

Theta Quarterly Review

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Outlook 2006 and Recap 2005

Theta Capital Management

February 2006

Markets often leap, don't glide

- Benoit Mandelbrot, 2004

Outlook 2006: volatility is on the rise

After several years of solid returns across many asset classes coupled with a continuous decline in market volatility, we believe global market risk appetite is likely to decline going forward. Our main argument is that the era of easy money is behind us. We note that we are not bearish on the **direction** of markets (remember that we leave the challenging task of having a view on market direction to our underlying hedge fund managers and they are handsomely rewarded for it), but we believe that the **volatility** of markets will increase. The low volatility market environment of recent years has been challenging for many hedge funds. Going forward, given their flexible investment mandates and opportunistic investment approaches, hedge funds should be able to benefit greatly from opportunities that will inevitably arise from dislocations in more volatile markets. In turn, diversified portfolios of hedge funds should also do well, provided that they are properly constructed. In our view, this means **focus on what we don't know, rather than on what we know**.

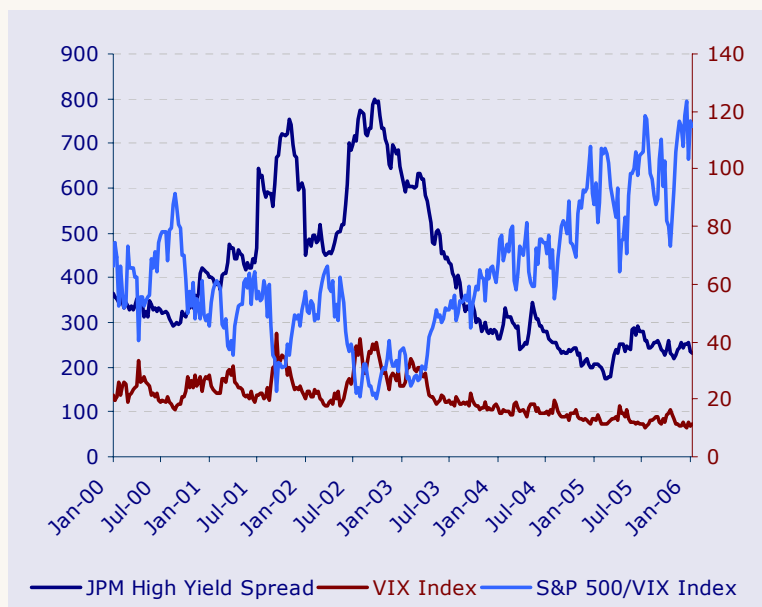
The end of easy money

On the back of a continuous supply of global liquidity, intrinsic values (measured by required internal rates of return, or yield) and risk premia have disappeared from many financial assets in recent years:

- the US yield curve has become flat or even inverted as the Fed raised short rates and market consensus indicates that other central banks are likely to catch up;
- corporate credit spreads are at all-time lows;
- following the 2005 rally in emerging markets debt and equity, yields have reached levels barely reflecting the true credit quality or profit potential of the underlying name or country (e.g. BBB-rated Bulgarian government bonds trade *through* AAA-rated German bonds in short maturities...)
- small caps have outperformed large caps;
- indicators of investor's risk appetite are at levels not seen during the last 15 years (see Exhibit 1 below).

Exhibit 1 plots (in light-blue, right-hand scale) the ratio of S&P 500 over the VIX Index of implied volatility. The latter index is widely regarded as an 'investor fear gauge'. The ratio we present is essentially a measure of risk appetite, which indicates a complete lack of fear or caution in a market awash with liquidity and craving for yield. The exhibit also shows that credit spreads (dark-blue, left-hand scale) are still around historical lows.

Exhibit 1 Investor risk appetite at historical highs



We believe this complete absence of risk aversion and indiscriminate search for yield will end, and differentiating the good from the bad will become increasingly important. In the past year, growth stocks as well as many more leveraged and speculative stocks performed well in Japan and (Eastern) Europe. The liquidity flows coming into these markets are prone to chase performance, often disregarding historical valuation ranges. In these areas, we may see an increase in volatility as fundamentals often still have to catch up with market valuations. It means that selective stock-picking and thoughtful exposure management will be critical going forward. This calls for flexible investment mandates allowing investment managers to (opportunistically) focus on their area of specialty and employing the risk exposures that they see fit and thereby at times going against the prevailing trend. No surprise, this pretty much covers the definition of hedge funds as we use it.

