



THETA
CAPITAL MANAGEMENT B.V.

Theta Quarterly Review

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Second Quarter 2006

Theta Capital Management

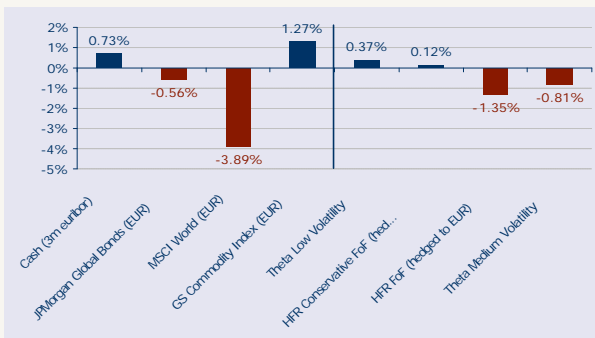
August 2006

1. Introduction

The second quarter of 2006 did indeed bring the volatility that was expected. After another strong month in April, sharp corrections took place in May and the first weeks of June. Exhibit 1 plots the returns across various asset classes.

Cash and commodities were the best performing classes, while equities gave away most of the built-up gains. The Theta Hedge Fund Portfolios did have a flat to slightly negative quarter, thereby outperforming their HFR reference indices.

Exhibit 1 Q2 2006 Returns Across Asset Classes



As can be concluded from these figures, hedge funds haven't as yet been able to fully profit from the volatility in the markets, although they clearly outperformed most other asset classes. The main problem for most hedge fund managers has been the lack of a trend in this turmoil which to a large extent was driven by inflation fears. While hedge funds are flexible in their mandate and can fully profit from downward movements, the whipsaw market volatility poses a difficult problem for them. Illustrative is the MSCI Emerging Markets index, which was down 12% by mid month June before finishing the month flat.

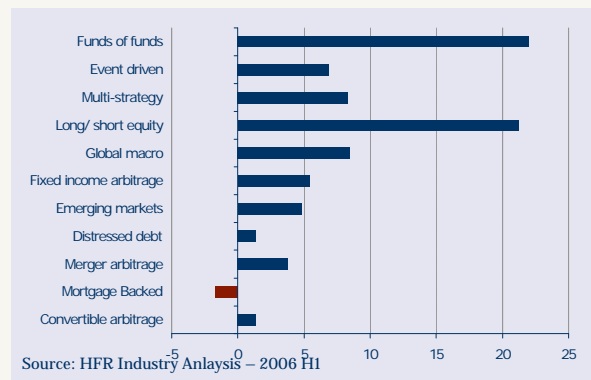
Asset flows

Total hedge fund assets have increased to over \$1.2 Trillion¹. As shown in exhibit 2 the first half year saw the biggest inflows in Fund of Funds and Long/Short equity. The only outflow was reported on Mortgage Backed Securities.

Theta agrees with the market that Mortgage Backed Securities, together with other strategies that are based on

a continuation of strong US consumer spending, are unattractive at this moment. We'll come back to this point later. Equity Long Short was the single strategy receiving the biggest inflows which can be explained by the fact that it was the strongest strategy in 2005 and investors are known for their performance chasing behavior. Funds of funds received a very substantial inflow as well.

Exhibit 2 H1 2006 Asset Flows by Strategy (USD bln)



2. Market Review

The second quarter of 2006 can be divided in three sub periods. First, there was the continuation of the liquidity driven bull market, which started in 2005. "Sell in May and go away" would have been a wise advice to equity investors. Much of the year-to-date gains on the stock markets were being washed away, most notably in those emerging markets that had seen the biggest gains. In June the inflation fear caused a further sell off mostly due to uncertainty about the FED's effectiveness in striking a balance between inflation control and economic activity. After FED Chairman 'Flip-Flop' Bernanke made some ambiguous statements, he later corrected these, bringing calmness back into the market and causing most equity indices to end June flattish.

That we *might* see more volatility, can be simply deducted from recent history with VIX-levels above 40 during periods in 2002 and an average VIX index level

¹ HFR Industry Analysis – Q2 - 2006

since 1990 of 19. Although there has been a large relative spike in volatility, the VIX index went from 11.59 to 16.44 in May alone (with intra-month levels up to 23.8 in June), the index was back at 13.08 at the end of June and therefore is still around its historical low.

