

FRIEDBERG
MERCANTILE
GROUP

FIRST
QUARTER
REPORT
1999

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REPORT
1999**

Dear Investors,

It's like a scene out of *Alice in Wonderland*. The surrealistic feeling pervading the global financial markets makes it very difficult - and very frustrating - for value-oriented investors to ply their trade. We are continuing to position ourselves in ways and markets that will protect us, and, we hope, even make us some money, when the day comes ...

"Only the fools are dancing", quipped the Japanese in the closing days of their financial mania, "but the greater fools are watching." We sure feel like the latter.

Yet, we believe that in the end we will be vindicated and great profits will accrue to those who keep their heads about them.

Thanking you for your trust,

Albert D. Friedberg



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CONTENTS

FOREIGN BONDS

CURRENCY PROGRAM

**DIVERSIFIED TRADING
PROGRAM**

FRIEDBERG FUTURES FUND

**INTERNATIONAL
PROGRAM**

EQUITY HEDGE PROGRAM

NEW ZEALAND

FRIEDBERG ALLOCATION FUND

FOREIGN BONDS

FRIEDBERG FOREIGN BOND FUND
FRIEDBERG TOTAL RETURN FIXED INCOME FUND LTD.
FRIEDBERG TOTAL RETURN FIXED INCOME LP
TORONTO SELECTED INTERNATIONAL BONDS TRUST

The negative 2.9% quarterly performance can be attributed entirely to capital losses on our long-term Treasury securities and an ill-timed, partial shift from US dollar assets to yen assets.

In our December 1998 letter to shareholders, we raised our concerns regarding the US dollar. Excessively easy money and sky-high historic stock market valuations are sustaining an artificial economic boom in the US. These boom conditions have attracted massive foreign inflows, which have financed the US's growing external disequilibrium. The decline in US corporate profits, which began more than a year ago, coupled with the reduced attractiveness of US assets (by virtue of their higher prices and lower yields) and the very dynamics of a cumulative foreign debt that has been growing exponentially will eventually reverse these favorable inflows - with disastrous consequences for the value of the US dollar. This belief led us to shift the fund's currency allocation away from the US dollar, with up to 40% in yen (effected via forwards; see our explanation in last quarter's letter), 20% to 27% in New Zealand dollars and 10% to 12% in Canadian dollars.

The last two named currencies had little or no effect on our portfolios. The shift to a yen exposure, however, proved to be particularly ill-timed. The currency slipped 4.7% versus the dollar (despite gaining against the euro) and the reduced yen earnings cost us an additional 1% for the quarter. Towards the end of the quarter, we reduced and then eliminated our yen exposure and thus returned, albeit reluctantly, to a currency allocation that gave priority to the US dollar (approximately 65%).

Our concern regarding the US dollar has not diminished. In fact, it continues to increase. While we remain extremely alert for the onset of a secular dollar downtrend, it is clear that we will need to improve the timing of our next currency reallocation. This is especially so in view of the fact that most non-dollar assets earn significantly less than corresponding US dollar assets.

Capital depreciation on our inflation-linked Treasury bonds (TIPS) was the result of a material backup in long-term US interest rates. These securities should shelter us, over the longer term, against a continuous rise in rates, if and when it comes. Rising interest rates are nearly always the result of rising inflation, and rising inflation is guaranteed to be reflected in a rising underlying value of these TIPS. Only on rare occasions, specifically when the Fed is proactively fighting inflation or is widely expected to do so, will interest rates rise faster than inflation, and then only for a very short period of time.

This past quarter has been one of those rare occasions. The Fed was expected to signal a tightening bias in view of the calmer money market conditions (evidenced by tighter credit spreads and rising stock prices) and booming economy. Instead, it chose to remain in an accommodative posture. In the interim, nominal rates climbed, unaccompanied by rising inflation, and long-term bond prices suffered. Mercifully, the decline of the TIPS was much gentler than the decline of their nominal counterpart, 30-year Treasuries.

