

Theta Quarterly Review

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Theta Capital Management

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1. Introduction

Going into 2005, there was still a strong sense of risk appetite in global financial markets despite little visibility about the next trend in equities. Furthermore, the consensus seemed to be that we were at an inflection point in credit spreads (a fairly good indicator for risk aversion) and they could only move wider from here. The second quarter of 2005 started with severe dislocations across a range of financial markets worldwide to which hedge funds proved not to be immune. We believe the events in March, April and May reflected a general re-pricing of risk across asset classes, the occurrence of which was widely anticipated but its timing still unexpected. It is this general re-pricing of risk that causes many (under normal market circumstances) unrelated positions and strategies to behave in a very similar way in times of market stress. In other words: when things turn bad, all correlations jump to one.

Assessing the impact of these dislocations in financial markets on hedge funds' performance, we note that drawdowns have been most fierce in sectors of the credit market where trades have become very crowded and for funds whose asset size has made them almost 'too big too move'¹. At Theta we believe that the best way to deal with this environment is to continue to focus on relatively small and nimble hedge funds which are flexible enough to adjust their portfolio to a changing market environment.

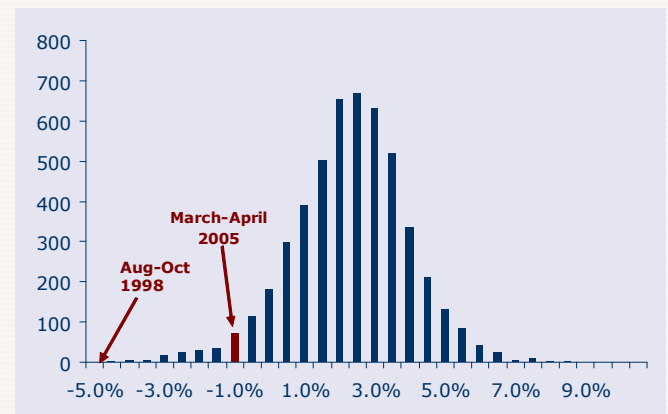
Furthermore, the strategies that are most sensitive to a shift in correlations are relative value or arbitrage strategies whose success depends in part on the stability of the correlation between longs and shorts. However, during periods of extreme market dislocations, correlations tend to deviate from historical patterns, thereby drastically reducing the quality of arbitrageurs' hedges. This problem is particularly acute for low volatility hedge fund portfolios since these tend to hold a large portion of relative value hedge funds. Our solution to this problem has been to diversify towards more directional investment strategies such as long/short equity and global macro where individual managers within a particular strategy

¹ For an extensive discussion of the recent volatility in financial market and its impact on hedge fund returns, please see our *Theta Research Note #2*, available at www.thetacapital.com

have more complementary risk/return profiles (i.e. are lower correlated). In addition, these strategies can provide a 'natural hedge': managers are able to profit by shorting the assets that sell off in a straight line.

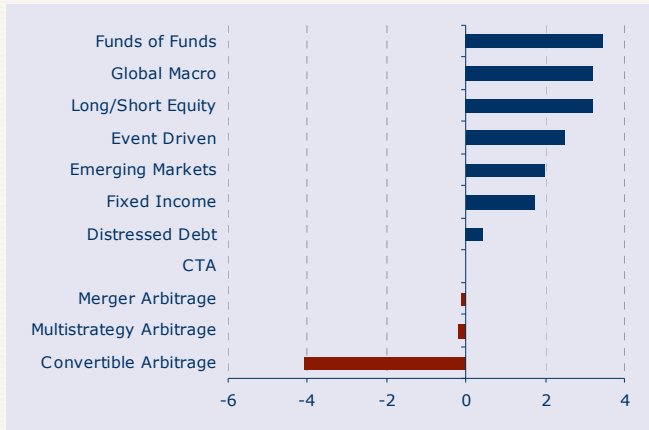
While hedge funds' returns have indeed been disappointing to many, the historical context we provide shows that we are nowhere near the most challenging period since hedge funds' inception: the fall of 1998 (see Exhibit 1 which plots the quarterly returns of the HFR Conservative Fund of Funds Index since 1990, the benchmark for our low volatility portfolios).