US housing markets play a crucial role

One of the big themes on investors' minds these days is the potential weakness in the US housing market and the impact on the US consumer. Throughout 2005, it has been a happy marriage with strength from both sides reinforcing each other. The newly developed mortgage products whereby payment of interest and principal may be postponed in part or in full at the option of the borrower are playing a crucial role in extending home price appreciation and the resulting monetization of home equity by consumers. Without the stimulating effect of rising house prices, the US economy would actually have shrunk!

It is not just the consumer sector which has become ever more reliant on financing in recent decades. Historically, the US economy was focused on designing, manufacturing and selling finished goods and services. However, in recent years, the focus has shifted to financing this productive activity, which has moved to China and India. Two indicators: 1) US asset markets are 5 times the size of annual production of goods & services (stocks and bonds sum up to more than \$56 trillion, compared to \$12 trillion annual US GDP); and 2) the US has a 3 to 1 debt to sales ratio. So, credit is key.

The Fed targets asset prices, not inflation

Servicing debt to maintain asset values has become much more important to sustaining the economy than fine-tuning production growth and inflation. In addition, previous Fed Chairman Greenspan was well aware that US asset prices are a function of the cost of financing them. That's why his first priority has always been with the health of US capital markets. Will this change under Chairman Bernanke? Just read this selection of research titles Bernanke has (co-)published in recent years (or visit SSRN.com and actually read them if you're interested – I did it years ago and trust me, it is solid stuff):

- *“Monetary Policy Alternatives at the Zero Bound”* (on how central banks can use non-standard policy measures to target asset prices)
- *“Monetary Policy and Asset Price Volatility”* (need I say more?)
- *“Inside the Black Box: The Credit Channel of Monetary Policy Transmission”* (monetary transmission is about the way in which Fed policy percolates through to the real economy)
- *“What Explains the Stock Market's Reaction to Federal Reserve Policy”* (basically, he is wondering what we will do when he does what he thinks needs to be done)

Our point is, *this Fed chairman cares about the (stability of) prices of financial assets* which are not represented in the basket of goods of services for which CPI inflation is calculated. Therefore, save yourself some precious time in 2006 and don't even bother reading those research pieces about a 'neutral Fed Funds rate' linked to inflation, because Bernanke surely won't. The US economy's dependence on capital and debt financing has made this measure much less relevant.

So, what lies ahead?

- *Asset price volatility is likely to increase in 2006.* US annual interest charges are backed by home equity and capital market assets, rather than savings. Another way to express this: households' liabilities are increasingly fixed with the obligation to repay 100% at maturity, while assets are marked-to-market with potentially high volatilities. Should debt service burdens become strained, people will have to sell stocks, bonds and their homes. The resulting impact on financial wealth and debt service burdens can become self-fulfilling.
- *Investors globally have taken on more risk in recent years, but markets are getting nervous.* We believe the events in credit markets in April-May 2005, and the sharp sell-offs in (Eastern) European equities in October 2005 and in Japanese equities in January this year are clear indications that investors are getting nervous. The analogy to the game of musical chairs is clear: when the music stops, everybody is afraid to be left without one.
- *We are already seeing some of our hedge fund managers buy options without worrying too much about paying a premium.* Instead, they realize that being long an option in the tail (far out-of-the-money) eliminates the need to try and figure out what they don't know: where overall markets will go in the short term. In other words, there are many uncertainties but they may be easily hedged (especially in this environment of cheap implied volatility), allowing these managers to focus on opportunities.
- *Short-term politics, geopolitics, monetary intervention and fear-based capital flows may prove to be more important drivers of financial markets than underlying trade fundamentals in 2006.* This should favor opportunistic (hedge fund) trading strategies, such as global macro.
- *Long-only investors will have a hard time sitting still.* Due to regulatory issues, many institutional investors (notably pension funds) employ much shorter time horizons when evaluating their investments. In addition, the bear market of early 2000 and its impact on funding levels have made these investors more sensitive to investment losses. Their market behavior has the potential to magnify initial movements of financial asset prices.
- *Some leveraged investors will face problems with their funding gap:* the difference between liquidity of their underlying investments and the liquidity conditions they have given to the (mostly institutional) investors which have helped them grow to multi-billion dollar firms in recent years. Potential forced redemptions of these illiquid positions may further increase market volatility.

