

FRIEDBERG  
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**Third Quarter  
Report  
1998**

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## Third Quarter Report 1998

Dear Investors,

As the investment scenario darkens, the investment choices narrow. Relatively conservative vehicles, such as our fixed income funds, are slowly finding the correct mix. This mix should allow them to earn satisfactory returns incurring only modest risk to principal. It should also position them to take advantage of the once-in-a-lifetime opportunities that we see developing in coming months.

Less conservative vehicles are struggling with explosive volatility, illiquidity and increased government meddling/manipulation. We are in the midst of crossing a veritable minefield; even with the best information and technology, casualties will occur. It would not be out of place to warn again that our speculative and leveraged vehicles - in particular the currency and commodity funds - are not for the faint-hearted.

We believe that we are well equipped to transverse this minefield successfully. The inside pages should give you a good idea on how we plan to do it. Take heart!

Albert D. Friedberg



## **FOREIGN BONDS**

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

Our long-heralded strategic shift has begun to bear fruit. Results for our larger two funds for this quarter put them well on their way to achieving a return that exceeds those provided by nominal US Treasury obligations. The US fund was unfortunately handicapped, for regulatory reasons (lack of "seasoning"), by its inability to own a specially designed derivative instrument, a situation that has finally, albeit only partially, been obviated. In the meantime, Canadian-based investors have continued to reap the additional benefits of being invested primarily in US dollars

The most-repeated complaint goes something like this: "We don't need your services to earn returns equal to (let alone less than) those of US Treasury obligations!"

This would be justified if our objective was in fact to earn Treasury-like returns. But this of course is not so. Our medium- to long-term objective is and remains capital preservation plus a fair return, to be achieved in as smooth, i.e. least volatile, a manner as possible. There will be periods, naturally, where we will underperform even lowly Treasuries simply because we will have accepted risks that exceed the risks inherent in Treasury securities. And the reason we accept these greater risks is precisely because we want to earn rates of return that exceed risk-free rates. As elementary as this reasoning may seem, nonetheless many investors become impatient and frustrated by the day-to-day lack of progress in the NAV, believing that investment success is a straight ladder to heaven. Progress, even in the best of times, is uneven. It is all the more so today, as we navigate the most dangerous waters since the early 1930s.

An additional comment with regard to performance: In judging a manager, it's important to look at what he or she has not done as well as what he or she has done. Ironically, our greatest success this year lies in having sidestepped almost totally the emerging market arena, having foreseen the current meltdown. Emerging market debt, you will recall, was an area that in years past greatly enhanced our total returns, enabling us to achieve 10-year returns that were at least 250 basis points better than the Lipper Global Income Index. This is all the more reason for patting ourselves on the back. While avoiding disaster does not earn real money, it should provide the investor with a degree of reassurance that the manager is aggressive but at the same time prudent, reads properly the current situation and, consequently, is geared to take advantage of the exceptional opportunities that lie in store.

During the quarter, we continued to improve the overall credit rating of the portfolios, eliminating and/or collecting on maturity some small speculative holdings in Korea Electric Power, a Korean bank, an attractive but relatively illiquid US convertible and a New Zealand straight corporate. Expecting lower short-term rates in the near term, we swapped in a timely matter the US-dollar-denominated

Canada FRNs into fixed five-year US Treasuries. These, in turn, were profitably swapped into our favorite inflation-linked US Treasury securities. Depending on the specific portfolio, our estimated overall credit rating ranges from AA- to A+. Moreover, reflecting our deep liquidity concerns, we have reduced the portfolios' average length to maturity, outside of the two inflation-indexed bonds, to between 1.38 and 2.28 years (which includes a small position in German 10 year Bunds).

The two inflation-linked bonds (now representing as much as 45% of the portfolios), Government of Canada 4.25% of 2026 and US Treasury 3.625% of 2028, have of course much longer maturity. In our opinion, however, they do not expose us to the normal interest rate risks associated with nominal bonds of equivalent maturity because of the close link between long-term interest rates and inflation risk premium. A rise in the former is normally associated with a rise in the latter. This would tend to keep the linked bonds close to par.

