

Trident Investment Management, LLC Opportunities Funds Commentary

September 30, 2008

Fund Performance

September 2008 will go down in history as one of the worst months for the global financial markets. Numerous large financial institutions failed or came close to failure. The resulting withdrawal in liquidity meant huge swings for virtually all markets which in turn engendered even bigger losses for the financial companies. Policymakers served only to exacerbate volatility by their increasingly desperate measures to stabilize markets. In particular the authorities in a number of countries banned short-selling of financial, and in some cases all, stocks. We are now facing a crisis of confidence in the world's financial system and particularly so in that of the developed world.

The losses in the equity markets were horrendous. The S&P 500 fell 8.91%, the MSCI Europe Index fell 12.56% and the Nikkei fell 13.32%. Oil suffered falling 12.84% to \$100.64 a barrel. Gold was a relative standout rising 5.46% on the month, but this rise came after the metal had dropped over 10.74% intra-month. Short term sovereign bonds globally rallied in the face of worries about depositary failures with the 2-year Treasury falling in yield 0.41% to end at 1.96%. Longer-term rates however, remained stable with the 10-year U.S. Treasury rising in yield just 0.01% to end at a yield of 3.83%. While the epicenter of the crisis was in the U.S., the dollar nevertheless posted a significant rally with the U.S. dollar index appreciating 2.67% on the month (all figures in U.S. dollars).

This has truly been one of the most difficult months in the fund management business. The concerns about institutional failures and market rule changes have created a degree of unpredictability that is unprecedented. While our performance was volatile as well, I am happy to report that our funds finished up meaningfully on the month. Our short equity positions hurt us because of new regulations that banned short-selling introduced by the U.S. during the month. However, our gold positions helped as did our long positions in short-dated fixed income. But our big winners by far were our short positions in credit.

We believe that the environment going forward will be much more treacherous. The economic and market situation globally is very fluid and much could change over the next few weeks. We have reduced our risk exposure over the month as we await policy and market developments.

Market Outlook & Portfolio Strategy

Events occurred with blinding speed over the month. First we had the failures of Fannie Mae and Freddie Mac, necessitating essentially the nationalization of both entities. The U.S. government, which had not in fact guaranteed these institutions, decided nevertheless to do so by agreeing to purchase up to \$100 billion in preferred stock in each of these firms as needed. Markets were not calmed by this action and the turmoil that followed resulted shortly after in the bankruptcy of Lehman Brothers, one of Wall Street's oldest and largest firms. With the collapse came a rushed sale of Merrill Lynch, another venerable Wall Street house, to Bank of America. These momentous events were followed by the virtual collapse of American International Group, one of the world's largest insurers. The near-death of AIG was averted by the U.S. Federal Reserve agreeing to provide the firm (which it did not regulate) a credit line of up to \$85 billion. Shortly afterward, Washington Mutual, the U.S.' largest thrift institution, had to be seized by the Federal Deposit Insurance Commission (FDIC) with its deposits being sold to JP Morgan. And before that transaction was even fully completed, Wachovia Bank had to be sold as well by the FDIC with both its deposits and debt being taken on by the already fragile Citigroup (or possibly, Wells Fargo, which seems to have suddenly decided it wants to play

spoiler in this transaction). If all these goings-on were not enough, a run started on Morgan Stanley and even on Goldman Sachs late in the month, prompting Treasury Secretary Hank Paulson to propose a bailout fund of \$700 billion to help avert a financial crisis. Events in Europe were no less exciting. The U.K.'s Bradford and Bingley had to be nationalized, the Irish had to contend with a run on their banking system by extending deposit insurance to all depositors and even the generally more hawkish Europeans had to move to bail out Dexia. Despite these government interventions with over \$300 billion in commitments already undertaken, credit markets globally remain mired in crisis with sovereign short-term yields at record lows, and corporate lending spreads at all-time highs. The financial crisis we were anticipating for so long is decidedly upon us.

Before turning to programs that might work in resolving the financial turmoil, it would help to understand the nature of the problem. I have written quite extensively about this for a few years, but a quick recapitulation should put our discussion in context.

The current financial crisis has its roots in three related factors. First, exceptionally easy monetary policy, especially in the U.S., with negative real interest rates served as fuel for a housing bubble that dwarfed anything we have seen in human history. Homebuilders built houses at an astronomical rate to satisfy demand from eager buyers. Many of the buyers were leveraged and had no savings, but nevertheless felt the need to profit from what they expected to be eternally rising home prices. Lenders, regulators and other policymakers had no trouble making loans available to even troubled buyers at low teaser rates despite obvious issues regarding their ultimate ability to repay. In fact, a whole new class of buyers that had previously been unable to afford any kind of house was induced to purchase houses with no money down whatsoever. This frenzy in turn begets even more construction as builders scrambled to accommodate demand. With this backdrop, no one bothered to consider that many more homes were built than were needed for the population at large. Even five years ago, inventories of houses relative to longer-term metrics such as the number of households in the U.S. had hit all time highs. Thus, a major contributing factor for the current turmoil was just gross overvaluation of real estate assets.

