FRIEDBERG MERCANTILE GROUP

Second Quarter Report 2000

SECOND QUARTER REPORT 2000

Dear Investor,

We are modestly satisfied with this quarter's overall results. Three programs performed well. We were especially pleased with the recovery of the currency program, a sort of specialty of the house. On the other hand, we continued to stumble with the diversified trading program, and we suffered an especially humbling setback with the international fund. In all, our notional allocation fund — the best gauge we have of overall performance — was positive for the quarter, which is more than can be said for most hedge funds. Neil will tell you more about this.

As you will gather from the enclosed comments, we begin the new quarter with high expectations. Because some of our old views are slowly being vindicated, I dare say that these expectations are realistic.

My staff joins me in thanking you for your trust,

Albert D. Friedberg

FRIEDBERG MERCANTILE GROUP

FOREIGN BONDS

DIVERSIFIED TRADING PROGRAM

CURRENCY PROGRAM

FRIEDBERG FUTURES FUND

INTERNATIONAL PROGRAM

EQUITY HEDGE PROGRAM

SKILL BASED FUND

FRIEDBERG ALLOCATION FUND

[redacted]

FRIEDBERG FOREIGN BOND FUND
FRIEDBERG TOTAL RETURN FIXED INCOME FUND LTD.
FRIEDBERG TOTAL RETURN FIXED INCOME LP

Continuing our winning ways, we managed, once again, to trounce benchmarks and deliver above-average absolute returns. For the quarter, we were up anywhere from 1.4% for the Canadian-based fund (weighed down by the relative underperformance of the Canadian Real Return Bonds vs. their US counterpart and the larger exposure to the slightly weaker currency) to up 2.7% and 3.4% for the US and offshore funds. For the same period, the Lipper Global Income Index and the J.P. Morgan Government Bond Global Index were down 0.008% and 0.001% respectively.

We made only minor changes during the quarter. Specifically, we allowed the Turkish T-bill position to run off at maturity, leaving us with an August maturity that represents a maximum of 12.5% of the portfolio, depending on the fund. The dramatic fall in rates made it unattractive to renew positions, or, at least, to compensate for risks.

We completed the disposal of the Trans-Tasman convertible notes denominated in New Zealand dollars at net prices slightly higher than their close at the end of last quarter, plus a pro-rata share of the interest due (in New Zealand these bonds trade “clean,” i.e., without accrued interest).

At the same time, we trimmed, if ever so slightly, the Kiwi Income Property Trust convertible note position so that the maximum exposure is now set at 11% of the portfolio.

We also lifted the corresponding portion of the New Zealand dollar hedges. Of note, the hedging operation “saved” us approximately 1% of assets, allowing us to benefit from the higher yields without incurring an exchange risk.

Our most important position, by far, remains the TIPS, or Inflation-linked US Treasury Securities and their Canadian counterparts, constituting between 75% and 86% of our portfolios. Despite their maturity of slightly more than 19 years, TIPS behave like securities with only one quarter of their duration, and to date they have provided returns that exceed cash equivalents. We can’t think of a safer security or of one with as much upside potential for capital gain (if we are correct in believing that real rates are heading substantially lower) in the entire fixed-income spectrum.

In the meantime, *static* returns on the TIPS approximate 7.5%, on their way to 8%, as inflation in the US heats up. Mercifully, these securities are linked to the Urban Consumer Price Index, the version that includes food and energy (never mind the nonsense about core inflation!). So when you fill up your tank, think of the benefits of owning TIPS.

In recent weeks we have begun to balance the currency exposure of our portfolios. Prospects for the US dollar have dimmed, as growth has slowed and inflation has accelerated. At the same time, prospects for the euro have brightened in line with the pick up in European economic activity and Europe's more modest rate of inflation. It is at this time that the massive US deficit on current account will become critical: A slowing US economy will find it increasingly difficult to attract long-term capital and thus make up for its low savings rate. Funding will become available at lower rates of exchange (as foreigners take protection) and/or at higher rates of interest. The latter will further crimp economic activity, making it even more difficult to attract capital, and so on.

