

FRIEDBERG  
MERCANTILE  
GROUP

THIRD  
QUARTER  
REPORT  
2001



# THIRD QUARTER REPORT 2001

Dear Investor,

We are pleased to bring you our report on the activities and financial results of our funds for the third quarter of this year.

Once again, the performance was somewhat uneven, with dramatic gains for The Diversified Fund (16.4%) and the equity hedge funds (9.2%), modest gains for the currency funds (0.2% to 5%), and modest losses for The International Securities Fund (-2.2%) and the fixed-income vehicles (-0.2 to -2.2%). Those who follow our suggested allocation (a fair measure of the overall performance of the Friedberg family of funds) saw positive returns for the quarter, for the year to date, and year over year: 2.59%, 3.75%, and 20.64%, respectively. In fact, we have been so encouraged by the natural complementarity of these products that we are in the process of setting up an offshore global macro hedge fund that will invest in them. The fund, expected to begin trading by the middle of November, will be set up with an initial \$20 million, a sum already spoken for by clients of the firm. We anticipate an initial allocation along present lines (see Neil's comments).

Our greatest disappointment lay in the miserable performance of the Canadian dollar. Even though Canada enjoys a current account surplus, a balanced budget, and a healthy economy and its currency is widely thought to be substantially undervalued, the dollar fell almost 4% against the US dollar during the quarter, inflicting significant losses on our income funds. These had been positioned to benefit from a "value" play and a positive carry, that is, higher interest rates than those available on US-dollar-denominated assets. Losses ranged from 0.20% to 1.73% of average equity, depending on the fund. The position was closed out before the end of the quarter and it is not likely to be reinstated now that a better alternative is at hand (see our explanation below). We continue to hold substantial exposure to Government of Canada Real Return Bonds, the Canadian equivalent of TIPS (see graphs for details).

Also disappointing was the erratic and inconsistent trading pattern of the single European currency, the euro. The disconnect between falling US asset prices and a huge current account hole on the one hand and a strong dollar/weak euro on the other leaves us puzzled. In retrospect, we have attempted to justify this phenomenon by arguing that: a. foreign investors take losses only grudgingly (hence there has been, as yet, no outflow of funds); b. Europe continues to be politically less attractive (to an almost ludicrous degree); c. the US enjoys a safe-heaven status; and d. European black-market money, worried about disclosure in the upcoming exchange for euro banknotes, is rotating from hand to hand like a hot potato and ending in US dollars. Still, we believe that it is only a matter of time before the US runs out of financing for its gaping current account deficit. In the beauty contest of floating exchange rates, the least unattractive candidate always wins. Hence, the euro is poised to become a winner. Our appetite for value and a positive carry can be satisfied, at least for now, being long euro.

For the quarter, long synthetic euro positions in the fixed-income funds contributed positively, though modestly, to results. As at the end of the quarter, 75% of the income funds' capital remained long euro via derivatives (see accompanying graphs). Currency funds, on the other hand, suffered significant losses trading the single currency. Nevertheless, we have persevered here as well. We begin the quarter with a heavier-than-average long euro exposure. It should be noted that these unfortunate forays were "covered" by some daring and high-risk/high-return trades in Argentine pesos, betting that they would not devalue. The Latin trades — long Argentina and short Brazil (not necessarily matched or weighted) — produced 100% of our total currency funds' profits. Return on initial capital for the quarter was almost 25%.

We continue to hold substantial leveraged and unleveraged positions in US Government inflation linked securities (TIPS) for the various funds. As the recession deepens and risk premiums widen, all the more so as a result of the September 11 attacks, risk-free real interest rates are slated to fall to much lower levels. At the same time, the bonds' inflation indexation should protect us from the re-acceleration of inflation that is certain to occur over the medium term in response to explosive monetary growth. In all, we expect TIPS to continue to provide above-average total returns for the foreseeable future.

