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Theta Deep Value Fund

Quarterly Investor Letter – Q4 2007

Theta Capital Management
February 2008

Dear investor,

The Theta Deep Value Fund (the Fund) had a good fourth quarter, generating a return of **6.5%**. This brings the 2007 performance to **33.4%** since January and to **45.2%** over the 18 months since inception of the Fund in July 2006. Performance is comfortably above our target range of 15-20% per annum over a five-year investment horizon. Whilst running the danger of sounding repetitive, we would like to note again that when marketing the Fund, we cautioned potential investors that unlocking *deep value* may take some time and that returns of the Fund are expected to be lumpy rather than smooth. 2007 has been a rewarding year but one should continue to evaluate the Fund's performance on a medium-term horizon of 3-5 years. Investors should remember that performance in intermediate years can be below as well as above 15%.

Theta Deep Value Fund - Performance (Series July 2006)

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	2006
Net Performance							-1.68%	1.19%	-0.75%	3.17%	2.90%	3.83%	**8.83%**
Cumulative Performance							-1.68%	-0.51%	-1.26%	1.87%	4.82%	8.83%	

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	2007
Net Performance	-0.08%	6.60%	1.12%	1.36%	0.99%	2.80%	6.47%	1.26%	2.52%	6.65%	-0.45%	0.28%	**33.38%**
Cumulative Performance	8.74%	15.91%	17.21%	18.81%	19.99%	23.34%	31.32%	32.97%	36.33%	45.39%	44.74%	45.14%	

Note: As the fund's independent administrator provides an official NAV on a quarterly basis, monthly numbers are estimates provided by the manager.

The bulk of the return during the fourth quarter was generated by our investments in the Paulson Credit Opportunities funds. These funds generated a return of around 30% for the fourth quarter, bringing the full year return to a stunning 590% for PCO I and 352% for PCO II. The Paulson Credit Opportunities funds generated in excess of 50% of the full-year return of the Theta Deep Value fund, not surprising given the strong performance of these two funds.

However, it is worth reminding that most other funds also contributed 15% +, although their performance was somewhat overshadowed by John Paulson's well-timed short on the US subprime market.

Another solid contributor during the quarter was Sector Speculare III which benefited from a take-over of one of its investments, generating a 150% return on that particular investment over a six month period. Over the fourth quarter, this fund generated a return of around 12%, very respectable given the performance of equity markets. The CQS Directional Opportunities Fund generated around 17% for the quarter and had particular strong months in October and November across a wide variety of strategies.

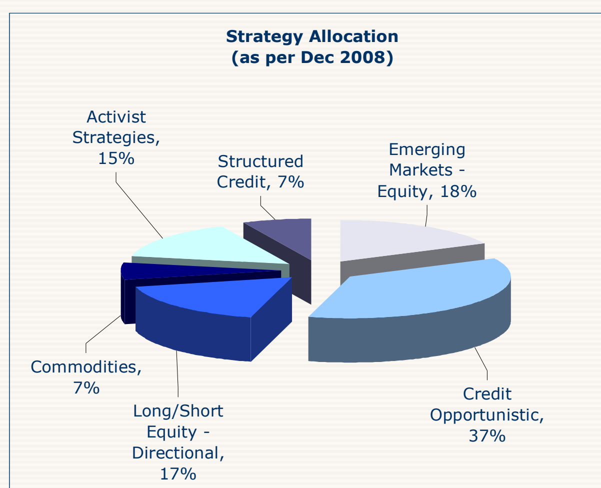
The largest detractor was the Red Kite Metals fund which lost close to 38% for this quarter. This was partly offset by a 8% return for the Red Kite Prospect fund (run by the same manager but focusing more on longer-term commodity contracts) in which the Deep Value fund has a considerably bigger investment resulting in a blended performance of -0.7% for the quarter. Another notable detractor was the CIM Special Situations fund which lost 10.6% for the quarter.

No changes have been made to the Deep Value portfolio of hedge funds during the fourth quarter.

The knock-on effect of the subprime credit crisis and the subsequent credit crunch (so far mainly in the US) throws up interesting opportunities for longer-term committed capital such as Deep Value. Obvious candidates are in the distressed ABS field where the disappearance of previous purchasers in the form of CLO and CDOs has meant that paper can be bought at very attractive levels by those funds who can afford to sit out the storm. Also, the sell-off in equity markets means that outsized returns can be generated by managers with a long-term view and the capability to sit tight. Many of our managers are genuinely excited about the opportunities they see but it is also clear that we will see further volatile movements as the combination of nervous investors and forced selling will continue to influence markets going forward.