As a result, we have felt it necessary to cut back on our US dollar exposure, moving as much as 50% of our portfolios into the euro. We have done this via purchases of forward euros and corresponding sales of US dollars. This synthetic transformation of our currency exposure enjoys the great advantage of allowing us to retain the present bond positions, in particular the exceedingly attractive TIPS. Moreover, it is the most efficient way to make the change after taking into account bid/ask spreads in the euro instruments that we would buy and bid/ask spreads in the US instruments that we would consider selling.

The risk/downside of being 50% invested in euros as opposed to US dollars is that: a) currency fluctuations may affect us adversely (though we believe that the opposite is what, in fact, will happen), and that b) the portfolio's overall yield may decline, as euro interest rates are as much as 200 basis points lower than US rates. We believe that for global investors, the risks are worth taking.

Credit quality remains exceptionally high, with an overall weighted credit rating of A. Duration, the measure of portfolio vulnerability to interest rate fluctuations, is relatively modest, at 2.7-3.5 years (adjusting TIPS to one-quarter beta).

Though at mid-year we have already earned more than what money market funds earn in a full year, we hope for an even better second half.

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FRIEDBERG DIVERSIFIED FUND
FRIEDBERG DIVERSIFIED POOL

The major disappointment was not the sizeable drawdown we experienced during this past quarter (24.4%) — though clearly this hurt, too — but our inability to capitalize on the Nasdaq plunge in early April.

Believing that the slide was only the commencement of the long-expected bear market, we pressed the position, via outright Nasdaq sales and long S&P 500/short Nasdaq spreads, only to find ourselves selling into a vacuum. The subsequent reaction decimated our position, accounting for almost 100% of our quarterly losses.

In retrospect, we still find no fault with the idea that US stock prices, particularly Nasdaq, remain massively overvalued. We also find no fault with the idea that inflation is finally on the rise and that the Fed is committed to bringing it under control — which would imply substantially lower valuations. What seems remarkable, we admit, and exceptional in the long historical record of US stock prices, is the extraordinary resilience of these markets to valuation excesses and tightening monetary conditions.

The equity cult seems to have gained such credence that investment inflows persist in the face of any and all adversity. Unfavorable data are interpreted in a favorable light, and past returns are continuously being rehashed and reformatted in a continuing effort by the media and Wall Street to remind investors that long-term equity returns are superior to any other kind of returns. Even as one bubble is pricked — the dot-com bubble, for instance — other bubbles appear, or persist, as with the marquee technology stocks like Cisco, Sun Microsystems, and Oracle, to name just a few. This rotational characteristic, even as breadth continues to narrow, is a sign that speculative juices are alive and well.

A full-fledged, old-style bear market is unlikely to germinate in this type of environment. Instead, we might enter a prolonged period of range-trading, or high-level consolidation, that will disappoint bulls and bears equally, but that will continue to channel more and more uninformed money into equity markets.

As pointed out earlier, the rotation involves a good deal of concentration in a handful of stocks, raising exponentially the risk of moral hazard. A handful of glamor stocks, sporting capitalizations in the trillions of dollars, will wag the US economy, the dollar, and the global economy. Their collapse could send us into a depression. The Fed, understandably, will become beholden to them, unable to continue its fight against inflation for fear of forcing a collapse of the house of cards.

The point, we believe, is clear: There is still too much bullishness for prices to go into a freefall. Maintaining stock prices at a high plateau implies an increasing concentration in fewer issues, as more and more companies suffer disappointing earnings results. The longer stock prices “stay up,” however, the greater will be the moral hazard, as fewer and fewer stocks concentrate more and more investment dollars. At some point, the central bank will be unable to defend the purchasing power of the dollar for fear of pricking the Great Bubble. The second-quarter slowdown is but only a small example of what falling stock prices can do to the economy.

In the interim, commodity prices continue to firm, led by soaring energy prices. It is only a matter of time before this gradual and orderly uptrend turns into a gallop, by which time serious inflationary pressures will be felt everywhere. We plan to capture some of these effects via our leveraged exposure to inflation-linked securities. Moreover, the commodity markets' anticipated move into the second, and somewhat faster uptrend, should provide us with good investment opportunities, provided we can manage to concentrate exclusively in this sector.

The above comments, written to you but directed at ourselves, should help us resist being drawn by the seductive siren song of a bear market. Sadly, we may have to resign ourselves to the possibility that it cannot be profitably exploited.

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FRIEDBERG CURRENCY FUND
THE FIRST MERCANTILE CURRENCY FUND
FRIEDBERG CURRENCY FUND LTD.
FRIEDBERG FOREX LP

A modest gain for the quarter (+6%), but a highly satisfying performance.

