



THETA
CAPITAL MANAGEMENT B.V.

Theta Quarterly Review

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First Quarter 2008

The Big Picture

Wouter ten Brinke, CFA

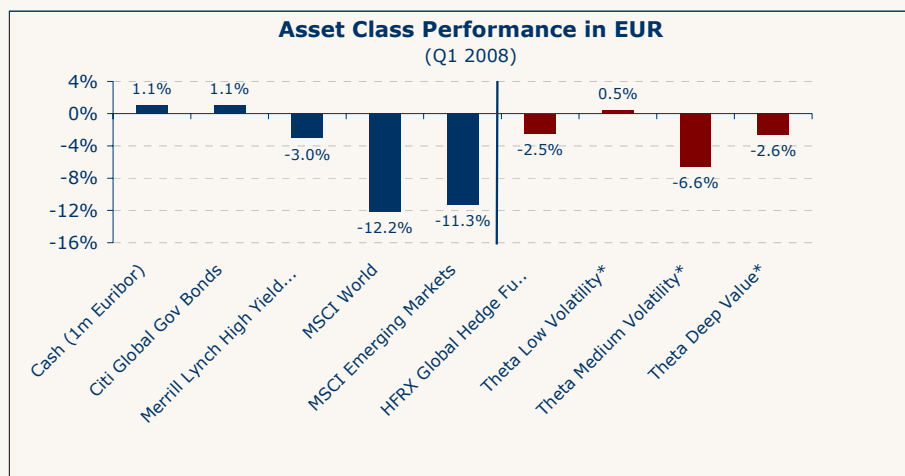
Theta Capital Management

May 2008

Market review

During the first quarter of 2008 we witnessed tremendous volatility in risky assets across the globe. Global (emerging markets) equities were down around 12% (see chart 1 below), while government bonds and cash acted as the only safe haven available. Much of this volatility was caused by the uncertainty related to the credit crisis in the US, which reached its climax (so far) with the bailout of Bear Stearns in March. Market pricing during these turning points in global market sentiment can be highly erratic and violent, as various market participants reassess the size and value of their exposures and seek to find a new balance between risk and return. The large dislocations and lack of liquidity in some market segments also impacted hedge funds as a group, although losses were limited to a modest -2.5%. While no investment can be judged on such a short time frame, it seems that hedge funds largely lived up to their proposition: preserving capital (or at least limiting drawdowns) in challenging market conditions.

Chart 1 Asset class performance in Q1 2008



Our portfolios proved not to be immune to the enormous intra-month volatility in financial markets. The Low Volatility and Deep Value portfolios managed to largely preserve capital, but our Medium Volatility portfolio had its largest drawdown since inception (more detail provided below). While in January (the worst January on record for almost all global equity markets), our portfolio positioning proved to be reasonably effective, March (“the largest margin call in financial history”) proved to be more challenging. With banks aggressively increasing margin requirements on loans, hedge funds were forced to de-lever their books. In addition, some of our managers were caught short during the rally that followed the Bear Stearns bailout. Despite challenging market conditions we are happy to note that our portfolios continue to see a steady inflow of new capital every month.

On the business front, Theta has further strengthened its portfolio management process and risk controls and Standard & Poors has confirmed our approach by awarding both Theta Multistar Low Volatility and Theta Multistar Medium Volatility with an “A” rating. This rating considers Theta’s investment team, process and performance of the Theta Multistar Fund. In the first quarter of 2008, we have also made two additions to our team. We have expanded our operations team to three professionals and we hired Mr Hein Jurgens as senior marketing manager to cover the German speaking European markets from his Munich home base. Prior to joining Theta in January 2008, Hein was a partner at Cazenove, one of the UK’s leading investment banks in London. Going forward, we are looking to grow our team to 14 by adding an accountant and a hedge fund data analyst.

Reopening of Theta Deep Value Fund

On April 24, 2008, we held the inaugural Theta Deep Value Investor Conference. Three of the underlying hedge fund managers from the Theta Deep Value Fund presented their investment strategy and discussed some relevant transactions. At this conference we announced the re-opening of Theta Deep Value Fund on 1 July 2008. Theta Deep Value Fund was launched on 1 July 2006 with the aim to capture 'deep value' investment opportunities in less liquid situations. The fund was closed to new subscriptions in July 2007 and has at present assets under management of around EUR 150 million. Partly based on compelling investment opportunities being created a.o. by the credit crunch, Theta has decided to open the fund to new subscriptions for a limited amount on 1 July 2008. Following that date, the fund will again indefinitely be closed for new subscriptions. We hereby invite you to participate in this interesting opportunity, which will be detailed below.

