

Theta Quarterly Review

DE LAIRESSESTRAAT 180
1075 HM AMSTERDAM
THE NETHERLANDS
T +31 20 5 722 733
F +31 20 5 722 744
I WWW.THETACAPITAL.COM

Second Quarter 2007

Theta Capital Management

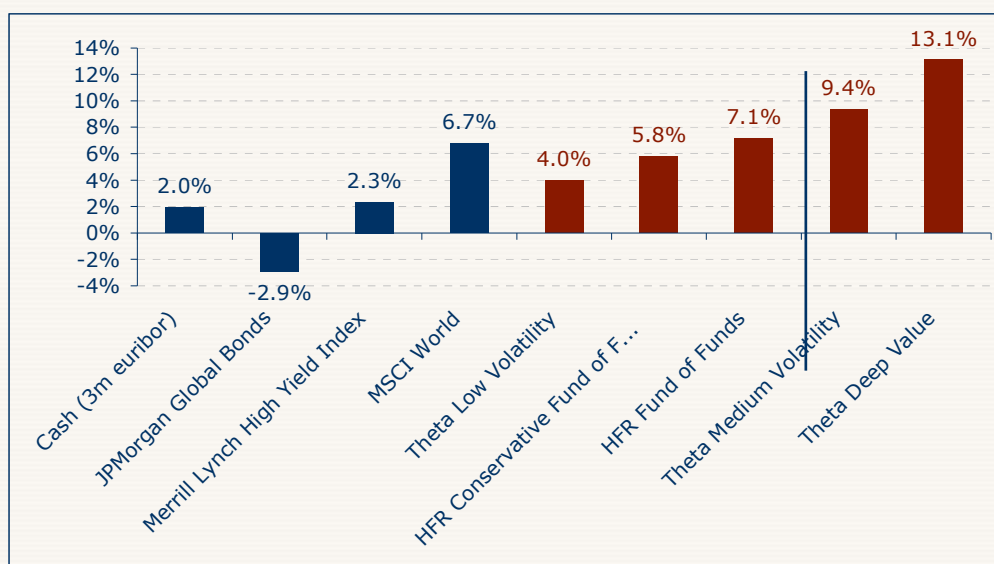
August 2007

Market review

The Theta funds posted strong returns in the second quarter and the first half of 2007, with Theta Medium Volatility and Theta Deep Value significantly outperforming the HFR Fund of Funds Index.

	2 nd Quarter	YTD 2007
Theta Multistar Low Volatility	+2.48%	+3.98%
Theta Multistar Medium Volatility	+4.95%	+9.36%
Theta Deep Value Fund	+5.12%	+13.09%

Exhibit 1 Year-to-date returns by asset class (hedged into EUR)



While global equity markets remained fairly strong in the first half of 2007, credit markets faced a considerably more challenging environment on the back of increasing concerns about the US subprime mortgage market, resulting in a few (temporary) spikes in volatility. Regular readers of our updates will remember that we first described this theme in our Quarterly Review Q2 2006: *“Looking forward one of the possible triggers for volatility to pick up substantially would be a hard landing of the US housing market. We do believe that it might only be the initial burst 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.”* While we were early with this call, our conservative positioning in credit markets in general and the US subprime mortgage market in particular has paid off well this year. Moreover, it has resulted in a significant outperformance versus many of our peers.