Exhibit 1 HFR Conservative Fund of Funds Index
(Quarterly return distribution since 1990)



Hedge funds continued to see inflows of assets in the second quarter, albeit at a much more moderate pace than before. Following the dismal performance, convertible arbitrage strategies continued to experience substantial net outflows (HFR estimates outflows to be close to USD 10 billion since the start of the year, see Exhibit 2). Other arbitrage strategies (including multi-strategy arbitrage which until recently was very popular with institutional investors) also have a hard time raising assets. As investors become increasingly convinced that most market inefficiencies may have been 'arbitraged away', they reallocate their investments towards more directional and opportunistic strategies such as long/short equity, global macro and event driven and emerging markets. Interestingly, a recent investor survey by Deutsche Bank indicates that close to 60% of investors plans to increase their exposure to these strategies, partly based on performance predictions. Also, 45% of investors indicate they will further reduce allocations to convertible arbitrage hedge funds.

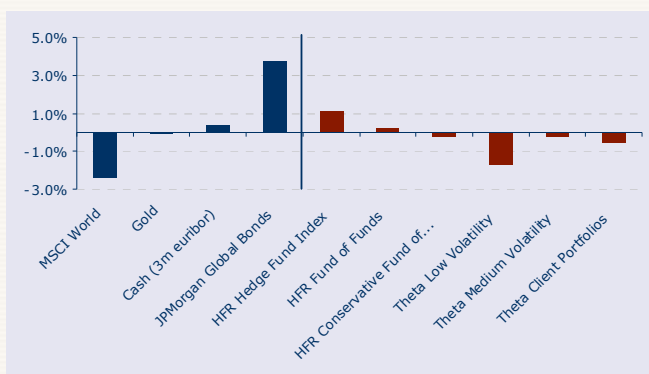
Exhibit 2 Q2 2005 Asset Flows by Strategy
(USD bln)



2. Market Review

Exhibit 3 plots the returns across various asset classes. Bonds and commodities were the best performing classes, as interest rates fell across the board and oil prices continued its uptrend with another increase of 10% in the second quarter. Equities, credits and hedge funds as a group struggled to deliver positive returns. Unfortunately, for the first time since inception, the Theta portfolios underperformed their respective fund of funds benchmarks.

Exhibit 3 Q2 2005 Returns Across Asset Classes



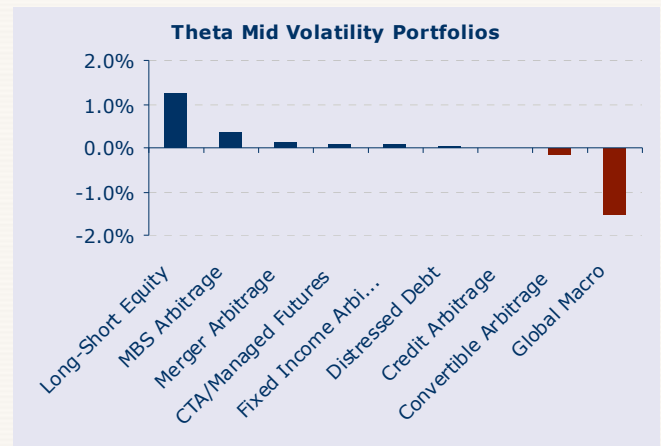
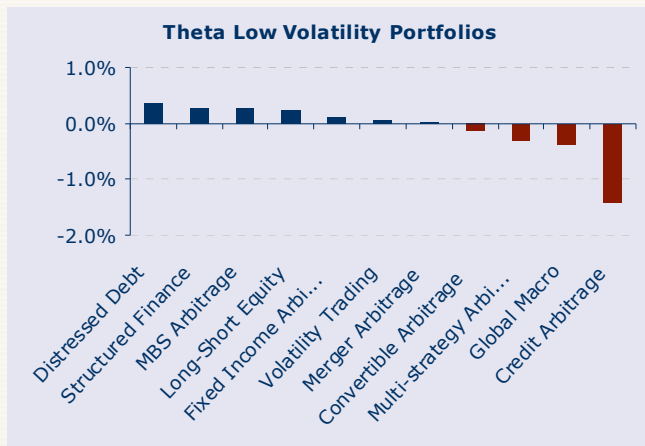
3. Portfolio Review