Looking forward one of the possible triggers for volatility to pick up substantially would be a hard landing of the US housing market.

One of the key concerns in this market is the sub prime mortgage market that has seen a tremendous growth in recent years. By far most of these mortgages (>80%) are so-called Adjustable Rate Mortgages (ARMs) that after 2 or 3 years reset from a relatively low fixed rate to some fixed spread over LIBOR. LIBOR climbed in this period from 1% to 5.25%.

Consider the following, unfortunately typical, example: In the extreme low interest rate environment in the US, with Fed rates at 1%, people with an income of gross USD 50.000 could take out mortgages with a debt to income ratio of 40%. With a net income of approximately USD 33.000 they were left over with a disposable income of USD 13.000. By far most of these mortgages are resetting after 2 or 3 years to a floating rate of on average LIBOR + 600bps. That is an increase of over 40% on their original costs, leaving them with virtually zero disposable income!

Pretty obviously, this will cause increasing delinquencies and foreclosures to follow. More so, considering that house price appreciation (HPA) has come off a peak since August 2005, and is expected to turn negative somewhere at the end of this year.

One of our observations pointing to potential distress in this space is that the last months have seen the emergence and ramping up of hedge funds dedicated to the short side of this sector trade. Shorting is very cheap at this stage with only few sellers and many more buyers,

and spreads being at their historic lows. The upside is much more compelling and can serve as a hedge to other parts of the portfolio that may suffer from a hard landing in this market.

Extrapolating House Price Appreciation numbers into the future, it can be expected that the first resets of ARMs that have seen negative year on year HPA will take place late 2007. Due to its clear event timeline, this is probably one of the most compelling trades in credit space. We do believe that it might only be the beginning of a much bigger credit bubble that could potentially compare to the 2000 bubble in Internet stocks.

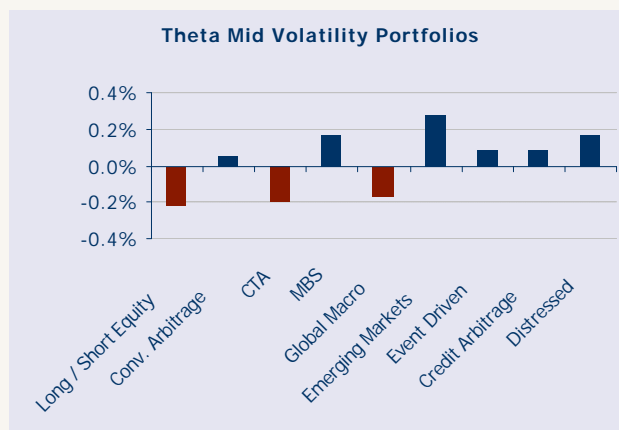
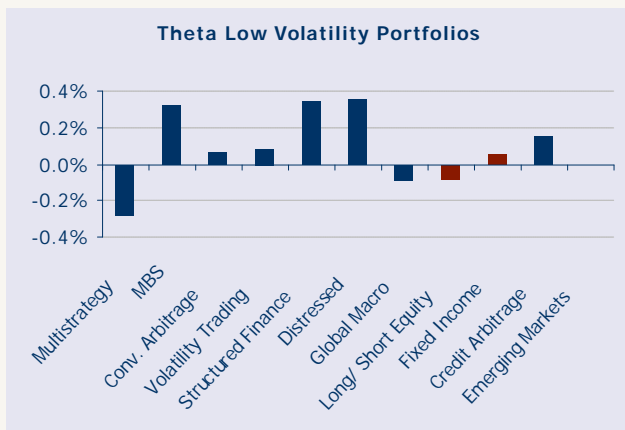
As most of the players in this sector are predominantly long only, Theta has already in late 2005 taken steps to reduce its exposure in the sector and to actively look for names that are in the position to profit from a potential downturn. Researching these themes and positioning the portfolios in such way as to be protected or even able to profit from it, is part of Theta's portfolio construction process. Although we are bottom up investors and don't consider it our job to make any predictions in terms of expected financial distress, we feel our task does include avoiding sectors where the odds are increasingly against us.