At any rate, it is highly likely that stronger CPI figures will bring about the next upward leg in rates, an event that will have positive consequences for our TIPS. Currently, TIPS constitute more than 50% of our portfolios (over 60% when the Canadian variety are taken into account). At present levels, they represent an extremely attractive investment: a real, inflation-adjusted yield of 3.9% and first-class credit. Even minimal inflation will result in nominal yields of anywhere between 5.5% and 6% per annum.

We continue to maintain an approximate overall credit rating equivalent to AA. From time to time, we acquire riskier positions but limit exposure to 3% to 5% of total assets. An example is the purchase of Turkish T-bills, yielding a nominal 130% per annum. Inflation and the concomitant currency depreciation should lower returns to 30% to 40% per annum in US dollars. Credit quality is fair to good, and expected returns, in our opinion, easily compensate for the risks.

Because we're not willing to aggressively acquire debt instruments lower than investment grade at this stage of the global credit and business cycle, we emphasize currency allocation almost exclusively as the means for maximizing returns. We view this development constructively, as we believe that we have a unique expertise in this area. As a result, we remain very optimistic of obtaining above-average risk-adjusted returns over the coming months.

CURRENCY PROGRAM

FRIEDBERG CURRENCY FUND
FRIEDBERG CURRENCY FUND LTD.
FRIEDBERG FOREX LP
TORONTO SPECIALIZED TRUST-CURRENCY FUND

The nearly 41% increase in net asset value was due entirely to the devaluation of the Brazilian real. Small losses occurred in a number of other trades - short Indonesian rupiah, short euro/yen and short dollar/yen, long Australian dollar.

At this time, we are still maintaining long positions in Canadian dollars and New Zealand dollars (as a play on the recovery of commodity prices), short positions in Hong Kong dollars (a very cheap bet on Chinese instability and the remote possibility that the yuan will be devalued) and short positions in the Saudi ryal. The latter is an extremely cheap bet on the possibility of a

devaluation, given Saudi Arabia's deteriorating fiscal finances and the two-decade-long fall in the country's terms of trade.

Conditions have once again become difficult. Low volatility in the principal currencies and hard-to-exploit, generally narrow interest rate differentials militate against dramatic results. Moreover, the cost of searching for a successful trade threatens to chip away at equity. We constantly have to remind ourselves that, sometimes, it is best to do nothing.

Fortunately, conditions tend to change rapidly and suddenly in the world of foreign exchange.

DIVERSIFIED TRADING PROGRAM

FRIEDBERG DIVERSIFIED FUND

FRIEDBERG DIVERSIFIED POOL

TORONTO SPECIALIZED TRUST-SELECTED COMMODITIES FUND

An abrupt and unexpected reversal in Japanese interest rates caused us to give up a good portion of our original gains and left us down 15.5% for the quarter.

We had argued that enormous fiscal deficits, now approaching 12% of GDP, would overwhelm the bond market and send interest rates soaring. All the more so, we reasoned, as cash flow considerations forced the Ministry of Finance's Trust Funds to scale back the purchase of JGBs. The full brunt of government borrowings would be borne by the market for the first time in at least a generation. In the face of this fiscal onslaught, 10-year interest rates of 1.5% or even 2.3% were not realistic; much higher rates would be needed to attract genuine savings.

It was not to be. Two factors, in retrospect, played a role in aborting the incipient rise in rates. First, the Ministry of Finance reversed its earlier decision and ordered the Trust Funds to continue purchasing JGBs at auction, albeit at a reduced pace. This decision had an enormous psychological impact on the market. Transparency was out, and the free forces of supply and demand were not going to set the level of interest rates in Japan.

The second factor was, in our opinion, an economic one. Deteriorating economic conditions and the prospects of a huge future debt overhang (which, sooner or later, can be serviced only through increased taxes), seemingly forced consumers to retrench further, making additional savings available to take up the extra borrowings. The demand for government debt is certain to grow in the coming weeks and possibly months. The newly recapitalized commercial banking system is likely to purchase a sizeable quantity of JGBs rather than extend loans to shaky corporations. This is another aspect of the phenomenon of rising private sector savings. We did not foresee either of

these developments and, consequently, were late in accepting profits on our swaption (later converted to an over-the-counter forward swap) position.

