

# Theta Quarterly Review

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## Third Quarter 2005

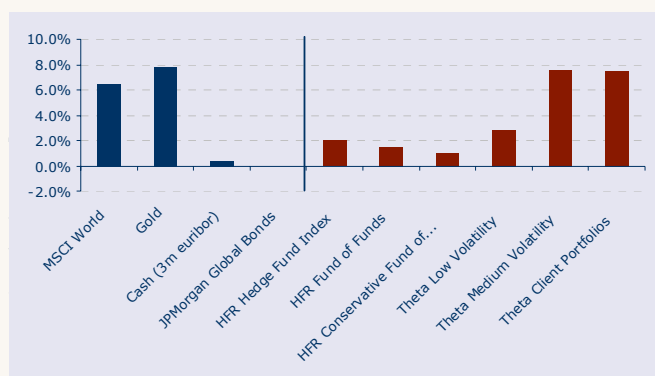
Theta Capital Management

November 2005

**1. Market review**

The third quarter of 2005 will be mainly remembered by its devastating hurricanes, volatile energy markets, increasing interest rates, and bouncing credit and equity markets on the back of strong earning figures.

**Exhibit 1 Q3 2005 Returns Across Asset Classes**



The S&P 500 Index returned 3.60% for the quarter, the NASDAQ Composite grew 4.61% and the MSCI World Index increased by 7.08% in U.S. dollar terms. Similar to the previous quarter, commodities rallied the most and emerging markets followed closely. Although there was considerable volatility, bonds were mostly flat.

Hedge fund strategies have performed quite well over the entire spectrum. Hedge funds as a group (HFR Hedge Fund Index) gained almost 2% in the third quarter, with funds of hedge funds only slightly behind (+1.55%). Interestingly, our Low Volatility portfolios outperformed their benchmark (HFR Conservative Fund of Funds Index) by 1.75% and our Medium Volatility portfolios outperformed their benchmark (HFR Fund of Funds Index) by almost 6% this quarter!

In the third quarter we witnessed some dislocation in structured credit markets, with spreads on lower rated paper widening out as higher rated paper remained unchanged or even tightened slightly. Issuance is still running strong, as the thirst for rated higher yielding paper seems insatiable. The higher the risk and the lower the gap, the less room is left for error or unexpected adversity: newer CDO vintages, both cash and synthetic, truly are “priced for perfection”. Our only investment in this space has a very conservative stance towards the market and is anticipating increasing credit risk, reflected higher defaults rates in 2006. In turn,

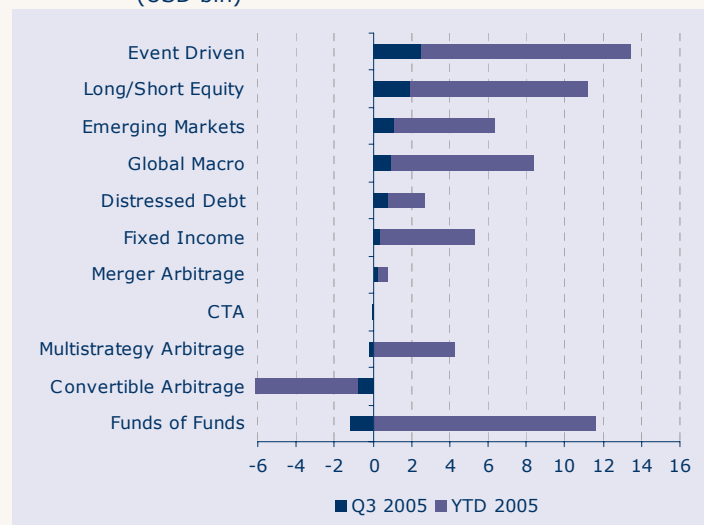
rising defaults will have serious ripple effects throughout the market: many CDOs have exposure to the same underlying names. His portfolio is currently partly in cash and tilted towards net short, to take advantage of the opportunities that may arise.

Spreads on investment grade rated ABS remain at or near their all-time lows. We are very hesitant to this part of the market, we do not believe in perfection, and are closely monitoring our related investments. Our funds in this space have started to depart out of lower rated ABS space, have much cash on hand and take market neutral short-biased relative value positions.

