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Theta Quarterly Review

Outlook 2007 & Recap 2006

How to navigate complacent markets

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Theta Capital Management

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Company review

2006 has been a satisfying year for Theta Capital. We have continued to grow our business in terms of people, processes, infrastructure and assets under management. As for the latter, we currently manage around EUR 0.5 billion, across a wide range of funds of hedge funds and customized portfolios. Recognizing that quality of people is crucial to a business such as ours, we have hired three senior investment professionals: Thomas Heidstra and Marco Smelter have strengthened our team with significant expertise in equity markets and emerging markets. In addition, Mark Vandertoorn joined us as head of Operations, being responsible for all fund administration, valuation, and reporting activities. Mark also has prime responsibility for operational due diligence on underlying hedge funds, an important element of our fund selection process. Finally, in the last quarter of 2006, we were joined by Mrs. Amy Wang for operations support and shareholder services and Mrs. Pilar Gonzalez for marketing support and client services.

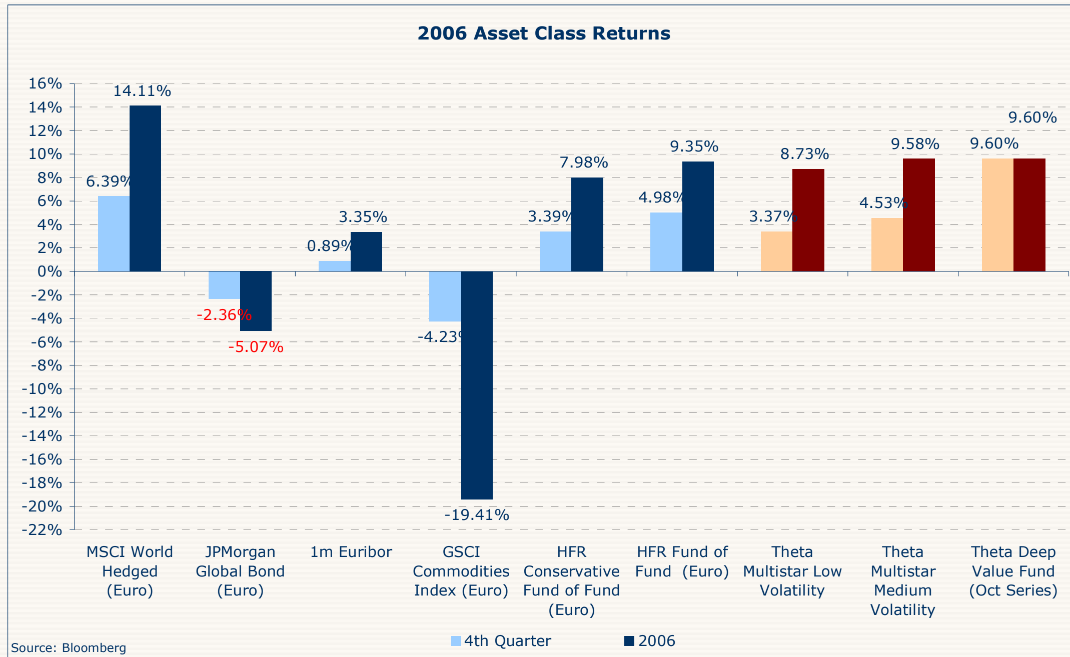
On the infrastructure side, we have made significant investments in three software applications supporting our investment process. The systems are: a hedge fund monitoring database for efficient contact management; a sophisticated tool for quantitative fund screening and peer group analysis; and a web-based portfolio management and administration system which will replace our current administrative system. We believe the fact that Theta was the first user in continental Europe for two out of three of these systems, illustrates our commitment to building an innovative investment platform of institutional quality. Now that new staff and systems have been integrated into our investment process, we will lay down this process in an updated investment manual. If you wish to obtain a copy of this document as it becomes available, please send us an email.

In 2007, we will further enhance our portfolio construction and risk management process and intend to leverage off our technology platform to expand our offering in customized portfolios of hedge funds for larger clients. This offering will include: customized portfolio construction based on specific client requirements, enhanced risk reporting, knowledge transfer and information sharing about individual hedge funds, and web-based reporting within a secure client environment. Should you wish to learn more about the service level and terms of this offering, please contact us.