How to position oneself for rising volatility?

First we distinguish between being long and short volatility. *Risk sellers or carry traders* are short volatility: FX carry traders, emerging market investors (investments funded in developed markets' currencies), yield curve carry traders and credit and small cap investors are all collecting a premium for the (remote) risk that their investments may blow up. As such, they are short volatility: as market volatility increases, they will lose money (although the premium they receive will partly offset that loss). The opposite or counterpart of the risk seller is the *volatility buyer*. He is effectively paying a premium for the chance to make substantial gain if market volatility increases.

Many investors have made money in recent years selling volatility by buying a risky asset, funded with a non-risky asset (essentially, the carry trade, as described above). Many hedge funds are following the same strategy but are also employing leverage to further enhance return potential. Not surprisingly, most studies find that, on average, hedge funds are short volatility. Therefore, at Theta, with the objective of generating positive returns across *all* market environments, we have taken on the challenge to find hedge funds which are long volatility. This *long volatility* position may take various shapes:

- Long volatility with financial options (e.g. long the implicit call option in a convertible bond);
- Liquidity providing in some other sense;

- Substantial short and/or cash positions, which should allow funds to benefit from opportunities that will inevitably arise from severe dislocations in a changing market environment. In addition, we note that active risk management may at times call for the simplest tool available: cash.

We view the foregone return on the long side simply as a premium to be paid, in order to generate substantial gains or just be protected when the market turns and/or volatility increases. While some of our emerging markets debt and credit managers missed a large part of the rally in Q4 2005, we are comfortable that their conservative (and in current markets contrarian) stance will pay off in the more challenging market environment.

On a more general - and admittedly rather philosophical - note, in our portfolio construction and risk management we increasingly focus on what we don't know, rather than on what we know. This implies we are happy to pay a premium (in terms of foregone upside potential) to protect our investors from the adverse and unexpected.

Risks we see to hedge funds' performance

In light of the vast amount of institutional capital that is flowing into the hedge fund industry, we like to make a couple of comments. Due to regulatory developments, the investment horizons of many (institutional) investors have become shorter, and these requirements are also imposed on hedge funds. We see two main risks. First, shorter investment horizons induce momentum investing, thereby increasing market volatility. Second, as one decreases the holding period of a stock (forced by required liquidity conditions of the end investor), the unique developments of the underlying company will have a proportionally smaller impact on price developments and the added value of fundamental security analysis decreases. On a portfolio level, this increases the beta of the portfolio to overall market indices, and reduces alpha potential.

Another point is the mismatch of liquidity of many hedge funds' underlying positions versus required liquidity conditions of their (institutional) end investors. This mismatch becomes apparent in financial instruments, the concentrated positions that many hedge fund take, and the notion that a true 'value' idea often takes 2-3 years to work out.

Finally, we highlight the 'straight-jacket' of performance and risk measurement for traditional investments which is increasingly imposed on hedge funds. To successfully service their institutional client base, many hedge funds have turned to risk management models and tools used for traditional investments. *We believe this may reflect a misunderstanding of the true risks and dynamics of hedge funds' investment strategies.* For instance, many conventional risk models rely on historical Value-at-Risk calculations that do not properly account for the hidden optionalities which are present in many hedge fund strategies. For example, many leveraged credit arbitrage strategies generate steady income but may be short a blow-up option (default event, combined with lack of liquidity), which essentially makes past data unreliable. In addition, a problem with hedge funds is that the concept of *average* (in terms of an index or benchmark) is meaningless: there is no such thing as 'the typical hedge fund'. Once you believe you have captured the characteristics of a fund, the flexibility of the hedge fund manager to move beyond traditional boundaries and adapt a more fluid set of opportunities and risks makes the defined characteristics of limited use for the future. We believe the application of standard models of risk to hedge fund investing reflects a false perception of safety-in-numbers: there has to be a measure of risk, even if it reflects the fatal contradiction of not working when you need it.

As mentioned earlier, in our portfolio and risk management we increasingly focus on what we don't know, rather than on what we know. If you wish to learn more about our way of thinking, we urge you to read *The (Mis)Behavior of Markets* by Benoit Mandelbrot & Richard Hudson. That is, assuming you have already read *Fooled by Randomness* by Nicholas Nassim Taleb, who describes Mandelbrot's book as 'the deepest and most realistic finance book ever printed'. Try Amazon.com, or simply contact us and you can borrow my copy.