3. Portfolio Review

After a strong first quarter, it proved to be much more difficult to make money in the second quarter of the year. Theta Multistar Medium Volatility Fund lost 0.81% over the last three months, bringing the YTD return to a still respectable 5.22%. Theta Multistar Low Volatility Fund gained 0.37% in the second quarter, bringing the YTD return to 4.03%.

Looking at hedge fund performance in more detail, Exhibit 3 breaks down the Q2 2006 returns of the Theta portfolios by strategy.

Exhibit 3 Q2 2005 Performance Attribution of Theta Portfolios
(contribution to gross performance by strategy)



For both portfolios all strategy contributions have been rather muted over the second quarter, even for those categories that saw a lot of turmoil in underlying markets. Clearly, this can be explained by the fact that April and May more or less cancelled each other out and June was flattish.

Overall, equity long short contributed negatively, albeit modestly so when compared to underlying markets. We have been disappointed in the CTA exposure for our medium volatility products, on an unweighted basis being the biggest negative contributor to the portfolio. CTA's apply trend following strategies over different asset classes and are generally conceived as being a very good diversifier to a portfolio of hedge funds. This proved not true, at least during this quarter, adding to Theta's concern that trend following might be a strategy of the past, with too much money applying the same rules.

Distressed securities delivered a good attribution in the quarter. One reason was that the high yield asset class was unharmed by the sell down of equities in May. It proves that the managers we have selected in this strategy stuck to their guns and haven't drifted into equities during the bull run. We know many of their peers have, and those have been punished in May and June. Distressed securities are not in abundance at these times with historical low default rates. This did not cause a problem for the relatively small and nimble players we have selected and who still find many opportunities.

Global Macro produced mixed results ending slightly negative over the month. There has been quite some long equity exposure, not the least in emerging markets, in this category that has been built up in 2005. As the figures show they have given back part of those gains. Mortgage backed securities have still performed (you know our vision on this market), and so has the structured finance category, volatility arbitrage and credit and convertible arbitrage. Low correlation and steady positive returns is what we expect from these strategies and that is what they delivered.

In terms of changes to the portfolios we have continued reducing our exposures to the US consumer lending sector. Also, we have redeemed a number of holdings that either had become insignificantly small, or whose strategy- or organizational directions reduced our conviction. These redemptions enabled us to add to existing high conviction names and to some new funds we have been identifying and studying over the last number of months. We feel these changes have further strengthened the portfolios and that we are positioned for a strong second half year.

More specifically, we feel reasonably protected to the US housing risk as we have taken out the long exposure. Also many of our underlying managers have direct or indirect trades on their books that are positioned to profit from a correction. This stretches from shorting the synthetic indices of Mortgage Backed Securities to shorting homebuilders or otherwise related businesses

to shorting the debt of investment banks that are in a tricky situation being the counterparty of huge amounts of related derivative contracts.

4. Theta Deep Value Fund

At July 1st, Theta Capital Management successfully launched the Theta Deep Value Fund. The initial round of seed capital raising resulted in approximately Euro 40mm of capital, and did surpass our target of EUR 25mm. This concentrated fund of hedge funds will for a large part invest in hedge fund strategies that invest in longer term and less liquid situations. Consequently these funds have longer term lock-up and less frequent redemption possibilities. These strategies don't fit the liquidity terms of our existing funds of funds. To facilitate investments in these funds, the Theta Deep Value Fund requires a two year lock-up from its investors and offers quarterly redemption afterwards.

We believe there is a premium to be captured from ill-liquidity and therefore the fund will aim to achieve higher returns than any of our other products with less regard to inter-month volatility. Independent research company EurekaHedge found that longer lock-up times for hedge funds lead to significantly higher returns. In the period 2003-2006 they found that funds with one-year lock-ups returned on average annualized returns of 30% while those with a one-month redemption period had returns of about half that percentage.

The Theta Deep Value Fund will be marketed on a wider basis after the summer break with the possibility to subscribe on October 1st or January 1st 2007. Afterwards it will essentially be closed for further subscriptions.

Would you be interested in learning more about this new fund and/or receiving the information memorandum don't hesitate to contact us. Full contact details are given below.

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