The second issue that has contributed to this crisis is the fact that leverage has been employed to a ridiculous degree to fund real estate purchases at the level of the consumer, the lender and the overall economy. In the U.S. for example, consumer leverage is at an all time high with savings at an all time low. Bank credit as a percentage of GDP is close to 400% which is the highest ever observed in any economy. And the U.S. trade deficit as a percentage of GDP remains close to its all time highs. The U.K. and Australia have been the U.S.' partners in crime in this regard with equally scary leverage ratios, though not quite for every metric like the U.S. When leverage is taken on to purchase assets that are declining in value, the consequences are obviously going to be serious.

The final factor which is a major contributor to the current turmoil has been the explosion in an alphabet soup of credit derivative instrument that were impossible to understand or value easily. These new instruments were created and sold to investors as being extremely safe but were anything but, because most of them used significant leverage, hidden with creative structuring, to invest in highly risky assets. Moreover, the values of these instruments were inter-dependent in abstruse ways creating the proverbial financial house of cards. The incredible growth in these instruments over the last few years has essentially meant the emergence of a shadow financial system that in many ways is larger than the official, regulated system. The perceived safety of these new financial instruments meant huge investor participation with virtually every bank, brokerage house, investment fund and insurance company being involved. We had over \$50 trillion of highly toxic instruments created and sold at fantasy prices blessed by the rating agencies to a group of clueless

dupes. The only positive in all this was for Wall Street where the firms raked in huge fees and the executives took home billions in compensation. Thus, we have here a problem that cuts through a huge part of the overall economy in often unanticipated ways, thanks to the extreme creativity of the bankers at defrauding the public. Sadly, the regulators actually encouraged all this “innovation” even going so far as to relax decades-old legislation that allowed our brokerage houses and banks to take on even more risk.

The above drivers have all worked to create our current problem. Other financial crises the world has experienced have appeared similar but the current one has some unique features that make dealing with it particularly problematic. To understand this, let us consider some of the financial tribulations of the last several years.

The NASDAQ bubble of 1999 was largely a problem of overvaluation. Market participants made fatuous earnings projections for technology stocks leading to inflated stock prices not unlike the current overpricing in real estate. However, most investors used little leverage in purchasing technology stocks (at least relative to our banks of today) and the companies in question issued stock to profit from the bubble rather than debt. Therefore, we had a stock market crash but one that did not reverberate too badly through the credit markets except for the limited universe of telecommunications companies which actually did have significant debt. This crisis led to wealth destruction, but no real longer-term effects. In fact, the Fed was able to control the crisis and even the 9/11 crisis that followed by using the simple expedient of cutting interest rates. Thus, overvaluation may make for a painful adjustment, but does not need to result in a crisis.

Leverage without overvaluation can also result in problems. The airline industry has usually operated with considerable leverage even though the debt was used to purchase aircraft and landing slots which arguably were not overvalued. However, in every economic downturn, the industry has had a mini-crisis which has resulted in several firms going bankrupt. These bankruptcies have typically been resolved in an orderly fashion because the assets the firms held have had reasonable and quantifiable values. As such, the claimholders could be dealt with very quickly in bankruptcy courts with little impact to other industries or the debt markets as a whole.

The Japanese real estate bubble of the late 1980s was more serious because here we had a combination of overvalued real estate and significant leverage in the corporate and banking sectors created in large part to finance real estate. The bursting of the Japanese bubble in 1991 led to major problems for the country. Over the next 15 years, the banking system essentially had to be nationalized, economic growth was dismal and the government’s indebtedness increased dramatically as it contended with huge deficits resulting both from the need to fix the banking system as well as promote growth. The country however, was not hugely leveraged at the start of the crisis and both the consumer and the government were in relatively good health even though the corporations were not. In particular, Japan was not indebted to foreigners, since even at the height of its real estate bubble, it continued to run a trade surplus and maintain significant foreign reserves. Moreover, the government did not have to contend with securities it could not understand or value – the problems in the banking system were with old-fashioned loans made against overpriced real estate. As such, the authorities were able to let the crisis play out in slow motion and control the slow destruction of their banks which, given the scale of the initial problem, was inevitable. The government, to its credit, focused its energies on supporting the real economy so as to preclude a full scale, rapid collapse in asset values. A good part of the country’s government spending over the period went to help the consumer with a sequence of tax cuts, infrastructure spending to create jobs and direct subsidies for the purchase of new homes. Paradoxically, due to its trade surpluses, the yen actually rallied during the entire period adding to the problems the country faced with growth. All said though, the cost to Japan was staggering and there is still argument whether the country has truly emerged from this crisis.