We expect the closing quarter of the year to provide, once again, satisfactory returns taking only moderate but calculated risks. As the world descends into the most severe economic depression since the 1930s, we remain confident of achieving the above outlined objectives by being in a position to take advantage of the many opportunities that undoubtedly will come along.

## **CURRENCY PROGRAM**

FRIEDBERG CURRENCY FUND

FRIEDBERG CURRENCY FUND LTD.

FRIEDBERG FOREX LP

TORONTO SPECIALIZED TRUST - CURRENCY FUND

This past quarter furnished a disappointing performance. We lost slightly more than 9%, bringing our year-to-date gains to just over 6%.

The Russian ruble was our Waterloo. Having correctly foreseen a devaluation, we sold a relatively modest amount (in relation to our funds) of rubles on the International Monetary Market (IMM), an amount nonetheless that represented around 15% of the exchange's total open interest. Forward dollar premiums were astronomical: with less than one month to settlement, forward dollar rates already exceeded the bottom of the newly designed corridor, implying a 50% devaluation in four short weeks. We were certain that the pegged rate was unsustainable but, at the same time, the huge premium prompted us to exercise caution. Our exposure was a "mere" 25% of funds available, by far the smallest currency exposure we had ever taken. The contract was to be settled in cash (that is, there were not going to be actual rubles delivered at contract expiration), against the fix on expiration on the actively traded Moscow Interbank Currency Exchange (Micex). Other non-deliverable forwards and options were to follow a similar procedure.

As the ruble disintegrated, falling as low as 21 to the dollar from 6.5 in early August,

the Russian central bank and the Micex suspended trading on the exchange. Alternative settlement procedures had to be implemented for futures, forwards and options. Together with the Emerging Market Traders Association (EMTA), the IMM decided on a survey reference rate, a price derived from a survey of eight ruble interbank market dealers polled by the Chicago Mercantile Exchange's clearing house in conjunction with the EMTA.

While the procedure appeared to us to be somewhat artificial (rates quoted are not the same thing as real transactions), we relied on the fact that, in a randomly selected group, bulls and bears would offset each other's bias and a fair rate would be achieved. Having been unable to cover positions on the exchange at what we thought were fair rates (turnover was pitifully low), we were satisfied to let the contract expire in accordance with the emergency procedures put in place by the IMM.

Little did we suspect that the central bank of Russia, in a desperate attempt to save the nation's largest banks - banks that had sold dollars forward to the tune of perhaps as much as 50 billion dollars - was about to engineer a massive four-day squeeze on short ruble positions (effectively prohibiting the borrowing of rubles) that saw ruble rates climb to 7.619 to the dollar by the morning of September 15, D day for all September derivative contracts. No sooner had the "fix" been done, than the ruble resumed its interrupted slide. Within two days, it settled in a range of 14 to 16 rubles to the dollar. The central bank manipulation, carried out in a veritable twilight of currency trading, saved Russian banks billions of dollars at the expense of Western banks and speculators. The cost to us - measured from the ruble's lowest exchange rate (September 8) - was a whopping 24% of equity, wiping out all the ruble gains, and then some. We actually lost 8.5% of our beginning equity on this trade, practically equaling the quarter's overall loss.

To add insult to injury, the absolutely sudden and unexpected overnight hit to our equity forced us to de-leverage the portfolio in compliance with the self-imposed blow-out constraint. This hurried liquidation cost us some additional percentage points.

Is there recourse to the IMM? We sincerely do not think so. The exchange notified all market participants of the emergency procedures, pointing out that they have had a great deal of experience in conducting impartial and well timed surveys. The CFTC asked for comments before allowing the IMM to proceed. There did not appear to have been any negative comments.