The proposition

- Portfolio of hedge funds in opportunistic and less liquid investment strategies where the inherent value likely to be unlocked, may take longer to materialize;
- Return target: 15-20% per annum over an investment cycle of three to five years;
- Capture the inherent illiquidity premium and significant upside return potential;
- Theta Deep Value has proven to be an excellent diversification tool for any traditional investment portfolio, as returns are mostly driven by non-market risk;
- Concentrated portfolio of around 10-15 hedge funds with highly diverse investment strategies;
- Reduced management fee and profit sharing only above a return of 8% ensure the alignment of investors' and Theta's interest in maximizing performance.

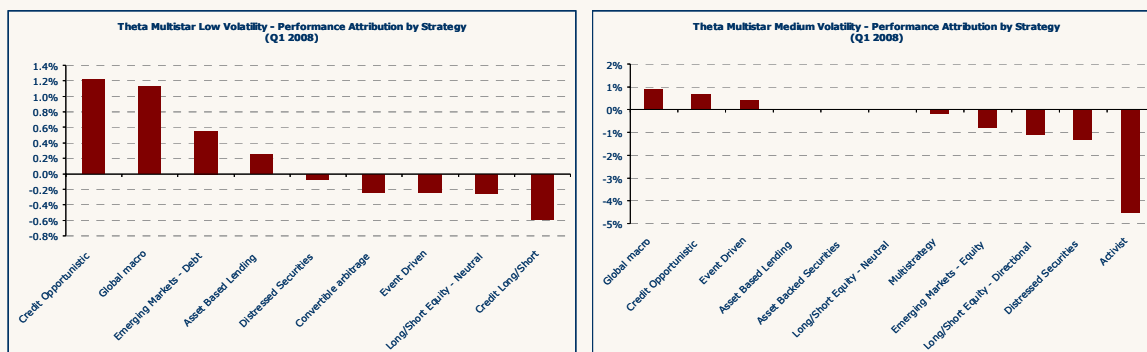
Book building has started on 24 April 2008 and will close on June 20, 2008. Should you require any additional information about Theta Deep Value Fund or the subscription procedure, please do not hesitate to contact us.

Portfolio Review

	1 st Quarter 2008	2007
Theta Multistar Low Volatility	+0.5%	+3.8%
Theta Multistar Medium Volatility	-6.7%	+8.9%
Theta Deep Value Fund	-2.6%	+33.4%

Since the summer of 2006 we have been communicating our bearish view of global credit markets and have positioned our portfolios accordingly. In particular, we redeemed all our long-biased mortgage funds and allocated to funds with a dedicated short strategy in the US mortgage sector and in the corporate credit sector. Our portfolio construction has been reasonably effective in what has been one of the most difficult starts of the year for financial markets in recent years. On the negative side, we have not been able to avoid some mistakes as well. Whilst the management of market risk -most notably as it relates to global credit- has worked well, we were less sanguine about the management of single manager risk. Our investment in Focus Capital, a New York/Zurich based activist manager active in the Swiss small-to-mid cap universe, was responsible for two thirds of the loss in the Medium Volatility portfolio this quarter. The fund also contributed -5% to the Deep Value Fund, but as other funds more than compensated this loss, Theta Deep Value closed the quarter with a modest loss of -2.6%.

Chart 2 Performance attribution Theta portfolios



A drawdown such as this raises the question whether this should be seen as an incident or whether there are more structural issues at play. Our internal (and external) discussions revealed some interesting lessons learned which, in light of our ambition to be transparent and open with our investors, we would like to share with you here:

- What looks too good to be true, usually is too good to be true. We have underestimated the risk of applying leverage (however moderate) to a concentrated portfolio of less liquid instruments;
- Asset-liability mismatch: a hedge fund's investment conditions and funding arrangements should match the liquidity of its assets/strategy;
- Beware of the confirmation bias. Like most investors, we sometimes overlook disconfirming evidence ("what are the 5 reasons not to invest?");
- Ask managers to back up their claims with detailed securities positions and balance sheet statements (to be verified with an independent administrator);
- Always perform external background and reference checks from independent sources;
- In our strategic thinking about the consequences of the credit crunch, we underestimated the impact it could have on activist hedge funds that tend to run concentrated portfolios with, at times, less liquid positions.