A more focused and disciplined approach produced excellent results for the diversified trading program. Half the total gains came from betting, via Nasdaq futures, on a continuation of the bear market in equities. The contract's enormous volatility forced us repeatedly to find a balance between a meaningful position with significant potential gains and a less-than-meaningful one that would cut losses at a predetermined point and eliminate the risk of being "blown out." Our strategy paid off, but not before stumbling and hitting blowouts a number of times.

The lesson that we have learned over the past few years is that one need not bet the

ranch on a so-called sure trade. Moderate leverage, used consistently and in a disciplined manner (that is, without over-trading) can produce dramatic results provided one is right. Needless to say, this rule requires an enormous amount of restraint for naturally aggressive traders like us.

For more details of our winners and losers for the quarter, please refer to the exhibits. It is worthwhile noting that the two positions we maintained throughout the entire period, short Copper and long TIPS, exemplified our condensed view of the world: recessionary conditions and falling returns on capital. This view has not changed, though we might add that the potential for the rate of inflation to rise more quickly has grown exponentially in recent weeks. We have written extensively on this matter in our bi-monthly publication, Friedberg's Commodity and Currency Comments, which is available to our clients on request.

Our equity hedge funds performed admirably, proving that selection and not market timing is the key to stock market success. Unable to gather much enthusiasm for buying into new sectors, we allowed overall leverage to fall (see exhibits). The long/short ratio, at 57/42, remained steady throughout and ended the period right where it had begun. Note that we adjust the ratio to take into account different levels of volatility and sensitivity to market moves among various sectors. Our aim is to be exactly market-neutral.

Contrary to what we had anticipated, the short side of our equity hedge funds did better than the market by a factor of more than 2.2 to one. Our long side, on the other hand, under-performed the market by nearly 30%, weighted down by an over-exposure to energy and waste disposal stocks. In all, however, we were satisfied, having produced a 9% return for the quarter compared with a 14.9% decline in the S&P500 index.

A closer examination of the Chinese stock market and the extraordinary compartmentalization of the Chinese foreign exchange market persuaded us to liquidate our China B position prematurely. It now appears to us that some type of convergence between the A shares and their far cheaper B counterparts will occur, but only on the way down (for a fuller explanation, see the article "Chinese end game: A/B valuation convergence stalling", which appeared in the latest issue of Friedberg's Commodity and Currency Comments). While the position proved profitable on the whole, we gave back some gains in the course of the quarter and moved overall results for the International Fund to the minus column (see details and breakdown analysis in the exhibits).

Similarly, the reversal of some of the gains in our Canadian junior oil and gas portfolio

contributed to negative results. On the other hand, good performances in all the other areas added stability and, ultimately, helped us post a dramatic year-on-year gain of 85%. For the past year, we have successfully carried out the mandate of this mini-hedge fund, namely, to establish long equity/fixed income positions in areas of the globe that enjoy a political and economic climate conducive to growth, and conversely, to establish short positions in areas where policies are inimical to growth.

Overall, it's been another good quarter. With some luck, there is a chance of ending the year on a high note.

Thank you for your trust,

A handwritten signature in dark ink, appearing to read 'A. Friedberg', is written over a light blue circular stamp or watermark.

Albert D. Friedberg

FRIEDBERG  
MERCANTILE  
GROUP

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## FRIEDBERG ALLOCATION MODEL

Neil Rackoff comments:

The Friedberg Allocation Model is up 2.59% for the quarter, up 3.75% year-to-date, and up 20.64% year-over-year. This compares very favourably with the NASDAQ Composite Index (down 36.16% for the quarter), the S&P 500 (down 14.98%), and the Dow Jones Industrials (down 15.75%). We do not mean to imply that any of these indices is a good or proper benchmark for our funds; rather, we use them as a point of reference. See our remarks in the October 2001 edition of Friedberg's Commodity and Currency Comments.

We are pleased to announce, as Mr. Friedberg noted, that we will be creating a vehicle for offshore clients that follows our recommended portfolio exactly. (We will inform you of its start date.)

