

FRIEDBERG
MERCANTILE
GROUP

**Fourth Quarter
Report
1997**

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Fourth Quarter Report 1997

QUITE A QUARTER!

"The world's strongest currency - the Asian economic debacle - patience and a steady hand" - are some of the key phrases that encapsulate the highlights of the 4th Quarter.

Overall, the performance of our funds and programs has been good, some obviously better than others.

We move into the coming year aware of the pitfalls, the possibilities, and the many opportunities that exist.

As always, our objective is to maximize long-term return for our investors.



Albert D. Friedberg

FOREIGN BONDS

FRIEDBERG FOREIGN BOND FUND

FRIEDBERG TOTAL RETURN FIXED INCOME FUND LTD.

FRIEDBERG TOTAL RETURN FIXED INCOME LP

During this past quarter we have continued to travel in the direction we charted in the previous reporting period - namely, towards a greater US dollar exposure and towards longer maturities.

Over the years, we have found that times when we have positioned ourselves slowly and deliberately, as now, have produced excellent long-term results - even as they inevitably incurred some necessary short-term costs. These times were characteristic of higher-than-normal uncertainty, typically associated with economies in transition. Such situations are frustrating. The manager is continuously forced to run uphill and against the crowd, alone in his conviction that the party is over. His investors suffer, both in pecuniary terms, as they earn little or no returns, and in psychological terms, seeing other investors continue to make easy money.

We are indeed experiencing today a momentous transition, one that could shake the very foundation of the postwar era of economic prosperity. We are not referring to the transition to price deflation from price inflation, which are but a necessary byproduct of a monetary regime that preserves the long-term purchasing power of money. We are referring, instead, to the punishing and much less understood phenomenon of debt deflation.

Glimmers of its devastating effects can be observed today in Asia, where overindebted economies are literally drowning in a sea of debt, causing instant depressions. The spread of this phenomenon, a global debt deflation, is more likely today than at any time in recent memory. There are tentative indications - such as the historically high default rates in consumer credit despite booming economic conditions - that this process is under way even in the mighty US economy. Debt deflation can run its course, as it has in Korea and Thailand among others, producing in its wake a long chain of bankruptcies, closures and layoffs;

or it can be postponed, as the Western economies have done for the past 40 years, by force-feeding a recovery with additional debt.

The latter alternative is feasible, of course, only as long as borrowers do not suffer from debt exhaustion and lenders are still willing to make credit available. Otherwise, as the Japanese are finding out, no government inducement or coercion can halt the natural process of debt liquidation.

In 1991-1992 the US came very close to the precipice. Only Greenspan's aggressive force-feeding operation, coupled with the consumer's capacity and willingness to take on more debt, saved the day. Will Greenspan be able to repeat this feat in 1998, in the face of an overindebted and overextended consumer whose principal financial mainstay is the most overvalued stock market in 70 years?

We are not willing to run the risk of overstaying. We have become convinced that the most prudent course of action is to position ourselves in debt instruments issued by some of the highest-quality borrowers. There is no borrower more creditworthy than the US government. At first, unsure of the prospects for inflation, we chose short-term, floating-rate obligations. These were highly liquid instruments, possessing defensive characteristics, suitable in the event that the Fed chose to raise rates. With time, we became convinced that near-term inflationary pressures were unlikely to surface (or at least, that was our reading of what was happening in the commodity front) and that there was no need to be so defensive as far as rates were concerned. We began to extend our maturity profile, purchasing 5-year Treasuries, then 30-year Treasuries and finally 30-year zero coupon (strip) Treasuries. Rather than chasing yield with the concomitant implication of taking on dubious credit risks, we chose to chase capital appreciation, an almost certain outcome in case of a full-fledged debt deflation. Our downside, should our scenario not play itself out, is the prospect of earning a meagre 5.75%.

We eliminated our exposure to the New Zealand dollar by selling an equivalent amount of Australian dollars.

We chose this cross-hedge over a more standard New Zealand dollar hedge simply because pressure on the Kiwi was judged to stem primarily from weakness in the Australian dollar. The worsening Asian crisis has had a depressing effect on both Australia and New Zealand, more particularly the former. The result has been deteriorating terms of trade, shrinking export markets and reduced tourism. Having protected the currency exposure, we see no good reason to dispose of our New Zealand holdings, which consist mainly of high-quality convertible debentures of leading property trusts. Yields are attractive (in the range of 8.2% to 13%) and the real estate sector remains undervalued, with interesting prospects for eventual capital gains.

