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MONTHLY UPDATE

Trident Investment Management, LLC
Opportunities Funds Commentary

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Performance Discussion

Markets rested a little in October after their frenzied bull run of the last few months. The S&P 500 was down 1.99%, the MSCI Europe Index was down 2.14% and the Nikkei was down 0.98%. The bond markets were down slightly as well with yields on the 10-year U.S. Treasury up by 0.08% to end at 3.39%. Commodities were strong with gold in particular rising 3.77% to end at $1045.40 an ounce. Credit was largely unchanged. Finally, the U.S. dollar weakened with the US Dollar Index depreciating 0.46% on the month (all figures in U.S. dollars).

Our funds recovered the prior month's losses in October with the bulk of our performance coming from our long gold positions. Our credit portfolio also contributed as many of our short positions moved lower despite the overall market's being quiet. Our currency positions also helped the portfolio. The fixed-income positions were a mixed bag. The gains in U.S. curve steepeners offset the losses in Australian fixed-income positions.

1. The Strange World We Live in

It is hard to believe what is going on in the world economy and financial markets today. Less than a year ago we were in the midst of the largest real estate and credit crisis in human history, fueled by record increases in private sector debt. This brought on the worst recession since the Great Depression characterized by high and persistent unemployment, declining incomes, and high rates of debt default, all of which are still with us. Yet, we now have an asset market bubble fueled by a huge increase in public-sector indebtedness. Even worse, the same policymakers and financial chieftains that got us into the mess are in control of things. This is an unusual world indeed that we are in.

The financial firms, and especially the regulated entities, have been active participants in the speculative markets of today, as they have been in every bubble phase over the last decade or more. The volume of derivatives in the financial world continues to increase apace to a whopping $610 trillion at the most recent count. Speculative, short-term trading in the stock and other exchanges is dominated by the regulated, and now taxpayer-bailed-out, firms. Some of the most actively traded stocks are those, such as AIG, which by any measure are already bankrupt. Even worse, the financial crew that gave us the CDO, CDO-squared and other toxic credit innovations, has now begun to tout Contingent Convertible or CoCo bonds, along with other hybrid rubbish as a panacea for the current ailments of the financial system.

2. The Failures of the Financial System

An important question that needs to be addressed is just why the global financial system has become and still remains so dysfunctional. We appear to have once-in-a-century crises every few years so that disaster management has become an integral part of central banking and monetary policy. Every crisis has been preceded by massive lending growth based on fairy-tale projections followed by a collapse with major wealth destruction. In each instance, governments have been forced to act, and on an increasing scale, to deal with the economic aftermath. An objective analyst of the financial system would have to conclude that it has almost entirely failed in its fundamental task of allocating capital efficiently, and could make a strong case for the nationalization of the entire system – after all it is unclear that a government institution would have done a worse job than the private sector.

We believe that the financial system's failures have arisen from a complex series of choices, made primarily in the U.S. over the last two decades. The problems began first with exceptionally lax regulation of the system, which was a consequence of the philosophical leanings of the regulators. Next, the government bailouts that followed the crises spawned by excessive risk-taking allowed the financial system to escape the consequences of its actions. Finally, the guarantee of government support led to even greater risk-taking and leverage with banking capital woefully inadequate to support the risk. The spectacular collapse of 2007-2008 was thus the culmination of about 15 years of excess. We believe that the reckoning from the last several years of bad banking practices has just started and should make for an unpleasant economic climate for the next several years, especially in the U.S. We will take up each of the above points in greater detail below.

2.1 The Philosophical Bias against Regulation

The U.S. banking system might arguably have been in rude health in the early 1990s. However, its main regulator, the U.S. Federal Reserve, did not believe that much regulation was needed to keep the system healthy. Alan Greenspan, the chairman then of the U.S. Federal Reserve, argued that the financial system was incentivized to regulate itself and did not need oversight that would impair innovation. The fact that such a belief was held by the head of the chief regulator for the U.S. banking system should have in itself been grounds for his disqualification from the post. But Greenspan used his position to push aggressively for further powers for the financial firms whose exuberance he was supposed to rein in, and fought increased oversight. The increased risk-taking by the banks allowed for a "Goldilocks" economy with strong growth and low inflation, and so the Treasury and Fed repeatedly fought any attempt to rein in the financial behemoths. In particular, Greenspan and the Treasury duo of Robert Rubin and Larry Summers successfully fought Brooksley Born, the head of the Commodity Futures Trading Commission, when she tried to regulate over-the-counter derivatives, an effort that was chronicled in a Bill Moyers special on public television, aptly titled The Warning. Greenspan, in testimony before Congress in late 2008, admitted that he had been entirely wrong in his belief that the financial system was self-regulating – in fact, he concluded that during his career which spanned over forty years, he had operated with a flawed model of the world. That said, the deregulatory mindset still seems firmly entrenched in the minds of today's regulators.