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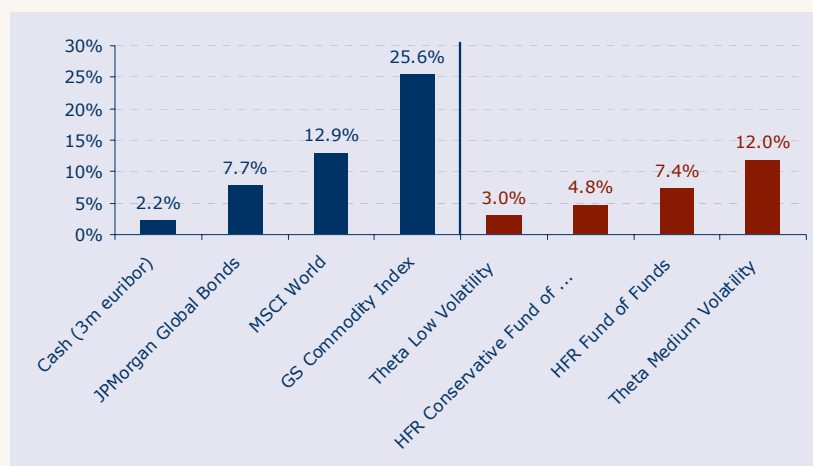
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2005 Market review

Exhibit 2 2005 returns by asset class



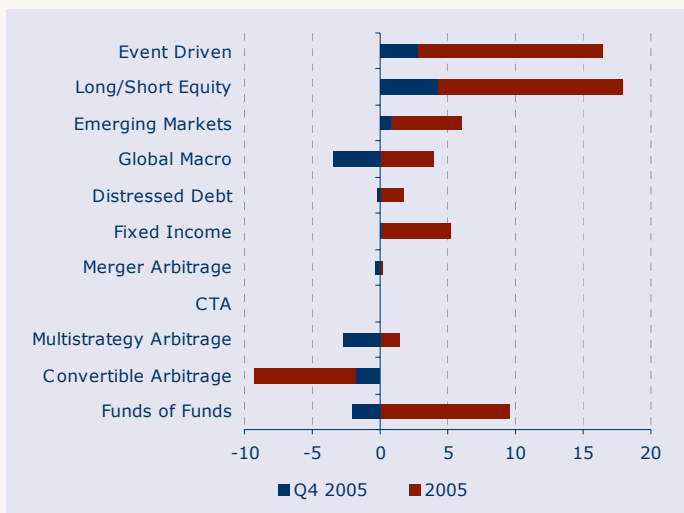
Conservative fund of funds outperformed cash by a margin, albeit less than most investors will have expected. The same is true for our Low Volatility portfolios, which were up close to 3%. We note that the difference between our Low Volatility portfolios and their benchmark (HFR Conservative Fund of Funds Index), is largely due to the fact that all our portfolios are fully hedged in EUR to movements in the US dollar and *the cost of this hedge is over 2% per annum*. Returns in arbitrage/relative value strategies have clearly come under pressure from asset flows. While hedge funds as a group underperformed global equities by about 3% (which is to be expected in strong equity markets – in providing downside protection, hedge funds will by definition miss part of the upside), the Theta Medium Volatility portfolios came very close with returns around +12% (in EUR after deducting about 2% of hedging costs) for the year, albeit with only half the volatility of equities. With this performance our Medium Volatility portfolios outperformed their benchmark, the HFR Fund of Funds Index, with a handsome +4.5%, and this ranks them consistently in the top 10% of multi-strategy fund of funds worldwide, according to *InvestHedge*, the leading industry newsletter.

Asset flows

Hedge funds experienced their first quarterly net outflow of capital in Q4 2005, led by multi-strategy and convertible arbitrage strategies which suffered from disappointing returns. Fund of funds also had a net outflow of more than USD 2 billion, although part of these outflows may be explained by institutional hedge fund investors moving into single hedge funds, after having gained more insight after working with their fund of fund managers in recent years. For the year 2005 as a whole, net new assets were USD 47 billion, bringing industry total assets to USD 1.1 trillion. The largest inflows were seen in event-driven and long-short equity strategies, followed by emerging markets and global macro. Fund of funds recorded a meager 3% growth in assets under management last year. In contrast, assets under management at Theta Capital grew by over 75% in the same period and we see healthy growth ahead. Increasingly, interest in our activities seems to come from (institutional) investors who realize that big is not always beautiful, and particularly not in hedge fund space.