Summing up, we have slowly repositioned our portfolio towards the world's strongest currency, the US dollar - representing virtually 100% of our currency exposure - and towards top credits and longer maturities. It has been a slow start and on the way we have sacrificed yield, giving us a rather flattish performance for the year. On the other hand, we believe that we are well protected from, and well positioned to capitalize on, the serious economic disturbances that we anticipate for the coming year.

CURRENCY PROGRAM

FRIEDBERG CURRENCY FUND
FRIEDBERG CURRENCY FUND LTD.
FRIEDBERG FOREX LP

It was a far better quarter than we had ever imagined it would be. Perhaps our only regret was liquidating prematurely the long sterling-short Irish punt cross trade to allow us to focus on the Asian crisis and its repercussions. The rapidly depreciating Malaysian ringgit provided almost 50% of our total gross profits, with another 25% attributable to bear strategies (selling calls and outright forwards) in the Japanese yen. The remaining profits came from a smattering of short positions in the Thai baht, Indonesian rupiah and the Czech koruna.

The Asian crisis theme remains, in our opinion, a profitable source of trading opportunities, although it is very volatile and thus risky. In the next few months debt deflation will almost certainly engulf Eastern Europe and Latin America. With this conviction in mind, we initiated forward sales of the Brazilian real during the past quarter. The position is showing a modest loss, mostly the result of time erosion in the forward points, as the Brazilian authorities reacted far more vigorously and decisively than had been anticipated in defending the pre-announced parity. The risk/reward ratio of maintaining such a position, however, remains favorable; it is quite probable that we will press this position further during the early part of the new year. Economic stagnation, the enormous burden of servicing domestic debt at real rates of more than 30% per annum, spreading business failures and mounting social pressure make it quite likely, in our opinion, that Brazil will be forced to abandon its austerity program. At that point, capital flight will intensify, international reserves will dwindle and the real will be allowed to float.

There are two sins that one can commit while being on a roll: one is not pressing the winning positions aggressively enough; the second is becoming too complacent. *HEAVEN SAVE US FROM SUCH SINS!*

DIVERSIFIED TRADING PROGRAM

FRIEDBERG DIVERSIFIED FUND
FRIEDBERG DIVERSIFIED POOL

Our most difficult task this past quarter was not allowing ourselves to be diverted from our "no-brainer" trades. Fortunately, we succumbed to temptation only once - buying soybeans in early November promptly to lose money on liquidating the position less than one month later.

The 'no-brainer' trades -short gold and long US T-bonds - represented 75% and 25% respectively of our total gains. Gold continues to sag mostly on fresh mine hedging, stale long liquidation and official disposals. Demonetization hangs over the market like the proverbial sword of Damocles and will continue to do so until a more rational and coherent plan is adopted by selling central banks.

Falling inflation and the Asian economic debacle, which is slowly spreading across the globe, provide an ideal backdrop for a long position in a high-quality fixed-income instrument. The situation becomes even more favourable when that instrument is denominated in the world's strongest currency, namely, the US dollar.

In the closing days of the quarter we took a small long position in silver in due deference to its outstanding relative strength and the growing tightness of physical supplies as evidenced by the metal's sky-high lease rates. We are monitoring the situation closely and hope that it is not another frustrating diversion.

FRIEDBERG GLOBAL OPPORTUNITIES FUND LTD.

Part of the trading activity of this offshore fund incorporates the diversified trading program. To avoid duplication, we refer investors to our earlier remarks regarding the Diversified Fund.

Aside from the futures positions common to this program and the diversified trading program (specifically, long US T-bonds and short gold), we did nothing but maintain the aggressive short position in Japanese banks established last quarter. As we explained in our third quarter report, this position was sensible to the point of being compelling.

Most Japanese banks - including many of those in the largest money-centres - are insolvent. Bad and uncollectible debts exceed capital many times over. The Japanese government has been extremely reluctant to admit the gravity of the situation. It has publicly minimized these losses and has practiced forbearance on a truly gigantic scale. The market, however, has begun taking the matter in its own hands by means of a run on deposits - and on share prices. The steady but relentless erosion in equity values has instilled a sense of panic in the authorities. While public moneys have been made available in recent days to solve the problem, this solution is far from ideal.