Over the past several years, we have encouraged investors to participate with us by using this approach. It has produced steady and interesting returns that reflect our macro view of the world and should continue to do so. Currently, as Mr. Friedberg has commented in his letter, the overall portfolio reflects our view of a world with increasing recessionary conditions and falling returns on capital.

One could ask that if we believe so much in an aggregate portfolio, why track the individual strategies. The answer is that from a risk management perspective segmenting our strategies into separate funds and looking at them individually has enormous value both to us and to our clients. If we were to only aggregate all our trades into one fund, we feel that there would be a tendency for all of our ideas to become one big trade with unidirectional risk. By separating the strategies we not only have to maintain consonance with our overall view but must also articulate and analyze the micro opportunities that arise in any given sub-strategy.

Although we find ourselves facing a world that none of us imagined at the end of last quarter, we must move forward. We are reminded of a line from Ecclesiastes that encourages our perseverance: *"One who watches the wind will never sow, and one who keeps his eyes on the clouds will never reap."*

The recommended allocation going forward is:

For non-North American investors:

Friedberg Total Return Fixed Income Fund	65%
Friedberg Equity Hedge Fund Ltd	15%
Friedberg Currency Fund Ltd	10%
Friedberg Global Opportunities Fund Ltd	10%

For Canadian investors:

Friedberg Foreign Bond Fund	65%
Friedberg Equity Hedge Fund	15%
Friedberg Currency Fund	10%
Friedberg Diversified Fund	6.7%
Friedberg International Securities Fund	3.3%

# FOREIGN BOND PROGRAM

## FRIEDBERG FOREIGN BOND FUND FRIEDBERG TOTAL RETURN FIXED INCOME FUND LTD. FRIEDBERG TOTAL RETURN FIXED INCOME FUND L.P.

The Funds seek total investment return, consisting of a combination of interest income, currency gains, and capital appreciation, by investing in both investment grade and non-investment grade fixed income obligations and corporate bonds denominated in a variety of currencies.

**LOW RISK. Objective: LIBOR+4% per annum**

### PERFORMANCE as of September 30, 2001

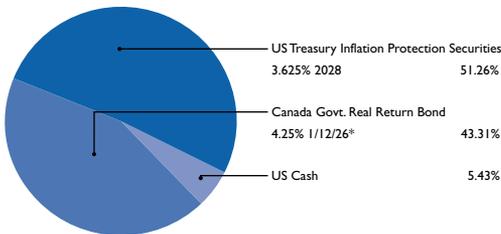
	NAV	Quarter	Year over Year	Two Years <sup>2</sup>	Three Years <sup>2</sup>
Friedberg Foreign Bond Fund <sup>1</sup>	11.79	1.73%	5.17%	4.68%	1.51%
Friedberg Total Return Fixed Income Fund Ltd.	1013.14	-0.51%	2.23%	2.27%	0.80%
Friedberg Total Return Fixed Income Fund L.P.	103.30	-0.18%	4.28%	3.64%	1.90%
Benchmark (see note on page 15)		3.15%	5.55%	3.81%	N/A

<sup>1</sup>Priced in Canadian Dollars

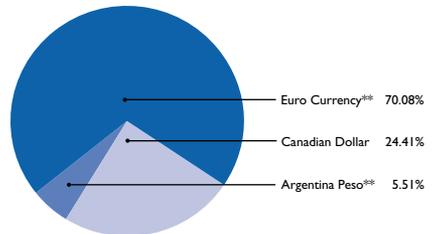
<sup>2</sup>Compounded Annual Rate of Return

## FRIEDBERG FOREIGN BOND FUND

Portfolio Allocation



Currency Exposure



Weighted average yield to maturity 6.21%  
Weighted average current yield 3.71%

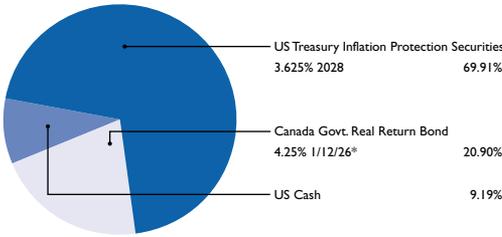
\*Currency Partially or Totally Hedged  
\*\*Via Derivatives