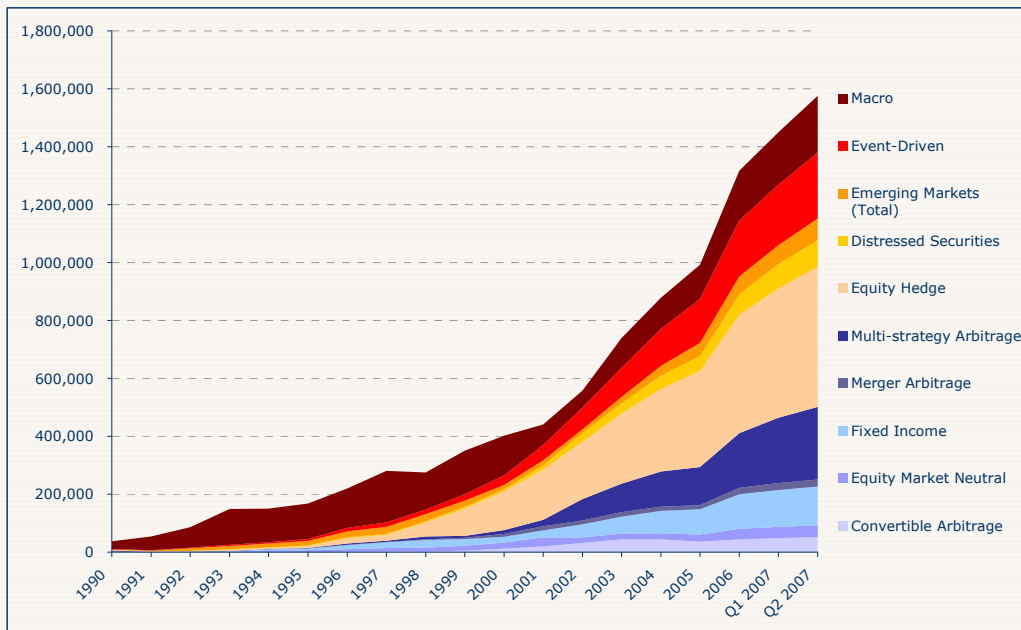
Asset flows

After a strong 2006 for the hedge fund industry in terms of performance, asset flows have picked up significantly in the first half of 2007: total assets under management increased by USD 118bln to USD 1.7 trillion (source: Hedge Fund Research). For most strategies, inflows this year already match or are even beyond the levels seen for the whole of 2006. Exceptions are CTA/Managed Futures, Merger Arbitrage and Equity Market Neutral. We believe these exceptions are largely the result of too many hedge funds chasing a limited set of opportunities. For example, while M&A activity has been buoyant in recent years (particularly in Europe) merger arbitrage hardly benefited from these opportunities. There is about USD 50bln of assets in merger arbitrage funds waiting for the next deal, which compresses deal spreads and profit potential. The same phenomenon can also be seen with Equity Market Neutral hedge funds, where many quantitative models are pursuing the same investment strategy, resulting in very tight spreads and limited trading opportunities. The only way to uphold the returns that investors have come to expect of these funds, is to increase leverage. Historically, CTA funds were popular based on the idea that they could provide a good hedge against falling equity markets. The main reason why CTA's are now out of favor is that their models trade in markets where the trend is strongest and this has been equities in recent years. As a result, the trendfollowing CTA models have been long equities for some time (with a considerable amount of leverage), reducing their diversification benefits in a portfolio context.

Exhibit 2 below shows the development of hedge fund's assets under management (by strategy) since 1990. The blue colors are relative value/arbitrage strategies, while the red nuances represent the various directional hedge fund strategies. It is interesting to note that, while in absolute terms arbitrage strategies have grown significantly, they still represent only a third of the hedge fund universe, with the majority of funds classified as Multi-strategy Arbitrage. This category is often regarded as a cheaper alternative to funds of hedge funds and has become particularly popular with institutional investors. As noted above, Merger Arbitrage and Equity Market Neutral have hardly grown in recent years, as the opportunities for generating consistent alpha were very limited. Within directional strategies, Long/Short Equity is clearly the largest today: about one third of all hedge fund assets. This in contrast to the early nineties, when most hedge funds were still Global Macro traders (Soros, Robertson).

Another interesting development is the growth of Event Driven funds, often with names such as "Special Situations" or "Special Opportunity". In essence, these hedge funds focus on positions where a particular catalyst (merger, acquisition, spin-off, asset sale, etc.) may trigger a revaluation of the positions and in many cases, the hedge fund managers play an active role in the event stream. Finally, in line with the boom in risky assets in recent years, two strategies have seen their assets more than quadruple since 2002: Emerging Markets and Fixed Income – High Yield. In contrast, other directional strategies such as Long/Short Equity, Event Driven and Distressed Securities have "merely" doubles in size. We believe that, given the current phase of the credit cycle, the latter two strategies will show considerable growth going forward.

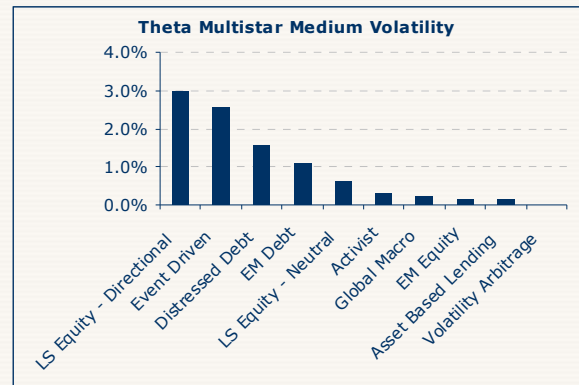
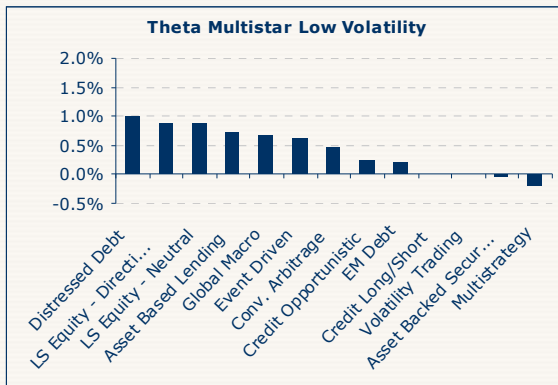
Exhibit 2 Hedge fund assets by strategy