Whilst we are certainly not happy with the performance of our Medium Volatility portfolio, we acknowledge that we are experiencing one of the most difficult periods for hedge fund investing in a decade. At the same time it is pleasing to note that our Low Volatility portfolio belonged to the handful of fund of funds with a positive performance in Q1 2008. We strive to learn from past mistakes and our shared awareness of the lessons learned is a key asset to our company going forward. Should you have any remaining questions, please do not hesitate to contact us directly.

Outlook and investment strategy

As is typical when the sky falls in, many specialists, obsessed with complexity, point to the impossibility to generalize about the weather – John Mauldin, 2008

While many investors and media are still preoccupied with the impact of the mortgage losses on the financial industry (so were we and we have made good money out of it), we thought it worthwhile to share our views on a few longer-term investment themes with you. As medium-term investors, we try to look beyond the current technicalities of US credit markets, acknowledging that, in the medium term, it is still the economic tail wagging the financial dog. This section has a distinct macro flavour, but we

believe the current environment (an inflection point in the global economy and financial markets) warrants a more strategic discussion. So for those interested, here we go.

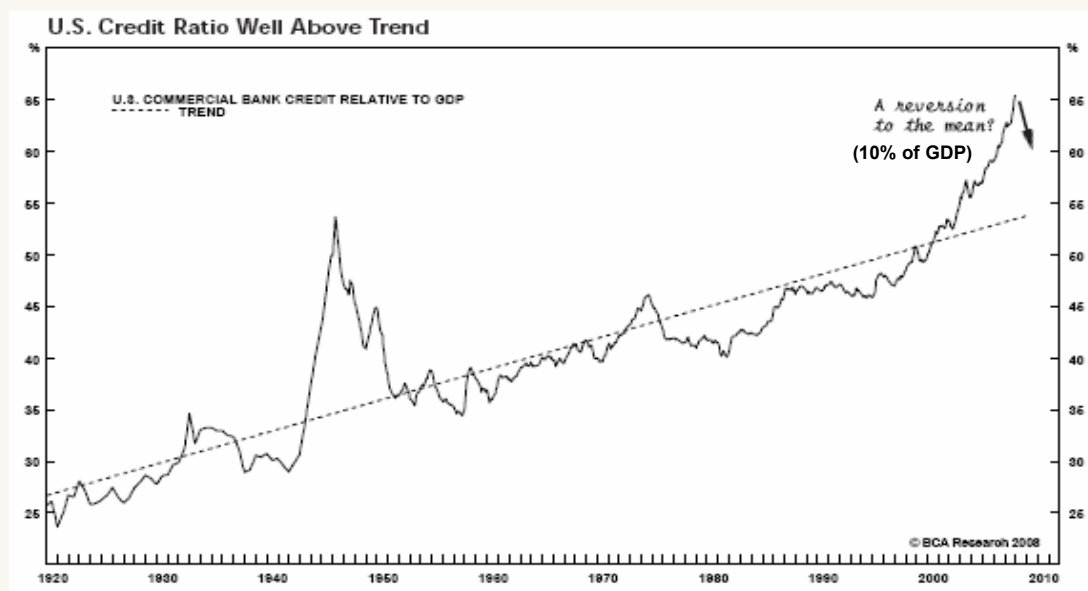
Looking ahead, we identify four investment themes:

1. Deleveraging the economy and financial markets
2. Return of inflation
3. Natural resources
4. Shift of global economic leadership

1. Global de-leveraging

It is our view that a prolonged phase of global de-leveraging has only just begun. The credit crunch hit the financial industry with immediate effect but it will take a lot longer for its full impact to be felt across the globe. It will take many more months before banks have cleaned up their balance sheets and public credit markets have found new equilibriums where risk premiums reflect fundamental rather than just technical supply/demand drivers.