Adjusted modified duration 6.84%  
Approximate overall credit rating AAA

Bond rating breakdown: AAA 100.00%  
Unrated 0.00%

## FRIEDBERG TOTAL RETURN FIXED INCOME FUND LTD.

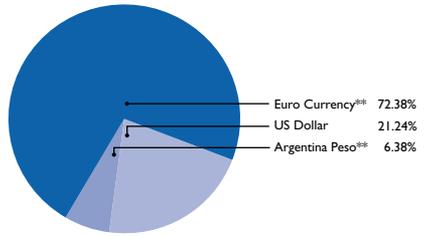
Portfolio Allocation



Weighted average yield to maturity: 6.11%  
 Weighted average current yield: 3.65%

\*Currency Partially or Totally Hedged  
 \*\*Via Derivatives

Currency Exposure

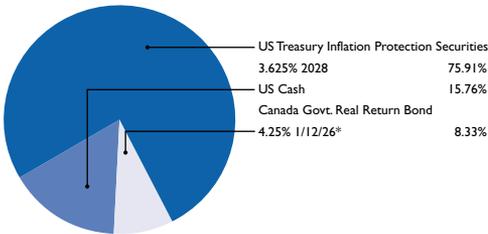


Adjusted modified duration: 6.68%  
 Approximate overall credit rating: AAA

Bond rating breakdown: AAA 100.00%  
 Unrated 0.00%

## FRIEDBERG TOTAL RETURN FIXED INCOME FUND L.P.

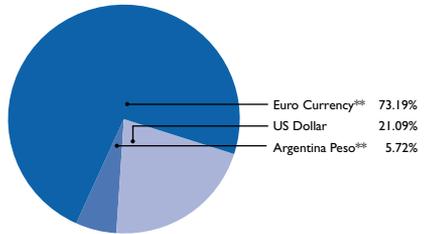
Portfolio Allocation



Weighted average yield to maturity: 5.95%  
 Weighted average current yield: 3.63%

\*Currency Partially or Totally Hedged  
 \*\*Via Derivatives

Currency Exposure



Adjusted modified duration: 6.26%  
 Approximate overall credit rating: AAA

Bond rating breakdown: AAA 100.00%  
 Unrated 0.00%

# EQUITY HEDGE PROGRAM

## FRIEDBERG EQUITY HEDGE FUND LTD. FRIEDBERG EQUITY HEDGE FUND

The funds use leverage to trade equity securities and stock index futures contracts and related options. The fund balances long and short positions in an attempt to eliminate systematic or market risk.  
**MEDIUM RISK. Objective: 20-25% per annum**

### PERFORMANCE<sup>1</sup> as of September 30, 2001

	NAV	Quarter	Year over Year	Three Years <sup>2</sup>
Friedberg Equity-Hedge Fund Ltd.	2067.30	8.98%	32.08%	28.48%
Friedberg Equity-Hedge Fund	18.55	9.25%	30.18%	26.15%

<sup>1</sup>Net of fees

<sup>2</sup>Compounded annual rate of return

### INVESTMENT ALLOCATION<sup>3</sup>

	Jun-01	Jul-01	Aug-01	Sep-01
LONGS	57.76%	58.15%	57.72%	57.20%
SHORTS	42.24%	41.85%	42.28%	42.80%
TOTAL GROSS LEVERAGE	2.35 x	2.14 x	2.17 x	2.18 x

<sup>3</sup>As percentage of total gross assets (based on the Friedberg Equity-Hedge Fund Ltd.)

### LARGEST SECTORS (LONGS)<sup>4</sup>

Small Cap Industrials (Russell 2000 futures) <sup>5</sup>	18.91%
Waste Disposal	7.08%
Aerospace/Defence Equipment	6.18%

### LARGEST SECTORS (SHORTS)<sup>4</sup>

Investment Banking/Brokers	10.08%
Computers	5.15%
Finance/Credit Card	3.83%

<sup>4</sup>As percentage of total gross assets (as per the Friedberg Equity-Hedge Fund Ltd.)