Portfolio Allocation

Strategy Allocation	Jan-08
Emerging Markets - Equity	**18%**
Montpelier Fund	
Greater Europe Deep Value Fund	
Credit Opportunistic	**37%**
Paulson Credit Opportunities Funds	
Camulos Special Situations Fund	
Autonomy	
CQS Directional Opportunities Fund	
Long/Short Equity - Directional	**17%**
Ecofin Special Situations Fund	
CIM Special Situations Fund	
Sector Speculare III	
Commodities	**7%**
Red Kite Metals Fund	
Red Kite Prospect Fund	
Activist Strategies	**15%**
Focus Capital Investors	
Marwyn Neptune Fund	
Pershing Square	
Structured Credit	**7%**
Eidesis Special Opportunities Fund	
ZAIS Matrix V	
Total	**100%**



As can be seen from the pie chart, the portfolio remains well diversified across a range of strategies. We do seek opportunities across a range of uncorrelated strategies as we feel this offers the best way to generate the 15%-20% average annual return over a three-to-five year period.

Fourth Quarter 2007 Performance Review

Paulson Credit Opportunities Fund I & II (Credit Opportunistic) generated returns of **+29% and +32%** respectively in the fourth quarter. The full year results were **+590% and +352%** respectively. For a full description of the short subprime trade, we refer to our last quarterly. Therefore, and because of the enormous amount of press coverage that we have seen over the last months, we will not go into further detail. It has been highly impressive to see how the Paulson team monetized the profits on the trade. Whilst we had been convinced of the attraction of the trade itself, the actual execution of the trade and subsequent exiting of its positions is something that worried us given the relative immaturity and illiquidity of the CDS market. However, last summer, when most market participants were still wondering how Paulson would unwind some of its trades and lock in its profits without moving the market, the fund had actually materialized all its profits and had drastically reduced its leverage.

In the meantime, the fund has almost completely exited the short subprime trade and has further increased its short position in the US Financials and corporate credit sector. Clearly, this has already paid off very nicely during the fourth quarter as investors have become increasingly worried, not only about the direct impact of the bursting of the subprime bubble, but also about the overall health of banks and insurers as spreads widen and various highly levered credit structures are unwound. Finally, the fund is carefully considering long opportunities in the debt markets. Although the Paulson Credit Opportunities fund has grown considerably in size, the size of the credit bubble (and thus the ensuing distressed mortgage opportunities) are such that, at the right time, there will be ample opportunities to start buying parts of the structures that will fall apart. The fund manager expects that both the US$1.2 trillion subprime market as well as the US$1.2 trillion Alt-A market will become distressed markets ('busted' in their own words) as the rating agencies downgrade these structures. Paulson will be in a strong position, given its research expertise it has build up over the last 2 years, to analyze these distressed structures and capitalize on mispricings.

There was little to report on the **Camulos Special Situations Offshore Fund** (Credit Opportunistic) in the fourth quarter, somewhat down over the period **(-1.1%)**. The fund **returned +2.0% in 2007** as a whole**.** The fund has been busy building up its portfolio of investments over the last nine months which now include a power plant in New England, an ethanol plant in Pennsylvania, hotels on the East Coast and a biomedical device business where the fund holds a significant stake through convertibles. The fund is closed as the managers are working on realizations/exits which should start coming through in 2008 when we expect significant, but lumpy, returns from this portfolio.

The **CIM Special Situations Fund** (Long/Short Equity - Directional) had another challenging quarter, very much a continuation of the third quarter**, losing 8.2%** for the quarter and **ending flat for the year**. The fund was up 7.4% in October but lost around 15% over November and December as both its natural resources as well as its technology holdings were hit hard by investors fleeing the more risky parts of the market. Newsflow which normally should prove highly positive for its holdings (typically taking into production of a mine or oil & gas field) was ignored during the last months of 2007 as investors became highly risk averse. Investors during the latter part of 2007 were looking for large, stable companies with positive cash flows whereas James Morton and his team look for small companies that typically are in the process of moving from exploration to production. Despite the disappointing year we still retain our confidence in this manager. They are transparent about their holdings and provide investors with frequent updates as to how their holdings are developing operationally. The disappointing performance is not because James and his team have temporarily lost their touch but because their approach is currently completely out of favour in the market. Unless we see a total global economic meltdown and natural resource prices plummet, valuations of companies in the CIM portfolio should recover and reflect the true earnings potential.

CQS Directional Opportunities Fund (Convertibles) gained **17%** in the fourth quarter, thus generating **23.7%** in 2007. Especially October was a strong month for the fund, generating more than 8% but also November and December saw very respectable returns. The returns came from a wide variety of sources including structured credit, single credit, equity strategies as well as positions in selected financial and insurance companies which the manager views as a hedge against the potential for a more sustained credit widening environment. Despite the general widening in credit spreads during October, the fund managed to generate strong returns in synthetic equity tranches, CDO equity and first-to-default baskets. In single name equity positions, the fund generated returns on both the long and the short side (generating profits from short positions in US financials).