For one thing, and in line with our new trading policy (discussed below), we put on only three positions, avoiding unnecessary slippage costs and the wear and tear associated with re-thinking new scenarios and strategies. The small US$/Indonesian rupiah position was liquidated at a slight loss despite good fundamentals for fear of the imposition of capital controls à la Malaysia. The remaining two positions, long euro/short yen and long euro/short Sterling, remain open and are profitable. It is also gratifying that the positive returns were accomplished without incurring excessive volatility, vindicating the earlier expressed view that volatility decreases as markets move *with,* rather than against, the direction wished by politicians and central bankers (see our First Quarter Report, 2000).

It is no secret that European Central Bank (ECB) officials have expressed surprise at the euro's inordinate weakness and have, in fact, engaged in verbal intervention on almost a daily basis. Of course, their pious pronouncements do not, and cannot, move markets in the desired direction unless the fundamentals support such a move.

Until very recently, the bearish case for the euro — or rather the bullish case for the US dollar — centered on differential rates of economic growth and their obvious impact on long-term direct investment and the overall balance of payments. Sizzling US growth was acting as a powerful magnet for short- and long-term funds, lifting the US dollar to multi-year highs. Over the most recent few weeks, a perceptible change has occurred: Euroland growth has picked up steam while US growth, weighted down by a more determined central bank (and the effect the Fed has had on stock prices), has slowed down significantly. What is worse, the US economy may have entered the early stages of stagflation — stagnating real growth accompanied by rising inflation (witness the sharp, upwardly revised, 3.5% rise in the personal consumption expenditures price index for the first quarter of the year). Such a development can bring about a substantial correction in the US dollar.

The short leg of our spread, the Japanese yen, is predicated on the idea that deflationary forces remain very strong in Japan. Since deficit spending is no longer feasible (witness recent credit downgradings), the only politically acceptable way of reversing this deflation is via a much more aggressive expansion of the monetary base, now growing at around 8% per annum (and generating only a 2.5% rate of growth in broad money). Finally, the Ministry of Finance has practically underwritten yen carry trades (i.e., funding all kinds of asset purchases via the borrowing of cheap yen) by drawing a line at the US$/¥105 level. All in all, a low-risk short position, with a minimum upside of cheap funding and a possible upside of, perhaps a depreciation towards the US$/¥125 level.

The other short leg, Sterling, is predicated on three factors: relative economic underperformance vis à vis Euroland, after years of much faster growth, faster relative inflation, and the political imperative for the UK to join the single currency. In all, we believe that euro/Sterling has some considerable upside.

In recent months we instituted a significant change in our modus operandi, namely focusing on identifying and waiting for longer-term trades that are capable, given compelling fundamentals, of yielding moves of 10% or more, and riding these with reduced leverage. This emphasis on modest leverage should not only produce a less bumpy ride, but it should also allow us to ride the larger trends to completion.

We look forward with renewed optimism.

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The Futures Fund combines the Currency and Diversified programs in approximately equal weights. Please refer to our earlier comments regarding these programs.

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The Global Opportunities Fund comprises the Diversified Trading Program and the International Fund. Comments in this section will cover the International Fund only.

In this latest stretch we suffered an extremely disappointing setback (–12.7%), giving back all the gains made last quarter, and then some. For the year to date we are off 3.7%.

Midway through the quarter we decided to close the European bank spread, at a small gain for the period, concerned about the possibility of further banking consolidation and the effect that it may have on the short side of the trade (mostly Italian banks). At the same time, the Right's improved political standing in Italy and the persistent Irish economic boom (though we are still convinced that it will bust) began to blur the divides between the stronger and the weakest members of the European Community, suggesting that the trade's rationale may no longer be valid.

It was the next two trades that brought most of the grief: a short position in Latin stocks, Mexico and Brazil, and the replacement of the overall profitable Korean short stock position (which we felt had at least temporarily discounted the lack of meaningful restructuring and the weak financial condition of its banking system) with a bearish play on Asia's weakest economies, Indonesia and the Philippines.

The Latin position, predicated on the fact that a monetary tightening in the US would stanch capital flows to that region, was mostly closed out in the days after the Mexican election (and the quarter) with losses representing approximately 5.5% of the fund.