The Japanese government is merely storing up future trouble. As the economy disappoints and contracts further, the Bank of Japan will relent to pressure (the ruling party was ready to enact legislation, just a few weeks ago, to force the BoJ to buy JGBs at auction in a desperate attempt to hold the line on rising interest rates) and will accelerate the pace of monetization. Eventually, reflation, whether accompanied by genuine economic recovery or not, will persuade savers to part with their depreciating financial assets and loan demand will recover. The era of artificially low interest rates will have ended. We remain attentive to this inevitable and proximate development and expect that once again we will capture the opportunity.

While conditions may not be quite ripe in all cases, exciting opportunities have begun to multiply. Commodity prices, which recently touched 21-year lows, have been showing signs of bottoming. In some instances, demand has begun to recover. In other instances, prices have fallen below medium-term replacement costs, threatening supply. It will not be long before prices shake off their lethargy and worthwhile trading trends emerge. Conversely, financial assets are caught in the middle of an historic speculative bubble. Already, one support pillar, growing corporate profits, has been removed. The end waits only for monetary conditions to change. Slightly higher interest rates, when they come (as they must, if commodity prices recover somewhat), will remove the second pillar and end the party.

Changing conditions. Needless to say, we look forward to them.

FRIEDBERG FUTURES FUND

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

FRIEDBERG GLOBAL OPPORTUNITIES LTD.

INTERNATIONAL FUND

Approximately one half of the Global Opportunity Fund is managed in accordance with the Diversified Trading Program (see our comments above) while the other half is managed in accordance with the International Fund. Comments in this section will cover the International Fund.

The 6.3% decline in net asset value can be attributed almost entirely to our core position, short Japanese secondary commercial banks that we believe are insolvent, or nearly so. While losses are never welcome, we ought to con-

sider this result in the light of the extraordinary rally experienced by the broader stock market indexes and the Nikkei Bank sub-index. Real estate prices continue to fall, now for the eighth year in a row, eroding whatever collateral value they may still have on the books of these financial institutions. Economic recovery is not yet in sight and new problems are looming: How will the government fund its bail-out of the private sector? At what cost in future taxes, interest rates and/or inflation? Our thesis is that the newly created Financial Supervisory Agency (which has already shown more teeth than any other government agency in the post-war period) will begin closing down failing institutions as soon as the recapitalization of the largest 17 city banks is complete. Among those to be closed will be the banks that we have sold short.

We continue to believe that most equity markets around the world are extremely overvalued and due for severe bear markets. We have reduced short exposure in Latin America, to 7.4% of total assets from 13.4%, giving due weight to the fact that this region has already undergone a substantial correction. In Europe, we've reduced short exposure to 9.1% from 23.2%, eliminating short holdings in the relatively strong UK market but maintaining bear positions in Germany, Sweden and Switzerland. We have maintained, on the other hand, short positions in the North American markets. We are short Russell 2000 and TSE 35 futures, accounting for 24.4% of total assets. Finally, we have added to the long side of the New Zealand equity market, via our own funds and the New Zealand Mid-Cap index. New Zealand represents almost 35% of total assets, the second largest country exposure. For a detailed discussion of the merits of the Kiwi market, please refer to our comments on New Zealand in this letter.