Investment review

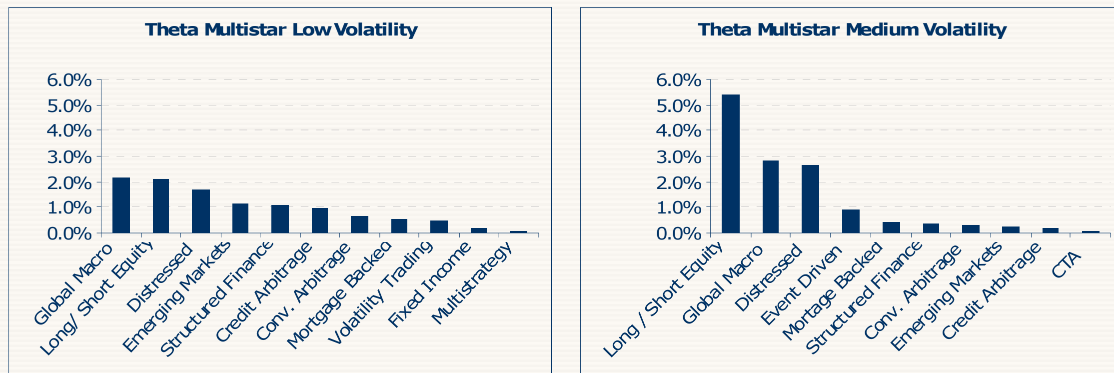
2006 was a rewarding year for Theta on the investment side. On the macro front, emerging markets economies largely went from strength to strength during the year. With the US external deficit showing no sings of abating, the curious situation of developing countries emerging as major capital providers to the developed world grew more pronounced. We believe that the secular case for growth in emerging markets strengthened even further during 2006. In line with this, we maintain our allocations to emerging markets hedge funds, both in equity and debt capital markets. However, being aware of high valuations in the large cap segments of emerging markets, we limit ourselves to investing with smaller hedge funds which are nimble and flexible enough to adjust to a more adverse market environment. 2006 proved to be another strong year for equities, albeit with significant intermediate volatility. After a very strong first three months for risky assets across the globe, the second quarter did indeed bring the volatility in (emerging) equity markets that was expected. Throughout the summer, commodity markets took over with significant price fluctuations in oil, natural gas and copper. For example, oil prices ended the year flat after having fallen 20% and subsequently recovered by the same amount. Eventually, the last quarter of 2006 ‘saved the day’ for many investors with (emerging) equity markets posting a strong rally. Worldwide equities ended the year up +14% (in EUR, please see Exhibit 1 below).

Exhibit 1 2006 Asset class returns (in EUR)



In light of this sometimes dramatic volatility of returns in various asset classes, we are very satisfied with the stable performance of our Low Volatility and Medium Volatility portfolios, all the while maintaining defensive positioning and low sensitivity to equity and bond markets. As a result, our Theta Multistar Low Volatility and Theta Multistar Medium Volatility outperformed their respective benchmarks by a handsome margin. Despite our conservative positioning, performance of both products is well above their target annual returns of Euribor+2% and Euribor+5%, respectively. Finally, our new Theta Deep Value Fund proved its upward potential, generating a return of almost 10% in its first three months of full investment.

Exhibit 2 2006 Gross performance attribution Theta Multistar portfolios



Looking at hedge fund performance in more detail, Exhibit 2 above breaks down the 2006 returns of the Theta portfolios by strategy. Here is how to read the charts: of the total performance of Theta Multistar Low Volatility, more than 2% came from our global macro managers.

As described in earlier reviews, starting in 2005, we have made our **Theta Multistar Low Volatility** portfolio less sensitive to event risks 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. In effect, our portfolio is much more diversified by strategy and manager and we believe our conservative approach has paid off. The directional and opportunistic strategies where we increased exposure such as long/short equity, global macro and distressed debt, helped limit the portfolio loss to a mere -0.7% in the difficult months of May and June and subsequently made significant contributions to this year's strong performance of +8.73% for Theta Multistar Low Volatility.