The situation in the U.S. today is unlike the above crises and much worse than Japan's because of the existence of the massive shadow financial system that is outside regulatory purview. The decline in U.S. housing prices has gradually led to a collapse in the entire shadow system thanks to the extreme leverage with which it operated and the over-optimistic, if not fraudulent valuations for most of the securities transacted there. Since our banks and brokerage houses were the biggest players in this world of shadow finance, their losses in this arena are significant, but have not been fully recognized with the corresponding hits to capital. The institutional participants all understand this and as such refuse to lend to each other even when both parties are "well capitalized". Thus, while the Fed and other central bank have undertaken heroic measures to bolster system liquidity, they have made little headway in reviving the inter-bank lending market. This is an ironic twist – a bank's knowledge of the tricks of its own trade makes it suspect its fellow partners in crime! A rash of institutional failures and near-failures have also made the public question the solvency of the whole system and in particular, their uninsured bank deposits leading to a run on weaker banks' deposits. In sum, there has been a considerable loss of confidence in the financial system, both in the U.S. and in many parts of Europe. And this is with good reason – most of the financial institutions are very likely bankrupt if their assets were valued at close to market prices.

Fixing the U.S. mess requires addressing not just the obvious problems in the banking system but also dealing with the network of participants in the shadow world of leveraged finance. Unfortunately, the collapse of a large member in this web will have ripple effects on other participants leading to cascading losses. However, it is virtually impossible for any regulator to gauge the financial health of all the participants in this network especially when they lack any regulatory authority over them. Many of the participants themselves are not yet fully aware of the risks they are running by owning many of these toxic derivative instruments and even the regulators themselves were totally clueless until very recently. For example, when all these problems surfaced in early 2007, Fed chairman Bernanke and Treasury Secretary Paulson were confidently opining that the subprime crisis was "contained". It is particularly galling that Secretary Paulson could hold such an opinion considering that as the head of Goldman Sachs from 1999 to 2006 he was instrumental in engineering the explosive growth of this shadow financial system!

We believe that we are currently in the worst financial crisis possibly since the Great Depression of the 1930s. It is very clear that policy action is needed on a global basis to halt what could easily become a worldwide financial panic. The objectives of any policy action should be to accomplish the following:

- Allow for deposit taking and credit extension to continue in the financial system. A total breakdown of both functions would be catastrophic for the real economy.
- Provide support to the real economy so that a depression can be averted. Any serious recession would only hurt prices of assets such as real estate and intensify the problems in the financial system.

It is important to note that the objectives cannot include saving any bank stockholders, bondholders or institutions. Moreover, policymakers cannot be concerned with asset prices directly – they should ensure that the real economy is stabilized so that asset prices indirectly are supported. The shadow financial system has already started to contract. The only thing that policymakers can do is to limit the spillover from this into the real economy because it is neither desirable nor possible to get conditions back to the way they used to be.

With these objectives in mind, a rescue plan can be devised. A plan we would propose would involve the following steps:

- The government would inject capital directly into problem financial institutions and in return would get partial ownership and total management control. Moreover, its capital would be rendered senior to all other claim holders including debt holders. Depending on the condition that the firm is in, the capital injection

may also involve a forcible lengthening out of debt maturities with holders being forced to take the associated losses. The amount of capital provided and the terms of such provision should be made very clear to markets so that confidence returns in these firms.

- Day to day management of the firms would be taken over by appointees of the government who would be paid to run the firm so as to limit risk and ensure an orderly reduction of leverage. The contracts for the management would be made public so that there is no question of taxpayer financed overpayment for bad management.
- At the end of a pre-defined period of say three years, presuming the deleveraging has occurred and the crisis mentality has eased, the government would turn back the institution to its stockholders and debt holders. Any losses sustained by the government would be made whole first and if there were no losses, the government would either get to retain its partial ownership stake or instead earn a punitive return on the capital it provided.
- Simultaneously with enacting such legislation, the government would also introduce measures to support the real economy, such as tax cuts and/or direct supports for spending.