Greater Europe Deep Value Fund (Emerging Markets Equity) gained **9.3%** in the fourth quarter, bringing its **full year performance to +28%.** The largest sector exposure of the fund currently is the Russian electricity sector which accounts for around 40% of the fund. Through a combination of activism and deep fundamental research, the fund has benefited from the ongoing restructuring of this sector and further realizations over the coming months will ensure that the allocation to the electricity sector will decrease in favor of real estate and private equity projects. The fund has now invested in four real estate projects in a wide variety of regions such as Syktyvkar, Moscow, Kiev and Yekaterinburg. All these projects are operated with partners, are in excellent locations and are expected to achieve an annual IRR of more than 40%. In total, these investments represent close to 40% of the fund's NAV, around which levels it will remain (barring revaluation). Another sizeable investment the fund has recently made is in a forestry project in the Arkhangelsk region and further investments like this can be expected over the coming months. Finally, the fund has cautiously started to invest in other FSU outside Russia such as the Ukraine.

Ecofin Special Situations Utilities Hedge Fund (Long/Short Equities - Directional) returned **+4.4%** this quarter, thus returning just under **20% for the year**. The main event during the quarter was the sale by Airtricity of its remaining European and Chinese operations after it already announced the sale of its North American business, to E.ON, in October. Over the 18 month holding period, the Airtricity investment roughly doubled in value. Currently around half the net exposure of the fund is in Special Situations whilst the overall net exposure of the fund is around 60%. Other special situations events during the quarter include the IPO of Iberdrola Renewables and the capital raising by Goldwind on the Shenzhen Stock Exchange. Goldwind is primarily active in China, where it has a 33% market share in the Chinese wind power equipment market which is expected to (continue to) grow explosively over the coming years.

Autonomy Capital - C Class (Emerging Markets Debt) gained **13%** in the fourth quarter, bringing its year-to-date performance, since we invested on August 1 2007, to **16%**. Returns continue to be driven by the growing use of securitization technology for consumer credit and mortgages in selected developing countries: Brazil, Mexico, Ukraine and, at a later stage, Turkey. Although securitization as a tool has been abused by banks and other financial intermediaries in developed countries to create a massive credit bubble, it should be remembered that when used appropriately the method is highly effective for increasing the breadth and depth of debt markets. Consumer debt and mortgage markets in developing countries such as Brazil are still in the very early stages of development and the fund will benefit from the steady growth of these markets over the coming years.

The **Marwyn Neptune Fund** (Activist Strategies) generated a return of **5.6%** in the fourth quarter, thus generating **20.7% for the year**. An impressive performance as overall market conditions in the second half were not supportive to the fund's strategy. As a reminder, the fund's approach is to establish an exchange-listed platform company, install new management with proven experience in the relevant sector and do follow-up acquisitions of companies and thereby grow the business. During the quarter, the fund realized its second exit of the year (following the sale of its slot machine business in January). Inspicio, its laboratory testing business, announced receipt of a cash offer of GBP290m in December which represents a value increase of 125% since the investment in April 2005. Clearly, the small and mid cap area on which Marwyn focuses is going to be volatile going forward as low levels of liquidity are likely to create significant pricing anomalies. However, this should also create significant opportunities for disciplined strategic investors such as Marwyn as it also has the opportunity to actively manage their investments through intensive interaction with management and shareholders.

Pershing Square (Activist Strategies) was up **+8.9%** in the fourth quarter, bringing the **full year performance to 22%**. A very respectable return for an activist strategy. The main source of return for Pershing in 2007 was its well-published shorts on the mono-line insurers MBIA and Ambac which together generated gross returns of around 31%. Pershing's approach to short selling is also activist: for nearly a year the company has been sharing its analysis with others to point out the dangers lurking in the business model of the bond insurers. Apart from making its detailed analysis public, the fund has also been meeting with the NY State Insurance Department and Moody's to share their concerns and discuss rating methodologies (which were/are the backbone of the bond insurers). During 2007, the credit spread (risk premium) of MBIA increased 24X, from 25bps at the beginning of the year to around 600bps which explains Bill Ackman's (the manager of Pershing Square) statement at the end of 2006 that "for some time, I have believed that our investment in MBIA CDS offers the most attractive risk/reward ratio of any investment I have come across in my investment career". The spread on Ambac widened even more, 42X from approximately 15bps at the beginning of the year to 625bps by year-end.

The strong returns from the fund's shorts were partly offset by sizeable losses on some of its longs, in particular Sears (in which the fund has been invested for some time) and Target (in which the fund initiated a position in June 2007). The Target position has since lost around 30% of its value as investors fretted about the impact of the slowing US economy on retailers such as Target. Pershing has unveiled parts of its proposal to unlock value from the Target shares which includes a plan to sell part of its credit card receivables and use the proceeds to buy back shares and thus use the balance sheet more effectively. Not surprisingly, this sales process is taking longer than expected in the current market environment.