For **Theta Multistar Medium Volatility**, almost 80% of 2006 returns came from long/short equity, global macro and distressed debt strategies, which is reflective of our allocation to these strategies. Throughout the year we have increased our exposure to distressed and event-driven strategies, particularly in managers focusing on Europe. We believe Europe's segmented markets provide many opportunities for hedge funds focusing on special situations (M&A, corporate restructurings, spin-offs etc.), sometimes with an activist approach. As explained below, Theta Multistar Medium Volatility is positioned rather conservatively in emerging markets debt and equity and (structured) credit. While this position has cost us some upside in the second half of 2006 when these markets continued to rally on liquidity rather than fundamentals, we are happy to 'pay this premium' to protect our investors from the adverse and unexpected.

Theta Deep Value Fund had a very strong performance of +9.6% in the fourth quarter (its first three months of full investment), bringing the year-to-date performance since July 2006 to +8.83%. In October, two activist managers with highly concentrated portfolios accounted for most of the performance. In the last two months of 2006 emerging markets and event-driven strategies took the lead, but all other strategies also delivered a positive performance. Interestingly, December closed the year on a very strong note with a performance of +4.19%, partly driven by substantial gains on our short position in the US sub-prime mortgage market. Following the January opening, the Theta Deep Value fund has EUR 62 million under management. Although the fund will essentially be closed for new investors, we will each quarter make an assessment as to the capacity available with the underlying funds. Based on that information we will decide the amount of new money, if any, the Theta Deep Value fund can absorb during that quarter. We therefore suggest that interested investors contact us.

Our thoughts and strategic positioning for 2007

Looking ahead, we see two themes which could translate into interesting opportunities for hedge funds with the right focus, flexibility and skill set: 1) developments in the US mortgage market and 2) the global glut of liquidity which continues to boost LBO/private equity activity.

US mortgage markets

Mortgage market developments have recently taken centre stage in the US financial markets. Mortgage credit quality is deteriorating because of recently created aggressive mortgage structures, falling house prices, and lax recent underwriting standards. For instance, we are already witnessing rising mortgage delinquencies and foreclosures, now matching the peak level seen at the tail end of the 2001 recession.

FirstAmerican Real Estate Solutions estimates that about USD 290 billion of subprime mortgage loans originated in 2004 and 2005 will default over the next few years: *this would almost double the overall foreclosure rate in the US mortgage market!* In addition, there are increasing signs of distress among subprime mortgage lenders. A large number of subprime mortgage lenders have filed for bankruptcy, exited the mortgage business, or significantly increased their loan-loss provisions (HSBC, one of the largest banks in the world, issued its first ever profit warning and set aside an additional 20% for loan-loss provisions).

So what lies behind these developments?

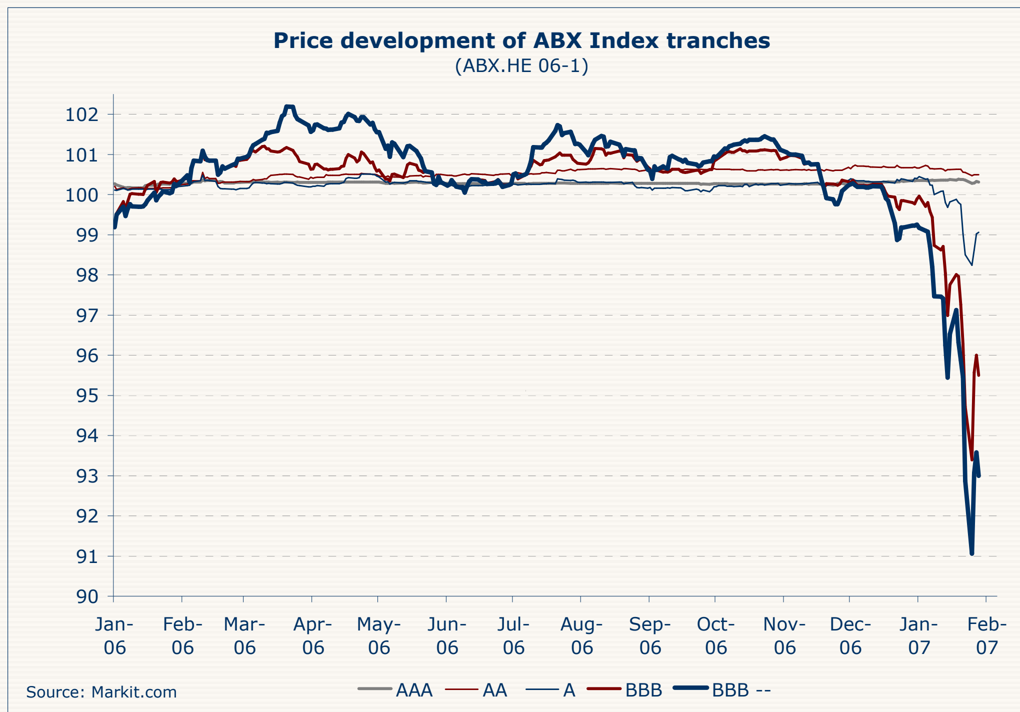
1. Resets of adjustable rate mortgages (ARM's). After an introductory period of 2-3 years, ARM's reset to a higher level (in many cases double or more the introductory or 'teaser' rate, leading to a sudden increase of monthly interest payments) unless the mortgage is refinanced;
2. Lower house prices. Although it is not (yet) a country-wide phenomenon, house prices have begun to fall in many parts of the country. In many cases (especially the more recently originated mortgage loans) borrowers have much less equity – and in some cases negative equity – to allow for refinancing of their mortgage loan;
3. Lax underwriting standards in recent years. Refinancing activity fell sharply after 17 interest rate hikes by the Fed and in order to keep their origination volumes high, mortgage lenders have continued to lower their credit standards during the housing boom of 2005-2006 and this has even triggered fraudulent activity in the mortgage market.