In Asia, too, we closed out a short position in PSI Technologies Holdings, but retained the remaining positions, namely PT Indosat and Telekomunik Idonesia in Indonesia and Philippines Long Distance Telephone Partnership in the Philippines, the total representing approximately 13% of the fund. Widespread graft, corruption and general mismanagement in Indonesia and the Philippines should have a continuing negative effect on their stock market.

Our largest bet — 83% of the fund's net assets — remains the short position in Japanese regional banks. On the back of improved economic conditions, some of these stocks bounced off their multi-year lows, affecting us adversely to the tune of 4.4%. But there is little to worry about, in our view. These institutions are, for the most part, the walking dead. Loan collateral continues to deteriorate as real estate prices continue to fall. Many other debtors are unable to service their debts but have as yet not bitten the bullet, kept (barely) alive by the likes of subsidized credit programs. The banks themselves have no reason to exist (they do not form part of the sacred city banks); we are certain that they will be liquidated before next year's Big Bang so that their larger brethren can fatten their absolutely meager or nonexistent loan margins. With some patience we should see dramatic gains.

We have retained our relatively large TIPS position, which, happily, contributed nearly +1% to results. As real interest rates continue to fall — a result of a US economic slowdown and accelerating inflation — we expect these bonds to show very substantial capital gains.

Finally, we have put on a short position in New Zealand Treasury Bill futures, betting that the left wing government will manage to frighten so many foreign investors that the Reserve Bank will be forced to hike rates, lest the Kiwi dollar collapses. The interest rate bet is to the end of September, but it may be renewed to the end of December, should conditions warrant it.

The past quarter's setback has left a deep mark on us and has forced us to reassess the program. The time for hope and excuses is past. Either our scenario pans out and we make a decent return for taking risk or we close shop. We concluded, therefore, that we are not prepared to continue this program unless performance improves sufficiently to yield a meaningful gain for the year in course. By this we mean a gain of at least 15%, close to 19% up on present levels. We bid for your last crumbs of patience.

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FRIEDBERG EQUITY HEDGE FUND LTD.
FRIEDBERG EQUITY HEDGE FUND

The decent, though unspectacular, gain for the quarter (+3.7%) capped a six-month run that saw net asset values rise anywhere from 28.4% to 33.3%, depending on the fund.

Sectoral trends became less clear in the second quarter, a fact that is reflected in the greater group diversity of winners and losers.

On the short side, we capitalized on the disintegration of the dot-com sector and on the steady decline of the regional banks. Some examples of the former: Ask Jeeves (from 61.125 at the beginning of the quarter to 18.0625 at the end of the period); Imaginex and Netobjects covered at 7.25 and 10.7238, after starting the quarter at 20.125 and 22.75, respectively. Examples of the latter category: First Union (37.25 to 24.8125); Bank One (sold during the quarter on the surge following the appointment of turnaround specialist J. Dimond at

35.875, falling to 26.5625); and Wachovia, which seems to have caught Wall Street napping, from 67.5625 to 54.25.

On the other hand, other winners peppered the short list, such as E*Trade and Conseco. We can say with some satisfaction that the last-named stock has been in our books for the better part of the past 2 years, having finally been covered at 6.5, a small fraction of the original sale price. Still short on our books is Revlon (last at 6.3125), a stock with which our readers and shareholders are familiar, especially in connection with last year's gut-wrenching run-up to 32.

Most of our short-side losses came as a result of takeovers or takeover rumors such as US Airways, Investors Group, and Trimark. The last two are mutual fund management companies in Canada, which became the beneficiaries of a consolidating trend in a fairly mature business. Which proves that it is not enough to identify poor businesses to find fodder for the bear — one must also guard against other people's stupidity.

We were not particularly "creative" on the long side, preferring to stick to Dow-type large market capitalizations and adding in a smattering of well-performing bio-tech stocks, such as Dusa Pharmaceutical, Cephalon, and Cor Therapeutics, a real estate stock, Newhall Land, and a designer and manufacturer of laser and laser systems, Coherent, Inc. At this time, we are considering reentering the long side of the Russell 2000 that so well served us in the latter part of 1999 and the first quarter of this year. Late cycle fundamentals do not appear to support their outperformance (witness the widening credit spreads). Yet value-oriented investors seem to have nowhere to turn but to small caps. The "cleansing" of the Russell 2000 list that takes place every June 30 should help us resolve this matter very soon.