<sup>5</sup>Market value of futures contracts

### LARGEST LONG POSITIONS

Russell 2000 index futures  
General Dynamics Corp.  
Valero Energy Corp.  
Alliant Techsystems Inc.  
Waste Management Inc.  
Cott Corporation  
TXU Corp.  
Waste Connections Inc.  
Republic Services Inc.  
Allied Waste Industries Inc.

### LARGEST SHORT POSITIONS

Goldman Sachs Group Inc.  
International Business Machines Corp.  
General Electric Co.  
Morgan Stanley Dean Witter & Co.  
Intel Corp.  
General Electric Co.  
AOL Time Warner  
Providian Financial Corp.  
Comcast Corporation  
Capital One Financial Corp.  
Stilwell Financial Inc.

### BEST QUARTERLY PERFORMANCE

	LONGS		SHORTS	
	Alliant Techsystems Inc.	36.49%	Ciena Corp.	72.92%
	Cott Corporation	13.82%	Veritas Software Corp.	72.28%
	General Dynamics Corp.	13.51%	Unitedglobalcom Inc.	65.32%

### WORST QUARTERLY PERFORMANCE

	LONGS		SHORTS	
IO	XOMA Ltd.	-42.61%	Edison International	-18.03%
	Ethyl Corp	-41.19%	Wal-Mart Stores Inc.	-8.71%
	United Technologies Corp.	-13.03%	Boston Scientific Corp.	-7.47%

# CURRENCY PROGRAM

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

Speculative trading in currency futures instruments, currency forwards  
 and options.  
**HIGH RISK.** Objective: 25% per annum

## PERFORMANCE as of September 30, 2001

	NAV	Quarter	Year over Year	Three Years <sup>2</sup>
Friedberg Currency Fund <sup>1</sup>	17.83	4.21%	29.20%	-4.19%
The First Mercantile Currency Fund <sup>1</sup>	15.34	2.27%	22.52%	-3.12%
Friedberg Currency Fund Ltd.	942.53	2.25%	17.92%	-1.16%
Friedberg Forex L.P.	15.54	2.17%	27.69%	-2.72%

<sup>1</sup>Priced in Canadian Dollars

<sup>2</sup>Compounded Annual Rate of Return

## OPEN POSITIONS - September 30, 2001

	leverage
Long Euro Currency	2.76
Long Argentina Peso	1.08
Long US Treasury Inflation Protection Securities	0.87
gross leverage at September 30, 2001	5.43 x
maximum gross leverage during quarter	11.15 x

## ACTIVITY REPORT - Third Quarter 2001

	profit as percentage of beginning equity	percentage of total profits
<b>PROFITABLE TRANSACTIONS</b>		
Long Argentina Peso	20.48	84.54
Short Brazilian Real	3.64	15.01
Long U.S. Treasury Inflation Protection Securities	0.11	0.45
	loss as percentage of beginning equity	percentage of total losses
<b>LOSING TRANSACTIONS</b>		
Euro Currency	(12.05)	52.23
Short Polish Zloty	(5.62)	24.36
Long Canadian Dollar	(5.21)	22.57
Long Japanese Yen	(0.19)	0.83

Model account value June 30, 2001	60,248.61
Model account value Sept. 30, 2001	60,898.91
Percentage gain (loss) in quarter:	1.08%

# Diversified Trading Program

## Friedberg Diversified Fund

Speculative trading of commodity, interest rates, and stock index futures, over the counter forwards and options markets.  
**HIGH RISK. Objective: 40% per annum**

### PERFORMANCE as of September 30, 2001

	NAV	Quarter	Year over Year	Three Years <sup>1</sup>
Friedberg Diversified Fund	8.82	16.36%	90.91%	-6.81%