**2. Asset flows**

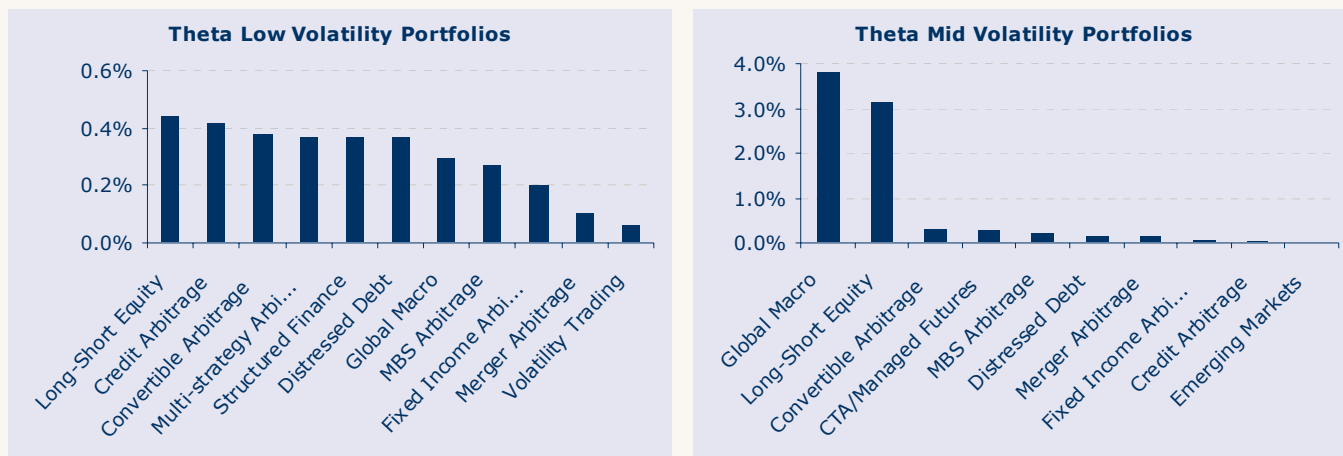
In line with the observation that new money is often chasing past performance, emerging market funds received the biggest percentage inflows in the third quarter, along with long/short equity and event driven strategies. While convertible arbitrage again had to cope with a net outflow, the size of the outflow was much smaller than in the second quarter as fundamental factors seem to improve for these funds. Funds of funds have suffered their first net outflow of assets since 1996, and multi-strategy hedge funds also saw net outflows. We believe that this is driven by institutional investors that have become disappointed with recent returns, particularly in the arbitrage universe.

**Exhibit 2 Q3 2005 Asset Flows by Strategy (USD bln)**



**Exhibit 3 Q3 2005 Performance Attribution of Theta Portfolios**

(contribution to gross performance by strategy)

**3. Portfolio Review**

The Theta Capital Management funds of funds delivered excellent returns over the third quarter. The Low Volatility Funds increased approximately **+2.7%** and the Medium Volatility Funds increased **+7.5%**, bringing the year to date net performances to **+2.6%** and **+11.3%**, respectively. With this performance, our Medium Volatility portfolios consistently rank in the Top 10 of multi-strategy funds of funds worldwide, according to the leading industry newsletter *InvestHedge*.

Looking at the performance of the various funds in more detail, Exhibit 3 above shows the (gross) performance of the various strategies we invest in. It shows that *all* strategies had a positive contribution to portfolio performance this quarter. As expected, based on strong underlying markets and the percentage allocation in our portfolios, long/short equity funds strongly contributed to overall performance. It also stands out that the performance contribution of our structured finance funds is very stable over the months. These funds engage in direct lending (trade finance, car loans) fully backed by underlying collateral (trade receivables and cars) and sometimes supplemented with insurance coverage. Their risk-return profile makes them a valuable addition to our low volatility portfolios.

Credit related funds have done best in July, while our global macro and our multi-strategy funds had an excellent month in September. As detailed in our monthly reports, in our low volatility portfolios we are moving away from traditional arbitrage strategies (where capi-

tal inflows continue to dampen returns while increasing risk), towards more directional strategies such as global macro. Although the volatility of these funds is generally higher, their correlation to our other investments is very low or even negative, which helps limit the overall portfolio volatility.

In line with some very strong trends in financial markets and using a highly opportunistic approach to investing, our global macro managers were the star performers in our Medium Volatility portfolios, contributing almost 4% to performance this quarter. Although the allocation to the global macro strategy is relatively large at about 30%, the individual managers are very lowly correlated between themselves and thus generate highly complementary risk-return profiles. While our long/short equity funds obviously benefited from strong underlying stock markets, they also create significant alpha: they outperformed their industry peers (HFR Equity Hedge Index) by more than 4% year-to-date.

On the company level, two of our analysts have decided to leave Theta as per 1 November and set up their own fund. We are thankful for their contribution to our success in recent years and wish them the very best in their new venture. We are proud to announce the hiring of Ruud Smets as portfolio manager, who has already made significant contributions to further enhancing and improving our investment process since joining Theta on 1 October 2005. For his curriculum vitae, please visit our website at: [www.thetacapital.com](http://www.thetacapital.com)