Exhibit 3 2005 hedge fund asset flows

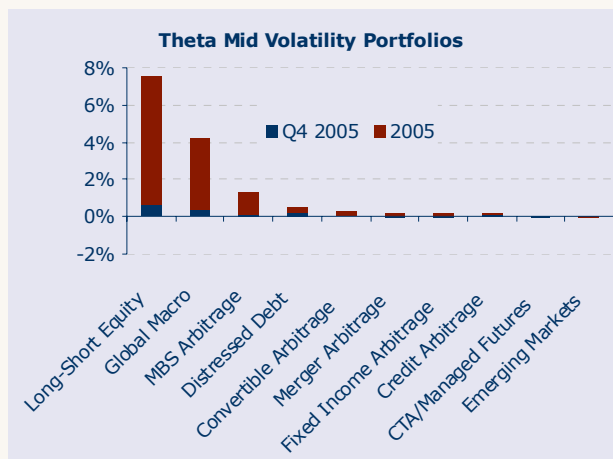
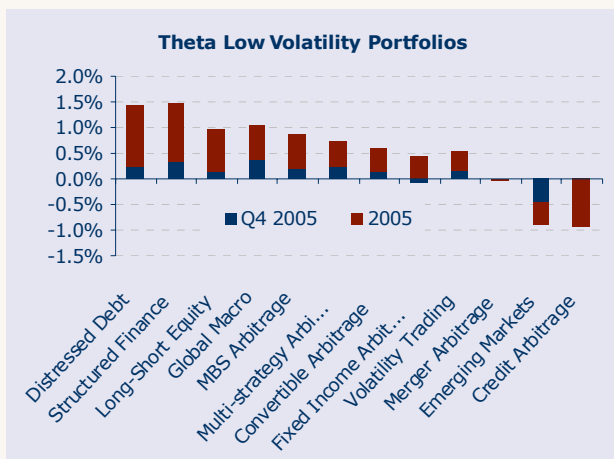
(USD billion)



Portfolio Review

Exhibit 4 2005 Performance Attribution of Theta Portfolios

(contribution to gross performance by strategy)

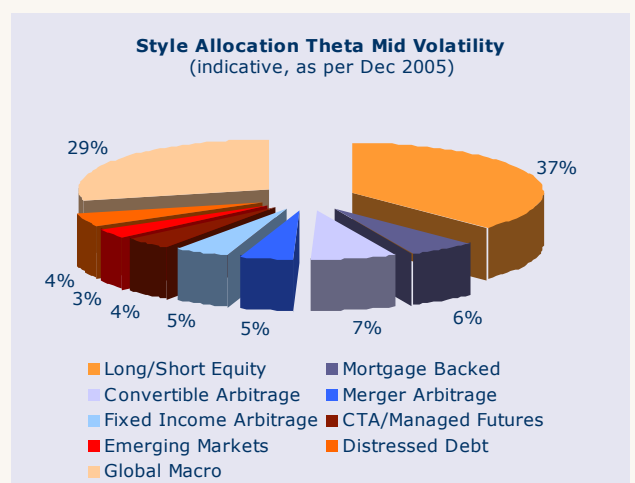
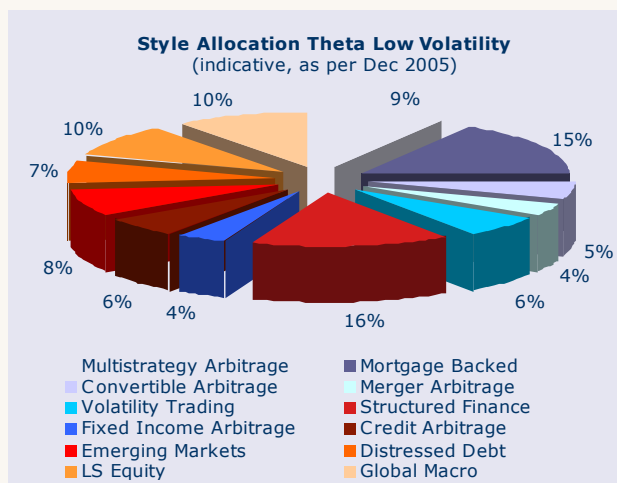