Chart 3 Leverage in US economy defies the long-term trend



The IMF estimates total losses from the credit crunch of almost \$1 trillion, of which only a quarter has been realized so far. Chart 1 taken from a recent BCA report is even more scary: it shows a surge in overall US leverage well above its long-term trend. Note that a reversion to the long term trend of the US credit ratio would mean a contraction of bank credit equal to 10% of GDP, i.e. \$1.4 trillion! We believe that the negative spill over effects of banks' de-leveraging actions will be felt throughout the rest of the economy; they will not prevent a recovery, but may be a headwind for growth for many years.

Investors are fully aware of this outlook and markets have been priced for a bad outcome, albeit with significant differences between market segments. For example, financial sector stocks and the most senior parts of capital structures (in both corporate credit and CLO's) are down more than 35% from their peak, while overall equity markets (arguably the most risky part of the capital structure which is

supposed to take the first hit when companies run into trouble) had a maximum peak-to-trough drop of just 18%. As profit growth eventually slows down, defaults will increase and the dislocation between senior and junior parts of the capital structure needs to reverse. We note that the corporate default rate is a lagging rather than leading indicator for economic growth: while in the previous US recession economic growth bottomed out in early 2001, default rates peaked eighteen months later in October 2002. So, while up to now the credit crunch was mostly confined to the financial sector, going forward the macro environment will take center stage.

The BCA report mentioned above puts current developments into perspective by looking at other real estate/credit busts in the past: the US savings & loans crisis in the late eighties, and Japan, Sweden, Norway and Finland in the early nineties. The results highlight the challenges facing financial markets today:

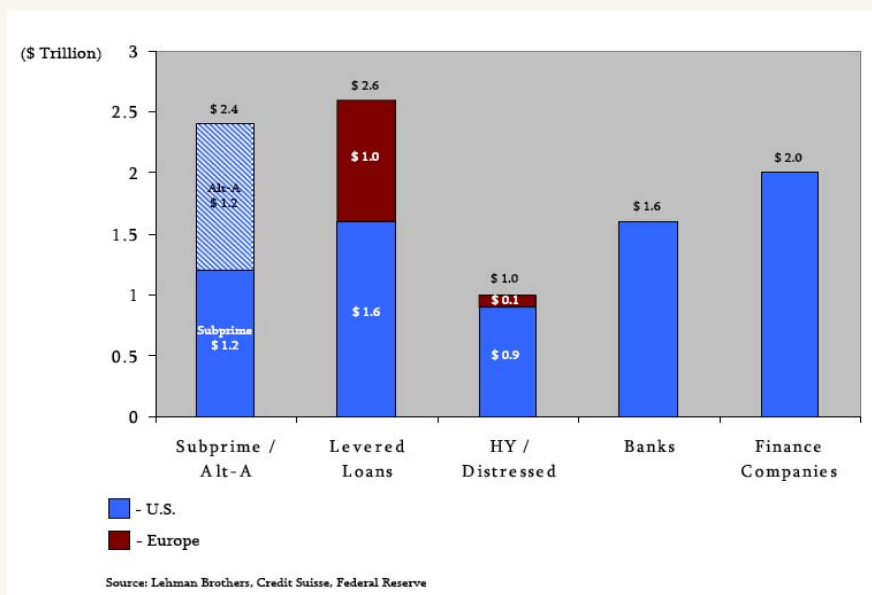
- Declines in house prices ranged from 25% to 65%. So far, US house prices have fallen only 10%;
- Equity prices dropped between 18% and 70%, with financial stocks falling between 40% and 90%. So far, the S&P 500 fell only 18% (and subsequently rallied almost 5% in April 2008);
- The impact on the economy was painful, often involving a lengthy and deep recession. The level of economic output remained below potential for 5 to 10 years;
- The fall in the credit/GDP ratio lagged the decline in real estate prices by about 3 years. US house price growth came into negative territory only recently, which suggests a prolonged phase of de-leveraging ahead.

So where does this leave us in terms of positioning our portfolios? Even though equity investors show remarkable resilience in risk appetite, the US recession is at an early stage and financial losses are a lagging indicator. Therefore we would err on the side of caution for a while longer until the financial fog shows some signs of clearing. This means that we are still comfortable with our short-biased exposures in corporate credit and are happy to note that most of our long-biased managers have taken some risk off the table.