The above plan has some attractive features. Most importantly, it would allow for the immediate normalization of credit markets with a resumption of lending. This is because all new lending to banks would be guaranteed by the government. Since the capital contributed by the government would be senior to existing bond and stock holders, the risk of taxpayer loss would be minimized and the fresh capital would go almost entirely to new lending. The negative to the plan of course is that it means a quasi-nationalization of the financial firms. However, given that their managements have already demonstrated what can only be described as criminal incompetence, it is unclear that their replacement by the government could make things any worse. The specifics of a workable plan might be different from the above. However, there are some essential ingredients that must be retained in any plan. In particular, there must be a direct and transparent injection of substantial capital to the financial system that would guarantee future stability and this injection must be done on terms that will protect the taxpayer from losses while penalizing debt and equity holders under most plausible future scenarios.

The plan proposed by Treasury Secretary Hank Paulson, which the U.S. Congress has just passed, is rather different in its philosophy. It requires providing the Secretary unlimited powers to spend up to \$700 billion of taxpayer funds to purchase financial assets in the secondary market, with limited oversight of his decisions. The implicit assumption being made here is that market pricing of these toxic assets is somehow incorrect and that the Treasury should purchase these assets at the correct, “hold-to-maturity” price whatever that might be. These purchases would be done using a so-called “reverse auction” process where the Treasury sets a price, and sellers offer securities at those prices. By buying these assets at inflated values relative to the market, a stealth capital injection would occur for the financial system and with some help from the Wizard of Oz, everything would be well again.

The Paulson plan does not deal with the fact that the shadow financial system has essentially ceased to function and that the role of any policy action should be to minimize the impact of this breakdown on the real economy. By purchasing toxic financial assets at higher-than-market prices, when market prices are already unreasonably optimistic, this plan will waste taxpayer money. Since the amount of capital injected into a financial institution by this method is not clear, there is no guarantee that markets will begin to trust problem firms. Also, there is virtual certainty given the amount of money involved vis a vis the size of the shadow financial system (which exceeds \$50 trillion) that more bailouts will be needed, and that the ultimate cost to the taxpayer will run very likely into the trillions. Finally, the Paulson plan involves retaining most of the current managements in the financial system, a group that should more appropriately be dismissed for incompetence or worse jailed for fraud. The world’s financial system desperately needs greater transparency in financial reporting and more capital to put it on a firmer footing. The Paulson plan amazingly provides for neither!

This plan has been enthusiastically supported by every firm that owns toxic assets and is looking for a patsy to buy them. The Federal Reserve and its able leader, Ben Bernanke are strongly supportive of the plan, as are numerous Congressional leaders who were the most visible beneficiaries of financial sector campaign contributions. Moreover, the SEC supports the measure too, and has thrown its own peculiar twist into it by prohibiting the short-selling of the stocks of “financial” firms, and believe it or not, IBM, GE, AutoNation and a host of other companies are all deemed financial companies with the only requirement it seems being that the firm employ an accountant. Members of Congress were corralled into voting for this plan with dire financial consequences promised were it not to be enacted. The fear-mongering was carried out with the willing help of the media, and was orchestrated by the same charlatans who created the problem in the first place. Congress agreed to this flawed plan despite overwhelming opposition from the public which sees this plan for what it is – a simple crony capitalist exercise which benefits the very rich in the financial industry at the expense of the already-suffering taxpayer. This is the U.S.’ version of Communism for the rich – an ideology that lacks even the superficial nobility of Lenin’s which was aimed at uplifting the poor.

With the Paulson plan’s passage we expect the markets to see a brief respite before turning down again. The financial crisis has already spread globally, and the U.S. instead of coordinating with its trading partners to resolve it, is expending its precious resources on non-fixes. Markets will soon come to this realization and when they do, we believe that we will enter a new phase in the crisis with a sharply weaker dollar and/or much higher U.S. bond yields. The eye of this financial storm is upon us and what follows could continue the market nightmare.

We have reduced our risk exposure significantly and are being very selective about where we deploy our resources. We are still long gold and U.S. defensives, and have remained short U.S. companies sensitive to consumer spending. We retain our fixed-income long positions, but are also hoping to enter short positions in longer-dated U.S. bonds as markets price in global deflation. The U.S. dollar moreover, has had a massive counter-trend rally providing us excellent entry points into what we believe will be the start of a long weakening trend. Market conditions are still very uncertain and difficult. However, we can take some comfort in the fact that we did anticipate all this and are well positioned to profit from opportunities that might arise. While near term risks are high, we see no shortage of opportunity.

Performance Summary at September 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)
4.5%	1.7%	11.3%	59.7%	55.1%	31.8%	20.7%	N/A	24.2%	14.3%

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)
7.8%	7.2%	17.1%	56.9%	61.3%	34.9%	19.2%	16.5%	23.8%	21.6%

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