We have retained the long two-year/ short thirty-year Treasury spread - in essence, a bet that the yield curve will widen. This trade, discussed in our last letter to shareholders, is predicated on a re-acceleration of inflation, the product of easy money policies around the globe, and in particular, the US. Over the past few weeks, the trade has become increasingly profitable. It's a clear indication, if any is needed, that the Fed has overplayed its hand. Moving in the same direction, but with the notion of maximizing cash flow via a positive carry, we have purchased 10 year TIPS, inflation linked Treasury securities, and funded them with fixed-term repos of 30 to 90 days. The recent price decline of the TIPS (see our comments regarding these securities in the Fixed Income section) has offset, so far, the carry advantage and the trade shows a small loss. We believe, however, that this is merely a temporary situation. We expect it to revert to profitability as soon as we begin to see slightly firmer CPI readings (the recent rise in gasoline and heating oil prices could be the beginning).

In all, we plan to maintain a bearish view on most equity markets, with the exception, for now, of New Zealand. Inflationary pressures will become more pronounced over the next few months as commodity prices begin to show not only reduced year-on-year declines but even year-on-year gains. This situation is not at all improbable, given the extraordinary decline that commodi-

ties have experienced in the past two years. Easy money will then give way to firmer money market conditions, which, in turn, should lower the boom in financial assets. Asset inflation by any other name is inflation; central banks will need to learn this painful lesson.

EQUITY HEDGE PROGRAM

FRIEDBERG EQUITY HEDGE FUND LTD.

FRIEDBERG EQUITY HEDGE FUND

Last quarter's performance, a drawdown of 22.7%, was easily the worst three months in the history of the program, which goes back to December 1992. It is also just shy of the worst total draw-down we ever experienced (- 28.75%, June 30, 1994 to January 31, 1995).

The common denominator of both losing streaks was poor stock selection, not incorrect long/short weightings. Significantly, both exposures lost money for us. The short side, which represented an average of 42% to 43 % of total assets, lost approximately 19% of initial equity. The long side lost just under 3%. During this time, the S&P 500 gained 4.65%. Clearly, our stock selection failed.

What went wrong? With rare exceptions, our value orientation stood us in bad stead during a market phase that rewarded hype, hope and promise at the expense of good balance sheets and decent profits. Short positions in Boston Scientific (P/E negative, P/S 7.1), Adaptec (P/E negative, P/S 3.7), Amazon (P/E negative, P/S 48) and Revlon (P/E negative, P/CF negative) were big losers, despite the fact that these companies either lose money or earn sub-par rates of return. Similarly, long positions selected on the basis of attractive numbers offered no comfort. This was the case with Philip Morris, Data General and some electric utilities.

In the closing weeks of the quarter, our investment committee recommended: a) that we gradually reduce overall leverage, from an average 2.7 times to 2.0 until such time as we have an opportunity to observe changes in market trends that are better consonant with our trading style; and b) that we ride winning positions (rather than trim them at pre-determined levels and replace them with new ones), even as their exposure became larger, at the risk of concentrating the portfolio in a smaller, more manageable, and more focused number of issues. Finding these recommendations reasonable, we began to implement them in the last week of the quarter. Perhaps not coincidentally, our performance in recent weeks has improved considerably. We will need more time, however, to ascertain the wisdom of these moves.

We are down but not out. History tells us that our approach has merit and that over time it achieves rates of return that exceed risk-free rates by some 300 to 500 basis points. The size of the most recent drawdown makes it

imperative that we achieve this objective. As a sign of confidence and as a way not to burden further remaining unit-holders with the normal liquidation costs associated with unit-holder redemption, we pledge that, until further notice, redemption requests will be met from our own resources rather than from the fund. We are holding our feet to the fire.

NEW ZEALAND

FRIEDBERG NEW ZEALAND FUND LIMITED
NEW ZEALAND EQUITIES FUND
FCMI KIM EQUITIES FUND
TORONTO NZ EQUITY TRUST

The quarter provided an uninspiring stock market performance, with the New Zealand Mid-Cap Index (our closest benchmark) up a modest 3.3% and our fund trailing it with a 2.7% decline.