2.2 The Socialization of Bank Losses

The lax supervision of the U.S. financial system may not in itself have created the sequence of crises we have observed over the last few years. The willingness of the Fed and other government institutions to ride to the rescue of the system when it was faced with the consequences of its own bad decisions dramatically compounded the problem.

To understand why, I refer to a classic paper from 1963 by the Nobel-winning economist, the late James Tobin, called Commercial Banks as Creators of "Money". One of the great lessons of elementary economics is that the banking system creates money at the stroke of a pen because of the genius of fractional reserve banking. That is, if the reserve requirement on deposits is 20% meaning that 20 cents of every dollar deposited has to be held as vault cash, the deposit-taking bank remains free to lend out the remaining 80 cents. Since the lent-out funds show up as deposits at another bank, the effect of this is a second round of lending now of 64 cents and so on. One can show that the total credit created by this process is 4 times the initial deposit. Most economists assume that the operative constraint on the banking system is therefore the reserve requirement which artificially limits the credit created. Tobin in his analysis considered, among other things, what would happen in a world where such a limit did not exist. The simple result is that in a world without reserve requirements, the expansion of

credit would be limited by the availability of assets that would earn adequate returns (net of defaults and costs) to compensate the lenders for the cost of attracting and holding deposits.

It must be noted that most of the banking system in the U.S. has operated since the mid 1990s without reserve requirements being a constraint. By the Fed's rules, only transaction accounts (which include demand deposits, NOW accounts and other similar types of deposits) are subject to any reserve requirements. Savings and time deposits have no requirements and in particular, money-market-sweep deposit accounts are classified as non-transaction accounts, and can be operated by the banks with zero reserves. This has meant that virtually all of the major banks have been able to satisfy the reserve requirement simply with vault cash they had for transactions purposes, and in fact, have been free to lend to the extent they wanted to without any real constraint on their activities. This has put us effectively in the Tobin world discussed above. In this situation, the central bank has an effect only to the extent that it sets a benchmark rate off which many banking transactions are denominated. The main constraint on loan growth for the system thus has been the availability of appropriate, risk-adjusted lending opportunities.

Consider now the situation faced by a bank in lending to a customer. The bank has to accept that some percentage of loans that it will make will go bad and it therefore needs to earn enough on the good loans to pay for its funding costs on liabilities. Assume that the bank has a borrowing rate of R, and that it lends to customers with a fixed loan spread S. If a fraction D of the borrowers it lends to defaults, then it can be shown that for the bank to break even, the spread it charges on loans will have to satisfy the condition:

$$S > D(1+R)/(1-D)$$

That is, if more borrowers default, spreads will have to increase even on good borrowers to compensate the bank for its losses. Moreover, if spreads increase, it is likely that the default rates also will increase as marginal borrowers default, or in mathematical terms, the default rate is not a constant, but a function D(S) of the spread, where the derivative satisfies the condition:

$$\partial D(S)/\partial S > 0$$

It can be shown with some calculus that there is an optimal spread level at which the bank maximizes profits. If spreads are lower, the bank would do well to increase spreads on borrowers and accept a higher level of defaults since the gains it makes on performing loans would outweigh the incremental losses from higher defaults. With spreads higher than the optimal value, the reverse would be true.