Portfolio Review

Exhibit 3 below shows the year-to-date gross performance by strategy for both Theta Multistar funds. The performance of Theta Multistar Low Volatility about +4% was broad based across the various hedge fund strategies, indicating a well-diversified portfolio. As described in previous reviews, we positioned the fund rather conservatively, focusing on Long/Short Equity, Credit and Emerging Markets funds with a neutral bias and increasing the allocation to Asset Based Lending. This diversification by strategy and trading style of the manager seems to have paid off this year: while one manager in the Credit – Opportunistic strategy generated a loss on his short credit position, this was more than offset by other credit managers. It is also interesting to note that, while many market commentators claimed that the current phase of the credit cycle provided very few distressed opportunities, our two distressed managers continue to generate strong returns, contributing about 1% to performance in 2007. The only negative performance came from our Multi-strategy manager, who took on too much risk in his event book. When his positions went against him, returns in his other trading books were insufficient to compensate for the losses. Because this manager demonstrated poor portfolio construction and risk management skills, we have redeemed the fund per 1 July.

Exhibit 3 Theta Multistar – YTD performance by strategy



In line with the allocations to these strategies in Theta Multistar Medium Volatility, Long/Short Equity – Directional, Event Driven and Distressed Debt made a strong contribution to portfolio performance in H1 2007. We are also satisfied with our two Long/Short Equity funds with a neutral bias, who continue to deliver returns independent of the direction of overall equity markets. About one fifth of the performance of Theta Multistar Medium Volatility this year was generated by an Event Driven manager who was one of the first to anticipate problems in the US subprime mortgage markets. Following extensive research and intense discussions with the manager as well as various market specialists, we made our first investment in the summer of 2006 and this has paid off very well so far this year. Going forward, we believe wider credit spreads, more price dispersion between similar securities and increased market volatility will provide ample opportunities for hedge funds to generate solid returns independent of market direction.

Volatility is back – how to benefit?

Where next? Tightening of credit standards set in motion by problems in the US mortgage market will deflate other asset bubbles or, at the very least, increase the volatility and dispersion of prices within these asset classes. The first assets we would think of are other areas of consumer credit (autoloans, credit cards) and corporate credit, particularly where financial leverage has been added through CDO's and CLO's. On the back of increased uncertainty about the closing of many M&A transactions, we also foresee wider deal spreads in merger arbitrage space. Indeed, in early August one manager reported potential IRR's around 50% on deals with a very high probability of closing. One risk worth mentioning in this strategy is the large amount of cash deals as opposed to share-financed deals. While traditionally merger arbitrage funds would take a long position in the target company and a short position in the acquirer stock, cash deals require that the manager hedges his market risk using index puts or futures, which adds basis risk to the position.

The Long and Short of It

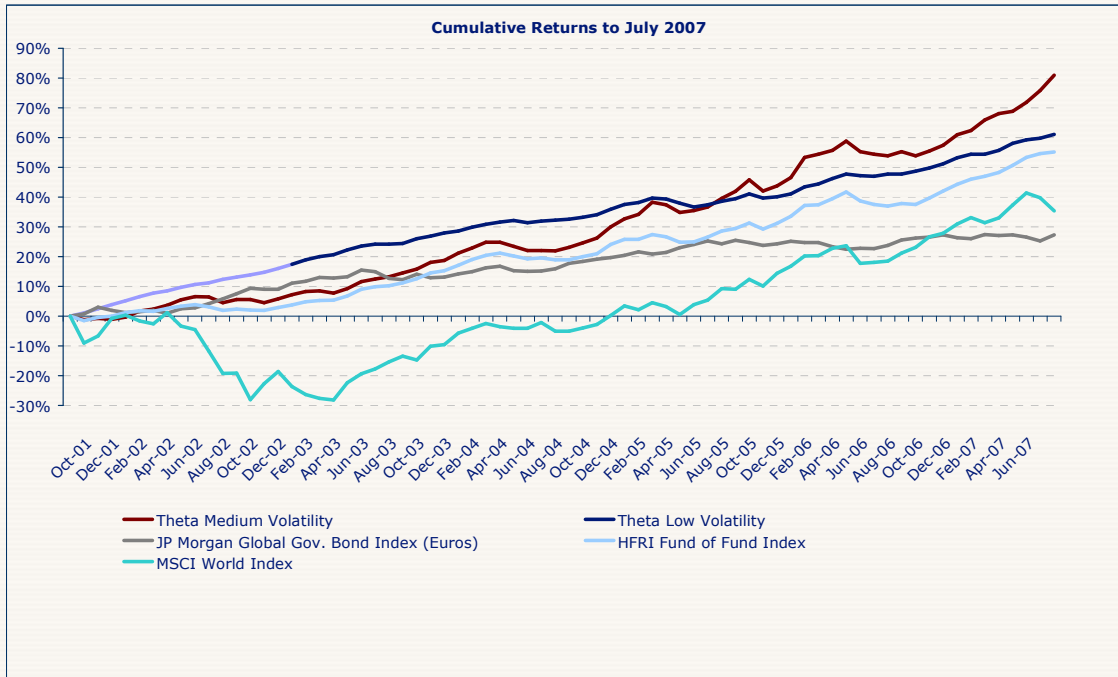
Below we describe how we aim to benefit from the new market environment where volatility is back and risk has a price again. We continue to focus on neutral or short-biased managers in markets most sensitive to a less benign credit environment. We have increased these positions already last year and they are now coming to fruition.

