industrial" model for the U.S. economy.

The problem with the U.S.' Wal-Mart-like real economy is that it is highly vulnerable to changes in overseas sentiment especially where it comes to the country's creditworthiness. The U.S.' trading partners are accumulating claims on the country that may not be repaid with assets that have the same purchasing power. And if a domestic slowdown starts in the U.S., as it has already, the overseas economies are going to feel tremendous pain too both due to the real and the financial linkages.

We can make the following important points based on the above discussion:

- The U.S. financial economy has been driving the real economy over the last decade or longer, rather than the other way around. A slowdown in the breakneck pace of financing will mean big problems going forward for the real economy.
- The strong U.S. GDP and productivity growth of the last several years are a mirage. With the crisis in lending, the pace of economic reversal should be stunning.
- Even were the banking system stabilized, a painful real economic adjustment, especially for the U.S. consumer, is essential. Any attempt to prevent such an adjustment is likely to be counterproductive.
- This is and has always been a serious global problem. The U.S. debt financed growth model's demise should take a toll on most of the world's economies.

When one understands the nature of the problem, it becomes apparent that a financial rescue plan alone is inadequate. At best, direct capital injections for the financial system can stabilize things so that bank lending can be resumed at a "normal" pace which is far lower than that in 2004-2006. Evidence so far with the TARP suggests that even that is not happening – in fact, most banks are using the funds provided to shore up their capital and take over other firms rather than to lend. But if some financial plan were to work, a normal pace of lending is still not enough to save the real economy. Much more drastic action with large tax cuts, job retraining and extended unemployment benefits will most likely be required to deal with the U.S. recession that is just getting under way. Unfortunately, the U.S. is entering this difficult period with an already bad fiscal position and huge global indebtedness. And the country's resources currently are being squandered on the flawed TARP plan which so far appears to be just a wealth transfer, without adequate oversight, from already suffering taxpayers to the main creators of the financial mess. In the country that has always stood for capitalism, we are now practicing a perverse form of anti-capitalism where fraud and failure are being rewarded with government largesse!

While the situation in the U.S. seems bleak, the real economy in the rest of the world is in much better shape, because the financially driven economy has largely been a U.S. creation. Markets however have reacted as though the rest of the world is in worse condition than the U.S. largely because participants cannot envision a world without U.S. economic dominance. A new world order is in the making – one where the U.S.' trading partners focus more on domestic growth generation and imports from the U.S., rather than relying on the indebted U.S. consumer for their development. Such a world would actually be in the U.S.' interest too and a continuation of the financial and increasingly, global growth crisis will force the

creation of a new architecture. If the world's economic system can be likened to the filthy Augean stables that Hercules had to clean in a day, the real-estate and credit crises may perhaps play the roles of the rivers Alpheus and Peneus whose waters Hercules redirected to wash the enclosures clean. We believe that more significant global policy coordination is imminent and hope that the macro measures undertaken will lay the foundation for global, long term stability.

From an investment perspective, we believe that the environment is rife with opportunity – for the first time in at least five years, we can identify numerous grossly undervalued assets which we can purchase. In the recent turmoil for example, the Canadian dollar has been savaged as has the Canadian equity market. Canada has no fiscal or trade deficit of consequence, and no inflation. As such, it has considerable room for fiscal maneuver – something that the markets do not discount at all. We are extremely bullish on Canada currently, and have been slowly nibbling away at select Canadian investments. We are equally bullish now on Japan which is trading at 26 year lows, despite having a banking system that, for once, has avoided the credit crisis. While the Japanese economy is not insulated from a slowdown in the U.S., its stock market is already pricing in the worst. The same is true also for many developing countries whose currencies and markets have suffered considerably despite being in relatively good economic shape. These represent extraordinary opportunities for an investor with a medium term horizon of two years or more. We have no good sense for market action in the near term, but markets are rewarding us handsomely for looking past that period.

We have been reducing our risk steadily over the last few weeks, especially in some of our U.S. financial short positions, both in credit as well in equities. We have added to initial long positions in Canada and Japan. We have also expanded our short positions in consumer focused companies, especially in credit. Our biggest single exposure remains our long position (through options) in short-dated fixed-income instruments in the U.K. and Australia, where we still see considerable upside. The last few weeks have felt like war in the markets – we are getting ready to purchase assets that will serve us well when peace returns.

Performance Summary at October 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)
4.9%	9.4%	23.4%	44.9%	58.9%	35.9%	21.8%	N/A	30.3%	14.8%

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)
4.8%	13.4%	28.9%	40.8%	65.2%	39.3%	20.4%	16.5%	29.8%	21.9%

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