This logic above is borne out in practice. Where it came to sub-prime lending for example, banks had long ago realized that a significant section of the low-income population was not creditworthy. The default rates within this group were so high that lending to them at any spread level was simply not possible – at low spreads, the bank did not make enough spread income to compensate for the defaults and with higher spreads, the defaults rose proportionately more than income for the bank did. The sub-prime thinking applies equally to corporate or any other type of lending. Thus, the free markets impose a logical limit on the amount of lending that can be undertaken, and even with excess capital, a bank cannot be induced to lend more. Unfortunately, if the government chooses to reduce the severity of default to the banks by making them whole on some percentage

of defaulted loans, what is obvious is that the spreads for risk will come down and more lending than is optimal (by free market logic) would occur. At the limit, if the government assumed the risk of all defaulting loans, the system would lend against any opportunity that provided a spread even marginally greater than deposit rates.

The discipline that the free-market banking model requires has been systematically subverted by the Fed over the years. In the Asian crisis of 1997, where the banks of the developed world were major lenders and potential losers, the U.S. government and the IMF actively promoted the interests of the financiers at the expense of the Asian nations. And they did so, even though it was patently clear that irresponsible lending by the Western financial institutions was a major contributing factor to the crisis. In 1998, following Russia's debt default and the collapse of Long Term Capital Management (LTCM), the Fed rushed in again to cut rates and bail out the banking system, with support from the US Treasury. It should be remembered that the LTCM crisis was entirely because of careless lending by the banking system to a high-risk hedge fund. Following the LTCM bailout, Fed Chairman Greenspan argued for the relaxation of the Glass-Steagall Act that separated commercial and investment banking, secure in the belief that the banks could manage their risks! This led to a new era of expansion by the banks, resulting in the technology bubble, followed shortly after by the Enron and WorldCom collapses. It must be noted that the financial firms were front and center in all of these situations, especially the Enron fraud. There was little punishment meted out to the financial sector for the unethical if not outright illegal behavior that characterized the Enron debacle. In fact, many of the toxic derivatives and off-balance sheet holdings of the financial system that came to light in 2007-2008 were virtually identical in structure and intent to those created by Enron in its heyday to fabricate earnings.

2.3 The Real Economic Effects of Flawed Banking Policies

With government bailouts assured, and the constant drumbeat from Wall Street for earnings, it is not surprising that the U.S. financial system has seen explosive growth, especially in lending. Excessive risk-taking has become a constant problem with each episode of careless credit creation being in an arena which inevitably became the next crisis domain. The U.S. government has invariably justified its policies of post-crisis bank bailouts in terms of the potential economic costs of non-intervention. But this has also meant that the country has refused to accept that the root cause of the bubble in each case has been an out-of-control financial system that needed to be reined in. Instead, the U.S. has preferred to create a new, larger bubble to mitigate the pain from the previous bust. Thus the real-estate and credit bubbles of 2001 to 2006, which ultimately grew to a size considerably larger than the US economy, were not one-off events but the culmination of a long chain of "serial" bubble blowing.

By forestalling a cathartic recession in each crisis period, policymakers have induced excessive lending to virtually every sector of the economy. As such, rates have had to be ratcheted down to lower and lower levels after each crisis to permit lending to grow given the paucity of attractive new opportunities. Not surprisingly, with this level of credit creation, the areas the banks have chosen to lend to over the last decade are rife with excess capacity. The low inflation and capacity utilization observed in the U.S. therefore, are simply artifacts of excessive lending and misguided investment.

3. An Evaluation of Current Policy

The U.S. has committed the bulk of its resources post-2007 to addressing the problems in the financial system caused by the bursting of the real estate and credit bubbles. The government has injected funds through the TARP program to shore up bank equity, though it is clear that the funds so injected are woefully inadequate in comparison to losses suffered. The Fed has provided huge amounts of liquidity at virtually zero cost to financial firms against

shaky collateral. The financial system has also been permitted to issue debt guaranteed by the Federal Deposit Insurance Commission, with a view to permitting it longer-term access to low cost financing. Mark-to-market rules were suspended so that any bad assets could be carried at mythological valuations. And finally, the government conspired with the banks to implement a series of "stress tests" for the industry, which by their very design virtually guaranteed that the scale and the nature of the problem would be understated. Even worse, these stress tests were used as the basis to force the banks to raise more capital from investors which cosmetically gave these firms a firmer footing, but in practice did little to fill the gaping hole left in capital by losses. In all, the Fed and the government have spent in excess of $10 trillion in guarantees and explicit support for the financial system, which is considerably more than all the funds expended to support the real economy more directly.