Looking at hedge fund performance in more detail, Exhibit 4 above on the previous page breaks down the 2005 returns of the Theta portfolios by strategy. It shows that the increased volatility in equity and credit markets provided a challenging market environment for convertible arbitrage, multi-strategy arbitrage and credit arbitrage strategies. In line with this, our **Low Volatility** portfolios returned a mere +3% for the year. Our low volatility portfolios have experienced relatively large losses from some credit managers and one large global macro manager. These funds were active in trades that have become very crowded or their asset size has made them almost 'too big too move'. Throughout 2005, we have made our portfolio less sensitive to event risks such as those of April and May last year by further reducing our exposure to convertible, credit and multi-strategy arbitrage managers and re-allocating to more opportunistic managers with complementary risk/return profiles. These directional and opportunistic strategies such as long/short equity, global macro and distressed debt already performed significantly better in the second half of 2005 but could only partly offset losses made earlier in credit strategies. October 2005 was a very challenging month as equity and bond markets experienced a joint sell-off in a time frame of just 1-2 weeks. However, our portfolios were not just hurt by market events, but also idiosyncratic events such as hurricane Katrina and the Refco fraud and subsequent bankruptcy. While the month was very challenging for our low volatility portfolios, the loss was well within our risk limits.

Another negative contributor was emerging markets debt. Two of our managers are very cautious with almost half of their portfolios in cash and various short positions. As the market continued to rally on global availability of liquidity rather than fundamentals in the second half of 2005, this provided a challenging environment for our managers. However, we note that this type of active (and in this case contrarian) management is exactly what hedge funds are all about, and we are happy to pay a premium (in terms of foregone upside potential) to protect our investors from the adverse and unexpected.

Following good experiences with one existing manager over a long period of time (actually, since we started Theta), we have made two new investments in the area of structured finance: these managers generate between +0.70% and +1.00% per month with very low volatility. Finally, our MBS arbitrage managers continued to perform very well, consistently contributing to the performance of our low volatility portfolios. However, we are now in the process of reducing exposure to US mortgage markets. The flat yield curve has already reduced the spread available from mortgage securities to zero for entities that borrow in excess of Libor, and mortgage-backed securities (MBS) hedge funds will follow soon. To counter this trend of diminishing returns, many MBS funds have moved down the credit and liquidity curves in recent years (essentially taking on more risk) and we believe the risk/reward profile of these strategies makes them less suitable for our low volatility portfolios.

Exhibit 5 Style allocation of Theta Portfolios



In line with global (ex-US) equity markets, the strongest performing strategy in our **Medium Volatility** portfolios in 2005 was long/short equity, generating about two thirds of total portfolio performance this year. Significant contributions came from (Eastern) European managers, although some of our US-focused funds also generated solid returns for the year. We believe our high allocation to the strategy (30%) is justified by the fact that overall volatilities of our medium volatility portfolios remain at the lower end of their target range of 5-7%.

A particularly challenging month for our portfolios was October 2005, when global equity market performance was very poor, led by emerging markets and European markets. As these markets had the best performance into September (partly driven by large inflows of capital and the arrival of many new participants), it makes sense to attribute the extreme selling pressure in October to profit-taking. In addition, as many small/mid cap and emerging market stocks do not allow for large volumes to be traded in a single day, this made things significantly worse. In a market driven by liquidity and profit taking and disregarding company fundamentals, one can expect long-term value driven equity managers (which we tend to hold in our medium volatility portfolios) to underperform.

As a group, global macro managers had a very strong contribution to the performance of our medium volatility portfolios performance of about +4% in 2005. Two of our managers in this strategy were up more than +50% while another posted a double-digit negative return. This divergence in returns reflects the fact that individual managers within this strategy are very lowly correlated between themselves and generate highly complementary risk/return profiles. This justifies a relatively large allocation to the strategy of almost 40% as per December 2005. As for the other strategies (which represent about 35% of our portfolio), performance was led by MBS arbitrage and distressed debt strategies. As the US distressed universe has become pretty crowded in recent years, we have recently added a distressed manager with a very strong presence in Europe (mostly Germany) and Japan.

To conclude, we are very satisfied with almost 12% performance for our Medium Volatility portfolios which outperformed their benchmark (HFR Fund of Funds Index) by more than 4.5%. Bearing in mind that, in the horrible equity year of 2002, these portfolio also made about 8%, we note that our funds generate solid positive returns across many market environments.

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