How have we positioned our portfolios for these developments?
The opportunities for hedge funds in the mortgage sector present themselves in two ways:

1. **Short positions** in mortgage-backed securities characterized by a high portion of ARM's in the underlying pool, recent issue vintages (less home equity) and weak underwriting standards of the servicer. As defaults in the underlying pool materialize, ratings of MBS paper are downgraded or the market simply starts to worry about potential losses. As a result, these short positions will generate interesting returns;
2. **Long positions** after distress in mortgage market has actually occurred. It will throw off a very large pool of opportunities for funds with the proper skill set and the availability of capital: they will be the buyers from the forced sellers as soon as either rating changes start to happen or defaults kick in (or both). We note that close to 70% of home mortgage originations in 2005 were securitized, which means that the risk has been transferred from the originating banks to institutional investors, mostly pension funds and insurance companies craving for yield. Some of these investors will become forced sellers as the ratings on the MBS they hold will be downgraded to levels below which they are allowed to hold them, price volatility will increase and actual loan defaults rise.

As described in earlier communications, we believed that problems in the US housing market could translate into very interesting investment opportunities for hedge funds with the right focus, flexibility, skill set and infrastructure. Therefore, in the second half of 2006, we initiated positions in hedge funds with significant short positions in mortgage-backed securities (MBS) collateralized by pools of sub-prime mortgages. In effect, these funds will gain if losses in the underlying mortgage pools exceed 5% (defaults are even expected with house prices **appreciating** by 3% per year or less). Interestingly, according to a seasoned MBS investor, there are already deals in the market, originated in June 2006 (with virtually no equity to allow for refinancing of the underlying mortgage loans), with a default rate on the underlying mortgage pool of 8%!

Exhibit 3 Price development of US sub-prime mortage-backed securities



These factors have combined in to significantly lower prices of sub-prime MBS transactions, with BBB-rated assets having dropped almost 10% in price since the start of 2007 (see Exhibit 3 above). Perhaps more importantly, we are seeing significant 'tiering' in credit spreads with the "bad" names now trading 100-150 bps wider than "good" names, whereas the difference between the "bad" and "good" would have been just 10-20 bps a year ago. Delinquencies spiked dramatically in the late summer and fall of 2006, precisely when a large contingent of hedge funds entered the market on the short side. The result was a massive tiering in spreads. *This increased focus on separating the good from the bad mortgage-backed transactions will provide many interesting opportunities for hedge funds with the right focus, flexibility, skill set and infrastructure. We believe to have chosen to work with the right managers in this area.*

The LBO cycle

Notwithstanding recent weakness in the US sub-prime mortgage market, the global credit market appears in pretty good health with few signs that capacity constraints are being reached in the short term. That being said, we just hope to be on the right bus and not miss the transfer if one is necessary. You cannot argue with the price charts being impressive but we would not want to be stuck on an island with no access to the outside world. One potential source of risk is the current state of the LBO cycle, which is currently in full swing. A sudden reversal of fortune in this market could have serious implications for other financial markets, especially credit markets since bank loans are increasingly used as a source of financing.