Looking at hedge fund performance in more detail, Exhibit 4 on the following page breaks down the Q2 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 -1.69% in the second quarter. By way of comparison, the fund’s benchmark, the HFRI Conservative Fund of Funds Index, was down -0.21%. Our low volatility portfolios have experienced relatively large losses from some credit managers and one large global macro manager. As noted above, these funds were active in trades that have become very crowded or their asset size has made them almost ‘too big too move’. During the severe credit market dislocations in April and May correlations started to deviate from their historical patterns, which resulted in substantial losses. However, for 2005 our low volatility portfolio are still in line with their objective of capital preservation in difficult market environments.

Going forward, we will continue to make our portfolio less sensitive to event risks such as those of April and May 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 and distressed debt already performed significantly better in the second quarter but could only partly offset the losses in arbitrage strategies. In addition, after good experiences with one existing manager, we have made two new investments in the area of structured finance: these managers between +0.70% and +1.00% per month with very low volatility. Finally, our MBS arbitrage managers continue to perform very well, consistently contributing to the performance of our low volatility portfolios.

Exhibit 4 Q2 2005 Performance Attribution of Theta Portfolios
(contribution to gross performance by strategy)



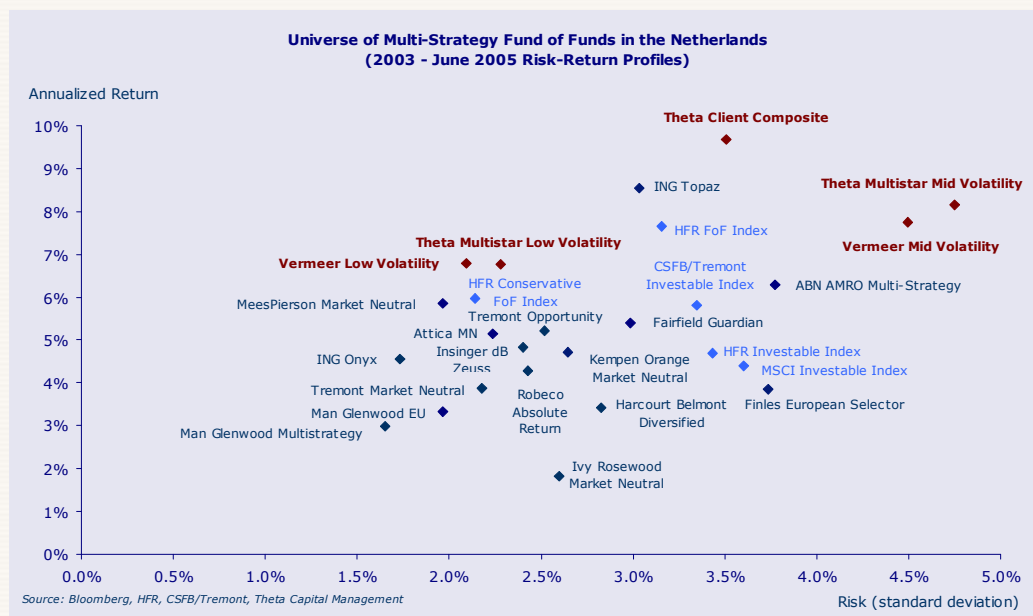
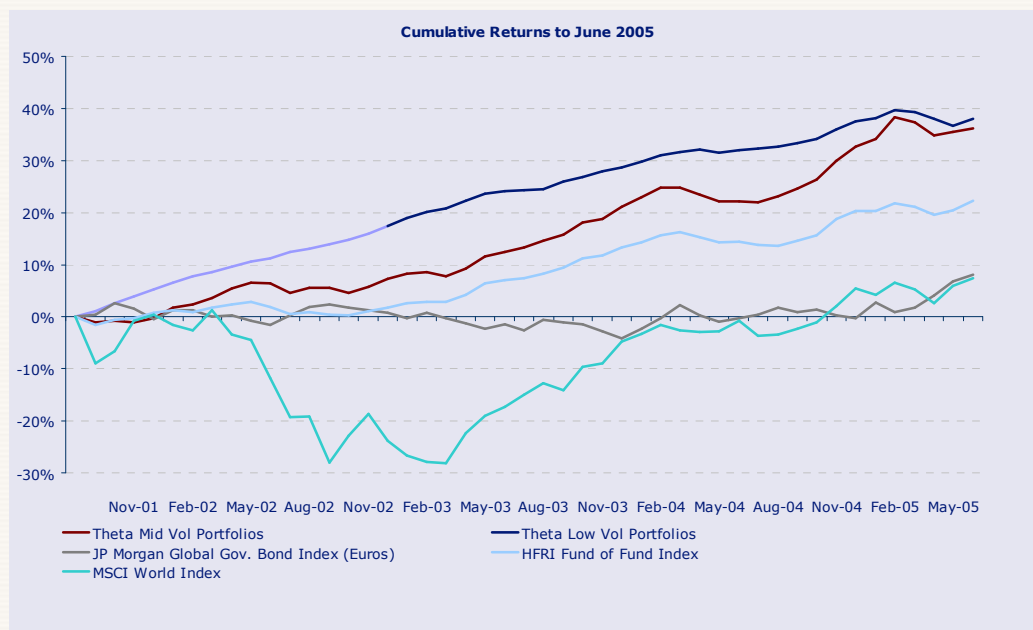
Our **Medium Volatility** portfolios also had a challenging quarter with significant performance differences across the various strategies. They lost about -0.20% in the second quarter, compared to a small gain of +0.20% for their benchmark, the HFR Fund of Fund Index. Interestingly, even with equity markets down on the quarter (MSCI World -2.5% and S&P 500 -1%), our long/short equity managers generated +1.25%, outperforming their peers (as represented by the HFR Long/Short Equity Index) by almost 1%. In April, equity markets proved particularly difficult for long biased value investors who are active in small cap equities. On the back of the negative credit environment, small caps across the board lost value such that stock selection did not offer protection. During the broad-based equity market rally in May and the largely flat market in June, all equity managers showed decent returns, led by our European small cap manager who generated +6.5% in June.

The second quarter of 2005 was particularly challenging for some of our global macro managers, although the performance picture was very mixed. Trends in currencies and interest rates reversed in April, creating a treacherous environment for global macro managers and CTA's. Several managers who were short the dollar experienced losses as the dollar strengthened. While

most managers were positive in May, generating gains of up to +6%, two managers incurred substantial losses as the market went against them. One fixed income manager had a short position in US Treasury bonds and lost almost 10% as the market continued to rally on weak economic reports. When the fund lost an additional 11.5% in June, it had to reduce its risk budget under its risk management guidelines. This limits the upward return potential, which is why we decided to redeem the fund from our portfolio. As a group, global macro managers had a negative contribution to the performance of our medium volatility portfolios performance of -1.5% 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 generate highly complementary risk/return profiles.

Despite the disappointing performance this quarter, our medium volatility portfolios are still up almost to +4% for 2005. With this, they consistently rank in the top 10 of multi-strategy fund of funds worldwide, according to the July 2005 issue of *InvestHedge*, a leading industry newsletter. Furthermore, we believe that our portfolios are well positioned to deal with any type of market environment going forward.

Exhibit 5 Performance Theta Portfolios Q2 2005



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