<sup>1</sup>Compounded Annual Rate of Return

### OPEN POSITIONS - September 30, 2001

	leverage
LONG U.S. TREASURY INFLATION PROTECTION SECURITIES	1.67
LONG TEN-YEAR NOTES	1.16
LONG GOLD	1.10
SHORT MINI NASDAQ	0.38
SHORT COPPER	0.17
LONG COCOA	0.17
SHORT SUGAR	0.08
gross leverage at September 30, 2001	4.73 x
maximum gross leverage during quarter	5.63 x

### ACTIVITY REPORT - Third Quarter 2001

	profit as percentage of beginning equity	percentage of total profits
<b>PROFITABLE TRANSACTIONS</b>		
Equity Futures	14.48	53.10
Copper	2.45	9.00
Cocoa	2.03	7.46
Gold	1.95	7.14
Treasury Inflation Protection Securities	1.90	6.97
Sugar	1.63	5.98
Soymeal	1.19	4.35
Ten Year Note	1.10	4.02
Wheat	0.54	1.98
	loss as percentage of beginning equity	percentage of total losses
<b>LOSING TRANSACTIONS</b>		
Energy	(5.91)	59.36
Soybeans	(3.05)	30.63
Corn	(0.53)	5.37
Aluminum	(0.46)	4.65

Model account value June 30, 2000	159,547.84
Model account value Sept. 30, 2001	187,184.37
Percentage gain (loss) in quarter:	17.32%

## FRIEDBERG FUTURES FUND

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

## FRIEDBERG INTERNATIONAL SECURITIES FUND

The fund seeks to capitalize on the rise and fall of local markets throughout the world by anticipating long term secular trends or by identifying, at an early stage, cyclical economic expansions and contractions of economies of selected countries.

**MEDIUM RISK. Objective: 20% per annum**

**PERFORMANCE<sup>1</sup>** as of September 30, 2001

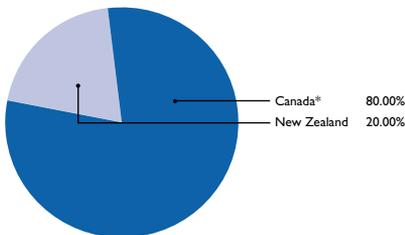
NAV	Quarter	Year over Year	Three Years <sup>2</sup>
13.01	-2.18%	85.33%	8.77%

<sup>1</sup>Net of fees

<sup>2</sup>Compounded Annual Rate of Return

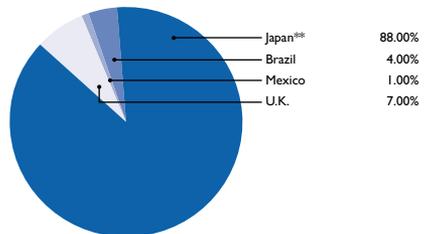
## EQUITIES EXPOSURE BY COUNTRY

**LONG (% of total longs)**



\*Oil & Gas Shares

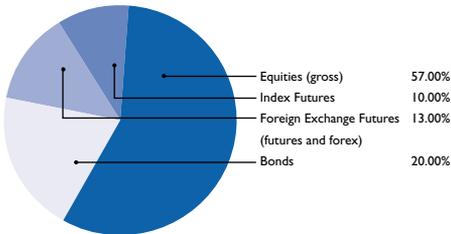
**SHORT (% of total shorts)**



\*\*Secondary Banks (hedged with JY futures)

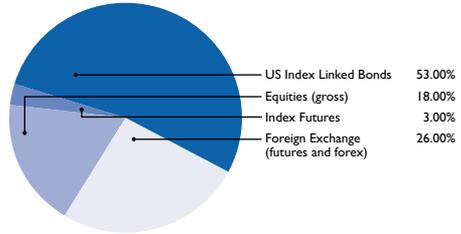
# FRIEDBERG INTERNATIONAL SECURITIES FUND con't