The **Montpelier Fund** (Emerging Markets Equity) returned **3%** in the fourth quarter, whilst the **Montpelier China Fund lost 8.8%,** bringing the 2007 performance to **44**% and **17%** respectively. The China fund had a tough quarter, particularly towards the end of the year when various subsidiaries of State Owned Enterprises were marked down sharply. The manager sees inflation as a clear threat in China and the fund is currently positioned very cautiously with around 40% of the portfolio in cash waiting to be deployed. The Montpelier fund has increased its investments in the Middle East over the last few months and currently around 35% of the portfolio is in that region. Its holdings in China decreased substantially during the quarter.

Sector Speculare III (Long/Short Equity – Directional) had a good quarter, gaining around **12.6%** bringing the **full year performance** (starting April 1) to just below +**18%**. A large source of the return is from the takeover of one of its investments, Eastern Echo, by Schlumberger. The fund realized a return of around 150% on invested capital in approximately 6 months, or around 8% on fund level. Following this exit, there are still 10 investments in the fund. The fund is 91% invested (with total committed capital of US$527m) with around one-third of the exposure in oil and gas producers and the balance in oil services.

Eidesis Special Opportunities Fund and **Eidesis Structured Credit Fund** (Structured Credit/Distressed CDO's) had a blended return of **+1.7%** this quarter resulting in **-11.7%** for the year. The investment strategy of the Eidesis Special Opportunities Fund is to identify distressed opportunities in CDO's backed by corporate credit and, as opportunities in distressed CDO's are only just arising, the manager has only called 50% of the committed capital. The managers is extremely bearish about the outlook for the market in general as the liquidity squeeze will get a lot worse before it gets better. CDOs and SIVs created both directly but also indirectly liquidity, by taking risk of bank's balance sheets and allowing them to extend more loans. Replacing their function will therefore be very difficult, will require a great deal of

fresh capital, structural adjustments within credit markets and a period of time measured in years rather than months. The market is, according to the manager, still underestimating the effect of the coming squeezes in the larger credit sectors (non-subprime mortgages, revolving consumer credit, commercial real estate and corporate debt) as a result of the restructuring of the banking system as a whole. In short, the manager sees a wealth of deep value distressed opportunities but once again things will get a lot worse before they get better and therefore there is no need to heavily start investing currently.

The **Zais Matrix V Fund** (Structured Credit / Distressed CDO's) was **down 13.3%** for the quarter and **-20.4%** for the year. However, the fund has so far only called 50% of our committed capital, which represents only 1.7% of the Theta Deep Value portfolio. The positions have been marked down in the recent turmoil but obviously the effect on our portfolio, given the small size, is very limited. A lot of what was said with regards to Eidesis above, is also applicable to Zais: there will be an enormous amount of deep value distressed opportunities but within structured credit/distressed CDOs, things will get worse before they get better. The downgrades by the rating agencies in the fourth quarter were larger in scale than expected and the opportunity set, on an absolute dollar basis, is therefore also larger.

Focus Capital (Activist Investing) generated a return of **-8.1%** in the fourth quarter, bringing the full year performance to **+34%.** The last quarter was difficult for the fund as its active hedging strategies were insufficient to offset significant draw downs in its core holdings. In particular November was a difficult month for the fund. The core long portfolio is concentrated on high quality, cash generative Swiss companies where the fund managers have a very strong relationship with the company's management and where they know the company and its sector a lot better than the market. Going forward, the active hedging strategy and active trading around the positions should steer the fund through the volatile market conditions.

Red Kite Metals Fund (Commodities) was **down 37%** this quarter and **Red Kite Prospect Fund** (Commodities) was **up around 8%**, bringing the **blended return** for our portfolio to **-0.7%.** Red Kite Prospect returned **+34% for the year** whilst the **Metals fund lost 55%** giving a blended return of **-12%** for the whole 2007. The large difference between the Metals and the Prospect Fund is due to different movements in short dated and longer dated futures contracts. However, the Metals fund also suffered from starting the year with too many assets under management which, due to the drawdown as well as redemptions, has changed significantly. The Metals fund is now at a size where it is far more nimble and flexible and should generate outsized returns again as the team has done in the past. Important also in our decision to stick with the fund is the fact that this is a highly experienced team that has made money whether commodity prices moved up or down. If we look at the track record of the team over the years, 2007 is a bad year of which we expect them to recover. Clearly, it is highly volatile but this is a strategy that should be judged on a longer-term basis. We also get further confidence from the fact that the managers have made a very substantial personal investment into the fund as of January 1. The January 2008 results, in which both funds were up significantly, gives us confidence that 2008 will indeed be a year in which the managers are back on track to generate outsized returns.

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