The logic that has driven the U.S.' actions is that some recapitalization of the financial system along with very low official rates will permit the banks to lend profitably again, and that the profits so generated will in turn help to build capital reserves. A requirement for this reasoning to work is that the financial firms in question find enough investment opportunities that provide high-enough risk-adjusted returns to compensate for the rates they must pay on their deposits. Most observers assume that such loans can easily be made especially when official rates are virtually at zero. But the discussion above should suggest that such lending may not be particularly easy any more, given the excess lending that has gone on globally for the last several years.

The problem with a world characterized by too much cheap capital for an extended period is that excess capacity is created in most industries. For example, in China, we have no shortage of industrial plants and office towers which cannot support existing loans even at zero interest rates and actually need additional capital to just continue operation. The real estate market in the U.S., especially in the lower income segments, is in the same situation. Many of the U.S. consumer-focused sectors (in the aggregate) could well be in similar positions. No doubt most tradeable goods sectors, given global excess capacity, are in the same situations too. As such, even zero interest rates on loans cannot preclude loan defaults and with a high enough percentage of defaults, it becomes impossible to lend profitably. The situation in the U.S. at least partially explains why the banks have gravitated to being among the biggest purchasers of Treasury debt – after all, a low risk, positive yielding instrument is much preferable to lending at high risk when one is already chronically short of capital. But this essentially means that healthy growth in bank lending will simply not occur, putting the U.S. in a Japan-like situation. It should be noted that the Japanese banks have not lent aggressively, if at all, since 1991. They, in fact, bought government debt while contracting lending – an action prompted not by a lack of capital, but by a lack of good domestic investment opportunity. The important point to realize is that the U.S.' philosophy of recapitalizing the banks, expecting them to lend to foster a recovery, is fundamentally flawed from the outset.

Viewed in this context, the Fed's policies of cutting interest rates and lending against rubbish debt from the banks are tantamount to a massive re-distribution of wealth on a scale that no elected official would dare to contemplate. And while members of the Fed and Treasury have argued that their policies were justified by the need to save the collapsing U.S. financial system, they subtly avoid discussing the numerous alternatives that were available to them, which would have better achieved the same objective at lower risk and cost to the taxpayer. Had policymakers forced an outright nationalization of the financial system along with massive write-downs of the debt issued by these institutions, the credit crisis would have been well behind us – something that we have yet to achieve today after trillions of dollars of bailout funds. It should be noted that even if the credit crisis were past, huge loan growth in

the banking system is unlikely given the over-lending of the last several years. Lending could of course be forced by fiat like in China, but a nationalized banking system is much better suited anyway for that purpose.

While our discussion so far seems to suggest that the U.S. might be entering a Japan-like period of deflation, that outcome is far from assured because the situation in the country today is vastly different from that of Japan in 1991. The U.S. is facing a world which has considerably more excess capacity than it did in 1991. The faster growing economies such as China are not large enough to serve as locomotives for growth, since they rely too much on global growth and continue to build export capacity. A prolonged period of economic pain both for the US and the world is therefore unavoidable. The U.S. can delay the recognition of this reality only by expanding the role of government and undertaking expenditures that will ultimately be wasteful in the extreme. Such expenditure in the mold of Japan will very likely trigger a debt crisis in the U.S. given its already very high levels of total indebtedness and its continued reliance on foreign funding.

In sum, we believe that the problems faced by the world today are significant and the policies instituted to deal with them make no sense from the perspective of long-term stability or growth. We expect the world to go through a sequence of crises particularly as the developed countries begin to understand that the usual fix of easy money and credit creation just cannot work anymore. That said, markets find it altogether more pleasant to ignore reality completely as they have persisted in doing for the last few months. There are numerous macro policy changes that are likely in the medium term, and valuations are as divorced from reality as we have ever seen. Therein lies the opportunity. Even as we worry about the world going forward, we are excited about our portfolio. We see at least as much opportunity today as we did in 2006.

Performance Summary at October 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)
1.5%	-0.9%	-1.0%	8.2%	25.2%	39.8%	23.2%	N/A	-1.8%	14.0%

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)
1.3%	-0.9%	-0.9%	7.5%	23.0%	43.1%	24.3%	10.9%	-2.1%	20.9%

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