Is there recourse to the Russian central bank, the ultimate culprit? Not really. All central banks in the world engage in currency and interest rate manipulation, some more blatantly than others, some more successfully than others.

Have we learned a lesson? Hardly one that we did not know already. When you deal with fire, you can get burned. And when you play with (or against) thieves, you are likely to lose. Can the same thing happen again, this time with the Brazilian real

contract? Yes, but it's unlikely. The Brazilian forex market is huge; closing it down could be well nigh impossible without creating an enormous black market, one that would create severe dislocations in a fairly complex and sophisticated economy. Moreover, driving up real interest rates to prohibitive levels, as the Russian central bank did, would cause more damage to the banking system than would a devaluation. (Unlike Russia, Brazil has a real banking system that borrows and lends a considerable amount of money.) Finally, it is not at all clear that the winners of such a manipulation would be local interests. On the other hand, Brazil could impose exchange controls and adopt a dual or multiple exchange rate regime. It is still not clear, at this point, what reference rate would be used for exchange contracts and non-deliverable forwards in such an eventuality. Obviously, shorts could be penalized if they are forced to settle against an artificially stronger, say, commercial rate.

We are convinced that the Brazilian real's peg, too, is unsustainable and that a devaluation is inevitable. Admittedly, forward discounts that reflect real interest rates of upwards of 30% per annum make it an expensive speculation. Nevertheless, we will continue to remain short, tempering somewhat our enthusiasm in the light of our recent ruble experience. If you play with fire...

During the quarter, losses in the Malaysian Ringgit (slight ones, as we just managed to sidestep by a few days the imposition of exchange controls), long DM/Sfr cross, and short Hong Kong dollar positions were neatly offset by gains in the short Brazilian real, long New Zealand/Australian cross and long DM/Sterling cross trades.

It is clear that opportunities in exotic markets are slowly disappearing, what with the threat of exchange controls, prohibitively high interest rates (and, consequently, forward discounts) and diminishing liquidity, as interbank dealers pull out of emerging markets. Once the Euro is effective, the search for meaningful trades will narrow to a handful of crosses. Our guess is that it will become more difficult to make money. Let's hope we are wrong.

#### **DIVERSIFIED TRADING PROGRAM**

FRIEDBERG DIVERSIFIED FUND

FRIEDBERG DIVERSIFIED POOL

TORONTO SPECIALIZED TRUST - SELECTED COMMODITIES FUND

We enjoyed gains of 19.5% for the quarter, managing to reduce year-to-date losses to just 7.5%.

The bulk of our gains came from a number of short trades in the Dow Jones and S&P 500 futures. We have become convinced that a significant bear market is in progress, one that will see US stock prices fall by a minimum of 60% before they hit bottom. Unfortunately, the extraordinary rise in volatility has prevented us from leveraging this bearish bet much beyond 1 to 1.5 times our equity. For the very same reason we

have discarded the purchase of put options, currently trading at near historically high levels of implied volatility. Only by timing trading turns will we be able to achieve outsized gains from this bear market. This presents obvious difficulties for committed bears as it forces them to cover on dips.

We continue to monitor closely a number of markets, including crude oil (which we have traded from the short side and expect to do so again when and if the contango widens), precious metals and foreign bond markets. The latter are in the grips of a financial bubble, driven by irrational fears of deflation. What is more likely is that rapid increases in money supply, particularly in the US, will cause inflationary headaches in the not-too-distant future. With patience and fortitude, we should be able to profit from the dramatic reversal in long-term interest rates implied in this scenario. This is especially true for the Mother of all financial bubbles: the Japanese 10-year bond, now yielding a preposterous 0.70%

There is no lack of opportunities if we can stay focused on the big ideas.

#### **FRIEDBERG FUTURES FUND**

The Futures Fund is equally invested in the Currencies Program and the Diversified Trading Program. Please refer to our earlier comments on these two programs.