After a sharp, terms-of-trade induced contraction in activity in the first half of 1998 (-1.6%), the economy regained its footing in the second half of the year (+1.3%) and entered 1999 on a relatively strong note. Overall macro-economic variables are nearly picture-perfect. Headline inflation is negative, underlying inflation is at the low end of the Reserve Bank band of 0% to 2% and the operating fiscal balance is back in the black. The government's net debt to GDP stands now at a modest 24.9%, slightly up from the 24.1% figure for the year ended June 1998. The extremely successful recent sale of Contact Energy will push the government's 1999 fiscal budget surplus to \$2.0 billion, enabling it to lower the net debt to GDP ratio a further 1.5 percentage points. Consumers are now positive about the economic outlook for the first time since the first quarter of 1997. Improving job prospects may be responsible. On an unadjusted basis, ads were up 7.7% from their levels of a year earlier, the strongest reading since November 1995 (January 1997 looked to be an aberration). In all, the New Zealand economy weathered extremely well the South Asian and Japanese economic crisis, testimony to its inherent strength.

A positively sloped yield curve denotes a comfortable monetary environment, one that is particularly favorable to share prices. Valuations are compelling. Earning yields (median reading on our large sample of publicly listed securities) are 220 basis points higher than bond yields (10 year Government bonds yield 5.8%). Dividend yields on the NZ40, at 5.9%, easily exceed three-month T-bill yields. Other similarly compelling measures are market cap/revenues at 1.06, price/cash flow at 6.66, and price/net tangible assets (a more conservative ratio than price/book) at 1.19.

Below, we present our 10 largest holdings, accompanied by some valuation measures:

NZ Cayman Equity Fund

10 Largest Holdings in the Fund

		Price 31-Dec-98	Price /Sales	Price /Earnings	Price /Cashflow	Price /NTA	Gross Dividend Yield
CDL HOTESL	CDL.NZ	0.31	0.54	14.07	4.37	0.57	3.70
DB GROUP	DBG.NZ	2.40	0.37	8.89	4.40	1.05	9.60
FERNZ	FER.NZ	5.70	0.56	11.87	7.04	2.81	5.20
FISHER & PAYKEL	FAP.NZ	6.20	0.86	21.65	12.52	1.84	4.50
HALL GLASSON	HLG.NZ	2.74	1.04	16.78	13.78	4.86	8.80
KIWI INCOME PROPERTY	KIP.NZ	1.02	N.A.*	13.27	11.78	0.92	10.30
SANFORD	SAN.NZ	3.65	1.09	14.59	7.13	1.50	5.30
ST LUKES	STL.NZ	1.75	N.A.*	21.18	18.82	1.44	8.10
THE WAREHOUSE GROUP	WHS.NZ	7.48	1.26	21.29	16.44	6.73	3.20
TRANS TASMAN PROP.	TTP.NZ	0.31	N.A.*	11.00	13.05	0.55	14.50

*N.A. (Not applicable for property trust)

Weighted gross dividend yield

7.83%

NZSE 40

5.90%

We remain extremely bullish and believe that this market has a minimum upside of 50% to 75% before the end of this year, short, of course, of a devastating global bear market.

FRIEDBERG ALLOCATION FUND LTD.

Neil Rackoff comments:

The Friedberg Allocation Fund Ltd. fell 3.15% for the first quarter. As we mentioned in the last quarterly report, this fund mirrors the overall asset allocation model of the Friedberg group and is a reflection of our ongoing view of the world across all asset classes that we trade.

At quarter-end, we were allocated as follows:

Cayman Fixed Income Fund	57.95%
Cayman Currency Fund	13.79%
Cayman Global Opportunities Fund	7.99%
Cayman Equity Hedge Fund	11.46%
Cayman New Zealand Fund	4.87%

While being over-weighted in our Currency Trading Program would have achieved a far superior return for the quarter, the risks associated with such an allocation would in fact have been much greater than even we would be willing to tolerate.

Although, as Charles P. Kindleberger says in his book *Manias, Panics, and Crashes*, "there is nothing so disturbing to one's well-being and judgment as to see a friend get rich," we stand firm in our conviction that our approach and allocation to world assets will provide the long-term rewards that will justify the current pain.

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