Once more, healthier banks will be induced, with generous dollops of money, to acquire failing institutions, for the sole reason of making good on the official pronouncements that there will be no more banking failures. This strategy is sure to spread the cancer and prolong the agony. Instead, failing institutions should be allowed to fall and depositors bailed out by the newly re-capitalized Deposit Insurance Corporation. Either way, many, if not most, of our short positions should go down to zero.

EQUITY HEDGE PROGRAM

FRIEDBERG EQUITY HEDGE FUND LTD.

FRIEDBERG TORONTO TRUST EQUITY-HEDGE FUND

This program turned in a rather disappointing result for the quarter, showing a loss of slightly less than 1% compared with a 2.45% gain for the S&P500. Perhaps our only consolation was that the S&P 500 gain was achieved in the face of enormous volatility. At one point, the index was down more than 13% from the post September 30 high, and as much as 9% in a matter of 2 days.

One could justifiably argue that the gains pale in comparison with the risks! Nonetheless, lower volatility is no consolation for negative returns, even if they are only minor.

The program is putatively market-neutral. As such, it bears little or no correlation to the market's direction. There are times when our fund is down and the S&P 500 is up, as in December, and there are times when the converse is true (i.e., our fund is up and the S&P 500 is down), as in August of this year. We use a proprietary method to try to balance long and short positions without straying too far from an intuitive 50/50 balance. As at the end of December, long positions represented 52.6% of total assets and short positions 47.3%. Combined long and short positions added to slightly more than two times net assets.

Given this market neutrality, stock selection is crucial to attaining long-term above-average returns.

Daily monitoring and weekly analysis of individual positions during this past quarter have prompted very few eliminations and substitutions, certainly no more than we usually experience. We are thus satisfied that there is nothing in our holdings that would justify an extended period of below-par performance.

We are confident that patience and a steady hand should very soon reward our efforts.

NEW ZEALAND

FRIEDBERG NEW ZEALAND FUND LTD.
NEW ZEALAND EQUITIES FUND
FCMI KIWI EQUITIES INVESTORS

The cavalier attitude we took towards the New Zealand dollar in the face of the economic collapse in Asia has brought us a measure of grief.

We did not properly take into account the fact that the Asian region is a significant market for New Zealand exports, with South East Asia taking 9% of New Zealand goods exported in 1996-1997, North East Asia (ex-Japan) taking 13% and Japan taking 15%.

In total, the Asian region is a larger export market for New Zealand than either Australia or Europe alone. It has also been a major source of export growth in recent years.

At the same time, exports/imports to and from Australia account for 20% and 24% of total trade respectively. This is a significant proportion, given that Australia has been severely affected by its own exposure to Japan and the rest of Asia (the destination of 60% of its exports). Impacts on export earnings are likely to occur through three channels: 1) reduced demand arising from slower domestic growth in the Asian economies; 2) reduced demand caused by a loss of price competitiveness associated with the decline in Asian currencies; and 3) weaker world commodity prices as a result of lower demand.

Moreover, with Asian visitors accounting for over 31% of New Zealand's total tourist arrivals, earnings from tourism are also likely to be dampened over the year ahead.

Presented with these prospects, the New Zealand dollar fell by almost 9% vis-à-vis the strong US dollar but only 4.6% in trade weighted terms, and gained slightly against the Australian dollar and the Japanese yen. This depreciation against the US dollar - a feature shared by almost every currency in the world - negatively affected our stock portfolio through currency translation. It constituted the single largest factor in our loss for the period.

At the risk of sounding like a broken record, we continue to embrace the country's solid fundamentals - competitiveness, healthy corporate balance sheets, fiscal surplus, transparent fiscal accounts, an independent and "hard money" central bank, good investment disclosure and relatively fair and improving corporate governance. To top it all, New Zealand valuations are cheap by comparison with other international markets. Being overweight in small caps and real estate issues - where we believe the real compelling values are - caused us to underperform the NZ40 by a substantial margin. As in the US and continental markets, safety in New Zealand is perceived to lie in liquid holdings. This too shall pass.

At the end of this cycle of debt deflation lies a renewed phase of global inflation, thanks to increasingly easier monetary policies about to be put in place by panicky central banks. New Zealand, in our opinion, is ideally positioned to take advantage of this situation. As such, it is a classic turnaround play on the world economic situation.

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