#### **FRIEDBERG GLOBAL OPPORTUNITIES FUND LTD.**

The Global Opportunities Fund combines the Diversified Program with a global securities program. As such, the following remarks should be read along with our earlier comments on the Diversified Trading Program.

The global securities program made a small but positive contribution to the Fund, for the second quarter running. The legislative paralysis in Japan regarding the proposed banking bail-out and reform has had a generally bearish impact on securities prices, especially on the large money-centre banks. We continue to believe that the final legislation, if and when it comes, however, will favor the larger insolvent banks (they are, after all, "too large to fail") over the smaller ones. The government will want to make an example of rectitude and toughness by pulling the plug on a number of secondary banks, without running the risk of a generalized financial panic. Even more likely is the possibility that the final package will be too little, too late, causing Western banks to pull their credit lines and precipitating a tragic run on banks. We remain short a list of "walking dead" banks. With or without a run, the equity of many of them will be totally wiped out in the coming months.

We rounded out the portfolio with a small trading position in Bunds, bought on expectations that long-term German rates will converge on short-term rates, now at 3.5%. The position is profitable and performing in line with expectations. Also, we

remain long a handful of stocks in Japan which exhibit outstanding balance sheets and earnings records. The list will be expanded and positions increased when the banking crisis is finally resolved.

We remain attentive to other opportunities but, so far, we refuse to be diverted. We firmly believe that the Japanese banking crisis will provide the home run.

## EQUITY HEDGE PROGRAM

FRIEDBERG EQUITY HEDGE FUND LTD.

FRIEDBERG TORONTO TRUST EQUITY-HEDGE FUND

We would like to think that the disappointing quarterly loss of 5.5% is more the product of the extreme volatility exhibited by the market than a flaw in our fundamental posture. If this thesis is correct, we ought to experience a significant rebound in NAV in coming weeks with only minor position changes.

A second source of difficulty, perhaps as significant, is the behaviour of our primarily value-laden long portfolio. In bear markets, good earnings and good balance sheets are of little import. Instead, glamour stocks with scant earnings and extraordinary promises are the only securities to buck the trend, until well into the last phase of the decline. It is no coincidence that our most profitable long position during the quarter was Inktomi (+22.16%), an outfit that develops and markets scalable software applications designed to enhance the performance and intelligence of large-scale networks. It sports a price/book ratio of 31, a price/sales ratio of 35, and negative earnings and cash flow. By way of contrast, we were stopped out of "cheap" stocks with good earnings and good balance sheets, such as Barnes and Noble, Lehman Bros. (at 64, now trading at 37), Seagram Co. and AMR simply because measurable fundamentals are deteriorating. Negative momentum on many of these well priced securities forced us to overtrade, with consequent slippage losses. Finally, a temporary imbalance in our long/short ratio towards the end of August had a clearly negative impact on September performance (more on this later).

A more detailed analysis of the third-quarter performance may force a reappraisal - at least for the duration of this bear market - of the selection process for the buy side. It may take into account longer-term fundamentals. Rather than ask ourselves what stocks will outperform the market over the next 6 to 12 months, we may ask ourselves what stocks we would want to own at the beginning of the next bull market. We may also consider the merits of moving to a greater degree of concentration than heretofore.

Patience paid off: two of our longest held short positions and the subject of earlier comments (expressing disappointment that they had moved adversely), Triton Energy and Carson Inc., finally caved in. They generated gains of 72.15% and 69.05% respectively and moved to the top of our scoreboard for the quarter. This is gratifying as well as reassuring: patience, discipline and common sense are still the three most important ingredients of any successful program.