## BREAKDOWN BY INVESTED AMOUNTS\*



\*Based on margins used in each category

## BREAKDOWN BY TOTAL GROSS EXPOSURE\*\*



\*\*Including notional values of derivatives

**TOTAL GROSS LEVERAGE 2.16 x**

### POSITIONS ESTABLISHED DURING THE QTR.

- 1) Bought long Argentinian Peso (Forex)
- 2) Sold short mini Nasdaq Futures
- 3) Acquired Comstate Resources Trust Units and Complex Minerals via Stock Exchange for Comstate Resources

### POSITIONS LIQUIDATED DURING THE QTR.

- 1) Covered short Indosat (Indonesia)
- 2) Liquidated long Nissan Motors (Japan)
- 3) Liquidated long China Equities (China)
- 4) Partially liquidated long Japanese Yen Futures
- 5) Partially liquidated select long Canada Energy Stocks

## APPROXIMATE RETURN ON BEGINNING EQUITY BY MAJOR SECTORS - (July 1 - Sept. 30)\*

China	-14.25%
Japan	6.00%
Canada	-4.35%
Latin America	1.50%
Argentina Peso (Forex)	2.00%
Nasdaq Futures	3.35%
US Index linked bonds	2.80%
Miscellaneous	1.30%

\*not time adjusted

# FRIEDBERG GLOBAL OPPORTUNITIES FUND

The Global Opportunities Fund comprises the Diversified Trading Program and the International Fund. Please refer to corresponding graphs and tables for these two programs.

## PERFORMANCE<sup>1</sup> as of September 30, 2001

NAV	Quarter	Year over Year	Three Years <sup>2</sup>
781.50	10.79%	132.46%	-11.15%

<sup>1</sup>Net of fees

<sup>2</sup>Compounded Annual Rate of Return

# FRIEDBERG SKILL-BASED MANAGERS FUND

**PERFORMANCE** as of September 30, 2001

	NAV	Quarter	Year over Year	Two Years <sup>1</sup>
Friedberg Skilled-Based Managers Fund	11.62	4.12%	16.43%	8.45%

<sup>1</sup>Compounded Annual Rate of Return

David Rothberg Comments:

The Skill Based Fund earned 4.12% during the third quarter, nearly perfectly in keeping with the funds objective of providing all-weather returns in a consistent manner. Over the period the fund reduced its exposure to all but three styles: risk arbitrage, convertible arbitrage, and long/short value. As suspected in the Q2 report risk arbitrage fared the worst. In a falling market the appetite for deals declines. In addition to less supply, crises of confidence widen spreads of pending deals. All told it's a testament to our managers' crunchiness that performance was as good as it was. Long/short value was and remains the bellwether of the fund. Equities' values remain out-of wack in many sectors and thus relatively easy prey for astute pickers. Convertible arbitrage enjoys volatility, a quality we currently enjoy and so should continue to thrive as a strategy, though not to the same extent as value managers.

## NOTE TO FIXED INCOME BENCHMARK

We have been working on defining benchmarks for our various funds. See our article in *Friedberg's Commodity and Currency Comments*, October 2001.

We have often found it difficult to find a proxy that replicates the mandate of our fixed-income funds. Most tradable funds are too focused or cannot have the broad exposure that we can in our program. Although we are not leveraged in our fund, we can invest in any currency unhedged. Generally, we will have a minimum of 70% of our assets in investment-grade debt, sovereign, agency or corporate. We can also have up to 30% in either high yield, un-rated, or emerging market debt.

We have therefore constructed an index that incorporates these basic characteristics. Our index comprises the Merrill Lynch Global Broad Market Index (Bloomberg ticker symbol GBMI <index>), a market weighted index of all investment grade debt, and the Global High Yield and Emerging Market Plus Index (Bloomberg symbol HA00 <index>), a market weighted index of all high-yield and emerging market debt. We created it using the custom index function on the Merrill Lynch global index system page on the Bloomberg Professional System. Our custom index assigns a 70% weighting to the GBMI and a 30% weighting to the HA00. The results can be tracked and monitored on an ongoing basis. The validity of this custom index as a benchmark does have its weakness, insofar as it is not really a passive alternative investment to our funds. We feel, however, that it does represent the broad weighted universe in which we can participate.

*N.R.*



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