The world is currently undergoing a boom in leveraged buyouts reminiscent of the late 1980s. Deal volumes have easily overtaken levels of the 1989 peak and the financial press is full of stories about strong investment flows into buyout and other private equity funds. However, it seems that activity is set to remain strong as long as corporate profitability is high, PE multiples are modest, the real cost of debt is low, and the risk appetite remains to buy the debt. With margins high and corporate balance sheets underleveraged across the board, the average company is a viable LBO target. We note that this takeover risk poses a serious problem for hedge funds who are trying to short overvalued companies, as takeovers or buyouts tend to happen at a premium of on average 20-30%!

The main limiting factor to continuation of the buyout boom may be the availability of credit. With equity representing around 30% of an LBO's balance sheet, the more than USD 500billion of buyouts forecasted for 2007 suggests the need for an additional USD 2 trillion in debt, and thus the need for continued benign conditions in credit markets[1]. A recent UBS study concludes that, while LBO activity levels are historically high and even accelerating, activity relative to market capitalization, premiums paid and gearing levels are low when comparing to conditions in the 1980s[2]. According to UBS, there is little evidence that the buyout boom has fundamentally over-extended but the warning signs that investors should look for are:

- A pick-up in valuations or control premiums paid;
- A general decline in deal quality, causing the banks to tighten credit terms;
- A high-profile credit default or business failure.

However, we note that leverage ratios (debt/EBITDA) in European LBO's are already on the rise and loan covenants are being loosened driven by investors' seemingly indiscriminate search for yield. In 1989, it was the banks unwillingness to finance the acquisition of United Airlines that called an end to the boom, shortly after KKR paid a handsome 100% control premium for RJR Nabisco. By 1993, 30% of LBO deals originated after 1985 had defaulted on their debt, 20% were bankrupt and the high yield market was effectively closed for business.

Risk is now more widespread, as banks have transferred risk on leveraged loans to other market participant such as leveraged loan funds, high yield investors and hedge funds (about 70% of loans underwritten by banks are sold to institutional investors). We note that, in the face of possible investor redemptions, investment funds are much more sensitive to price volatility on their loan portfolios. In contrast, banks tend not to mark-to-market their loan books (and certainly not in the 1980s). The failed LBO of United Airlines in 1989 shows that the virtuous cycle can quickly become vicious as lenders reach capacity constraints, credit conditions worsen and confidence fades away. Since that is exactly the type of environment which provides ample opportunities for distressed debt hedge funds, we have positioned part of our portfolios to benefit from such an event (as explained below).

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[1] See "Buy-Outs are forecast to raise USD 500 bln", Financial Times (26 January 2007)

2 "Barbarians at the Gate Again", UBS Investment Research (12 February 2007)

In light of our view on risky assets, how have we positioned our portfolios?

As for credit, we continue to remain constructive overall, but believe that the “tail” portion of the market (second liens, B and CCC-rated assets and specifically LBO transactions) will lead to ratings instability, higher than expected realized defaults and potentially interesting investment opportunities for distressed buyers towards the end of 2007 and early 2008.

Indeed, we have positioned our portfolios more conservatively in recent months. In particular, we:

1. reduced exposure to long-biased hedge funds in US mortgages, equity, emerging markets debt and CDO’s/structured credit;
2. maintain positions in smaller and more nimble funds in the above mentioned hedge fund strategies. We expect these funds to be more flexible to a changing market environment and investment opportunities;
3. initiated positions in hedge funds which we expect to benefit from (short-term) adverse price movements in the market segments mentioned above. Examples of investment strategies are short US sub-prime mortgage backed securities; short synthetic CDO tranches, buying credit protection on potential LBO buyout target companies;
4. increased exposure to hedge funds focusing on distressed debt in corporate, asset-backed and emerging market debt securities. These funds have a more long-term value approach, anticipating that a turn in the credit or LBO cycle will provide many interesting buying opportunities when other market participants need to sell.

While our rather conservative stance has meant some underperformance versus some of our more aggressive peers in recent months, returns on our Low Volatility and Medium Volatility portfolios are still above their target annual returns of Euribor+2% and Euribor+5% respectively. Moreover, we believe it will eventually pay off because history suggests the delicate balance can collapse quickly when a sudden shift in any of the drivers of this benign credit environment occurs.

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