- Dedicated short US subprime. While problems in the US subprime mortgage markets are by now widely documented in newspaper headlines, we believe the problem has not yet manifested itself in its full entirety, especially as it relates to rising interest costs on adjustable rate mortgages (ARM's) and its effect on mortgage affordability. For example, in the remainder of 2007 about USD 200 billion of ARM will reset but next year this will be more than USD 800 billion! Add to that the fact that it takes about 9-12 months for mortgage delinquencies to translate into the realization of actual losses and we note that there's a lot more to come. To mitigate single manager risk, we have allocations to several funds playing this investment theme;
- Dedicated short corporate credit. As we believe credit spreads will continue to edge wider with higher volatility and more price dispersion between credits with similar characteristics, we have allocated to a manager, dedicated to taking short positions in single name credits. Markets will increasingly differentiate between good and bad companies and old fashioned bottom-up credit analysis will be paramount again. Moreover, the value of a rating by Moody's or S&P has been heavily discounted. As access to credit becomes increasingly difficult and costly, public (structured) credit markets will no longer be available as emergency exit for companies with financing problems;

- Long/short emerging markets debt. After the rally in emerging markets debt in recent years where one could make very decent money by just being long, distinguishing between good and bad countries, companies and currencies becomes increasingly important. Earlier this year we have invested in a fund with a fundamental, bottom-up long/short strategy in emerging markets debt (both sovereign and corporate). The manager runs a concentrated long portfolio of high conviction names alongside a short portfolio of high-beta, weak credits. We have known this manager for years and have confirmed that idiosyncratic events rather than overall credit spread movements are the main drivers of portfolio returns.

As for long-biased managers, timing these investments is very hard but having “dry powder” is important to exploit opportunities once valuations reach attractive levels. Increased volatility and price dispersion should provide ample opportunities for investors with the right mindset, capabilities and infrastructure to operate in a nimble and flexible way. We try to capitalize on these anticipated opportunities by positioning our portfolio appropriately. For example, we are currently evaluating two long-biased managers in the ABS space (one for our Low Volatility and another for our Medium Volatility portfolios) who we believe have the right combination of sector experience, nimbleness, infrastructure and the skills to perform old fashioned bottom-up analysis of the underlying credit fundamentals combined with a solid and proven understanding of the covenants and indentures in asset-backed structures.

Another implication of the view described above is our sizeable allocation to managers in the distressed debt strategy; around 10% in our Low Volatility and 20% in our Medium Volatility portfolios. Having increased these allocations already last year we were, in the eyes of many commentators, probably too early. However, the success of these managers in the first half of 2007 confirms our philosophy that even in a market with limited opportunities from a macro/cyclical perspective, flexible and diligent managers can still generate very solid returns. We prefer to invest in hedge funds where returns are driven by individual distressed situations with a certain degree of control or activism by the manager, rather than general market conditions. For instance, an important theme with one of our distressed managers is the anticipated deleveraging and potential bankruptcies in LBO companies. The idea is to look for low interest coverage and recent loan issues to finance superdividends to the private equity buyers. The manager expects many legal disputes between creditors in the same company, especially between first, second and third lien creditors. Experience in the legal procedures of a restructuring process is crucial and our manager tends to focus on situations with legal complexity or where an active role in the bankruptcy process adds value.



Theta Capital Management B.V.

De Lairessestraat 180

1075 HM Amsterdam

The Netherlands

Telephone: +31 (0) 20 5722733

Fax: +31 (0) 20 5722744

E-mail: info@thetacapital.com

Website: www.thetacapital.com