Excessive volatility towards the end of last quarter suggested to us that it would be prudent to reduce leverage to modest levels (1.53x). As the quarter wore on and volatility decreased, our overall market exposure increased and we ended the quarter with a still sub-normal, but higher, leverage of 2.12x. The long-to-short ratio remained bound between 58.5/41.5 and 55.6/44.4, depending on the volatility of the two portfolios (the short portfolio is almost always more volatile, thus its smaller participation).

Ideally, the long and short portfolios should show profits. This, however, is not always possible, as overall stock market trends may sometimes overwhelm the behavior of one of the two lists. The next best outcome is relative outperformance: Long positions rise more (or fall less) than the "market" and/or short positions fall more (or rise less) than the "market." Depending on magnitudes, the results can still be favorable.

As an example, during this quarter, the short side provided the absolute gains for the quarter (as well as, relatively, falling more than the market), while the long side managed to lose less (–1.4%) than the "market" as represented by the S&P 500 (–2.93%). The combination made us profitable.

As one can understand, the market-neutral approach remains heavily dependent on specific stock and sector selection. One cannot be bailed out by directional bets, the very essence of equity fund performance for the past quarter century. It is hard work, highly rewarding when properly executed, and *should* provide comfort to all those who believe that stock market bubbles end in busts.

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The Skill Based Managers Fund recorded essentially flat performance during the quarter. While by comparison to the S&P this may be considered somewhat commendable, the performance falls short for our objective: 12%-15% per annum or 3%-5% per quarter. It is especially disappointing having to acknowledge that the failure is nearly entirely attributed to the poor performance of Friedberg's own Diversified program. While we have made it a point of policy not to de-list a manager only for performance reasons, we have allowed the Diversified Programs allocation to slip to approximately 6.25% in our quarter-end rebalancing. Also we removed the market neutral; futures overlay specialists from our list-for style drift-and have just this week added another futures specialist. The portfolio is now allocated as follows: Long short value 25%,Event driven 25%, Arbitrage 25%, Forex 12.5% commodity and Financial Futures 12.5%.

Briefly, our views on the future of these are as follows: While long only value specialists generally still find the market a tough go, long short value specialist –witness Friedberg's own Equity Hedge Fund-have done and should continue to do well in an environment that has begun to punish companies who remain negligent of earnings. Given deal flow and the on going trend toward international consolidation, these are indeed halcyon days for event driven strategies, especially those specializing in merger arbitrage. With no credit risk apparent and it being ever less likely that rates will be pushed too much, if at all, higher in the foreseeable future, arbitrage, especially convertible arbitrage, is poised for the boring but determined success it enjoyed until tech stocks and junk bonds collapsed in April. Finally, there is a 'trendiness' about both futures and currencies once again. Hurrah!

The Friedberg Skill Based Managers Fund is a fund-of-funds that seeks to generate returns that are consistent and uncorrelated to equities. For further information contact your broker at FMG.

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Neil Rackoff comments:

The Friedberg Recommended Allocation Model returned 1.34% for the quarter, and is up 7.01% year to date.

In this past quarter, we witnessed the closing of the most famous of the global macro hedge fund operators, the Soros Fund Management Group. In addition, the US equity markets finished the half-year mark still in negative territory. While relative value strategies continue to perform well this year, few are the number of value-oriented global macro managers that have been able to negotiate the fog with a profit.

The major themes that Albert has outlined in his previous comments and in our bi-monthly market letters — creeping inflation, grossly overextended capital markets (highly leveraged companies), and irresponsible allocations of resources to enterprises that make no sense — are asserting themselves.

We continue to encourage our clients to take a portfolio view of the manager and to investigate how the manager is allocating ***his*** money. This will provide the steadiest, most consistent, and most satisfying ride.

In contemplating the struggle to see through the confusion of today's financial markets, I am reminded of a stanza from the poem *Invictus* by William Ernest Henley.

> In the fell clutch of circumstance,
> I have not winced nor cried aloud;
> Under the bludgeonings of chance
> My head is bloody, but unbowed.

The recommended allocation going forward is:

Fixed Income	- 65%
Equity Hedge	- 15%
Currency	- 10%
Global Opp.	- 10%

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