Other noteworthy statistics: at the beginning of the quarter, longs exceeded shorts by a margin of 13 percentage points (56.7% vs. 43.24%); by the end of the period, shorts exceeded longs by a little more than 3 percentage points (51.67% vs. 48.33%), driven by our proprietary balancing mechanism. Overall leverage remained fairly stable at around 2.5 times, except for a small period at the end of August when momentum-induced liquidations on a greater-than-anticipated scale, in line with our earlier discussion, de-leveraged our portfolio down to 1.61 times. The rapidity of the decline also pushed our relatively stable long-to-short ratio out of kilter for a short period, with shorts exceeding longs by a record 23 percentage points at the end of August. In view of the September stock market rally, this too may have hurt our September performance, as we pointed out earlier.

We take little consolation from the fact that our hedged vehicle is now ahead of the S&P 500 index on a year-over-year comparison: -5.5% vs. -10.3%. As we stated in the past, the equity hedge fund's medium- to long-term benchmark is not the S&P 500 but T-bill rates plus 300 to 500 basis points so as to compensate properly for risk/volatility. In view of this quarter's extreme and unexpected volatility, we move to target the higher of the range, that is, T-bill plus 500 b.p.

We remain extremely confident of achieving this ambitious goal.

#### **NEW ZEALAND**

FRIEDBERG NEW ZEALAND FUND LTD.  
NEW ZEALAND EQUITIES FUND  
FCMI KIWI EQUITIES INVESTORS  
TORONTO NZ EQUITY TRUST

There is no relief for our long-suffering investors: our New Zealand equity vehicles fell between 7.4% and 10.4% in US dollar terms during this past quarter, reflecting the continuing bear market. The New Zealand 40 index, our principal benchmark (we are not mandated to invest in any one area of the market), was down 15.05% in the common currency, while the mid-cap index was down only 4.76%.

As prices continue to fall, values become ever more compelling. The median ratios for all listed securities were the following: market capitalization/revenues (otherwise called price/sales), 0.72; price/earnings, 8.69; price/cash flow, 5.46; price/net tangible assets (a more conservative measure than price/book), 0.90; and debt/market capitalization, 0.26. The New Zealand 40's gross dividend yield stands at 8.15%.

Our own 10 largest holdings, shown below, exhibited even more extraordinary valuations.

10 Largest Holdings						
	Price 29/09/98	Price/ Sales	Price/ Earnings	Price/ Cash flow	Price/ NTA	Gross Dividend Yield
AIR NZ	158	0.30	6.62	3.89	0.57	18.99
DB GROUP	275	0.43	10.19	5.04	1.21	8.18
FISHER & PAYKEL	540	0.75	17.62	7.97	1.61	5.00
HALL GLASSON	157	0.57	8.27	4.66	2.76	18.15
KIWI INCOME PROPERTY	91	N.A.*	11.80	10.75	0.83	10.64
LWR INDUSTRIES	107	0.34	5.98	Neg.	0.76	21.03
PDL HOLDINGS	375	0.15	4.51	2.41	0.64	16.00
SANFORD	255	0.87	14.40	9.55	1.08	6.47
ST LUKES	136	N.A.*	16.60	12.54	1.02	10.27
TRANS TASMAN PROP	37	N.A.*	16.43	10.29	0.38	12.16

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

A number of favourable developments in recent days are sowing the seeds for the next bull market. Specifically, short-term interest rates have collapsed, a result of higher domestic savings, without unduly affecting the exchange rate. At 5.5%, short-term rates compare extremely favorably with the dividend yields shown above. The trade-weighted dollar has stabilized around 56, a plus for foreign investors who can now enjoy in relative safety the double whammy effect of cheap securities and a cheap currency. Falling interest rates also point to reduced pressure on the balance of payments, a previous source of concern. Finally, the political scene has become more investor-friendly with the ouster of Peters from Finance and the breakup of the coalition agreement that had so stifled the conservative government. We are now likely to see far more privatizations, spending cutbacks and the second installment of the previously planned tax cuts.

Last July we urged "rational investors" to consider increasing exposure to the New Zealand equity market in view of the extraordinary valuations. Contrarians should take comfort from the fact that only one client accepted our urgings.

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