Clearly, the economic slowdown due to credit contraction also creates interesting opportunities for distressed debt hedge funds. Delinquencies on subprime mortgage loans are still rising and spilling over to less risky instruments such as Alt-A and prime residential mortgages (both in the US and the UK). Construction loans and commercial real estate are also starting to feel the pain. As the economy slows down and unemployment rises, consumers will also start to default on their credit cards and auto loans, which act as collateral for about \$2.5 trillion worth of ABS securitizations (equivalent to a quarter of the total amount of securitized debt outstanding in the US). Historically, credit card debt has been far riskier than mortgage debt. As corporate profit growth slows, corporate credit markets are also at risk, notably the most leveraged segments: loans related to leveraged buyouts. With about \$13 trillion in size, this market is 10 times larger than the US subprime mortgage market!¹ Never before have we entered an economic downturn with so much leverage in the system, provided to companies known to have such poor credit quality. Moreover, investors in securitized vehicles such as CLO's and CDO's are exposed to default risk of borrowers they have never assessed. This risk is particularly acute for the most risky part of a CDO's balance sheet: the equity and mezzanine tranches.

¹ Source: Financial Markets Meltdown: What Can We Learn From Minsky? *Levy Economics Institute Public Policy Brief No. 94, 2008*

Chart 4 'Troubled' debt universe



In short, asset price depreciation will not be restricted to residential real estate, and losses in one sector will generate recursive losses in others. Therefore, we see tremendous opportunities in distressed ABS, corporate credit and CDO's and we are actively researching hedge funds in this space in preparation of potential allocations later this year. Chart 4 above illustrates the opportunity set of troubled debt securities, as calculated by one of our hedge fund managers. While we risk being too early, we have no edge to time the bottom of the market and we stick to a simple truth of distressed investing: one has to buy when the blood is running through the streets. In fact, already in November 2007, we made our first small allocation to a unique US-based distressed ABS fund which is active in purchasing whole loan portfolios directly from banks that are shrinking their balance sheets, and we are considering making an allocation to a similar fund in the near future.

2. Return of inflation

Following almost two decades of low inflation, this benign environment is now changing drastically. Unfortunately for investors, high inflation is unkind to financial assets. In fact, it reduces the real value of any asset, which is why there exists a strong inverse relationship between inflation and equity PE ratios. By definition, equity yields are the inverse of PE ratios. If we view earnings yields as a risk premium earned from owning a claim on the uncertain stream of future corporate earnings, the positive correlation between earnings yields and inflation means investors are less confident about the level and quality of earnings in a high inflationary environment. Indeed volatility of profits and economic growth tends to rise with inflation. Clearly, this does not bode well for the medium outlook for equities.

The inflationary impact of monetary and fiscal stimulus we are seeing today effectively debases the currency and reduces the principal value of outstanding debt in real (not nominal) terms. The real value of debt is inflated away. Less directly felt by consumers than having to pay back principal loan amounts, but nonetheless a very effective way to get rid of an excess consumer debt burden. Simultaneously, the fall in dollar reduces the value of US external debt. *Therefore, the high-inflationary environment created by central banks' monetary stimulus is a crucial and well-designed element of the prolonged phase of de-leveraging we anticipate going forward.*

Markets have relied on a benign environment of ample liquidity and low volatility of monetary and fiscal policy for more than a decade. This provided the perfect base for a proliferation of financial technology, which, in turn, at some stage became the main driver of returns in many markets. The resulting market environment can be characterized as a trending market with low volatility and little price dispersion between comparable assets. However, going forward we expect markets to focus increasingly on underlying economic fundamentals and differentiate between good and bad investments. As a result, risk premiums will be higher, more volatile and more dispersed. Now that the credit bubble has burst, a prolonged phase of global de-leveraging will bring forward the underlying fundamental imbalances between regions, countries, sectors, companies and financial instruments.

An interesting example trade is the European Divergence Trade, to which we currently have a small exposure. The idea is that borrowing costs for some European sovereigns (notably Greece, Italy, Portugal, Spain but also Hungary, Romania, Poland, Latvia) are set to widen and diverge significantly from fiscally more sound governments such as Germany, Holland and Finland. In short, the arguments are as follows:

- As global growth decelerates, budget deficits are bound to grow rapidly, hurting countries with a fiscal situation already weak during the boom years;
- European governments have been heavily financed by the fast growing Asian countries, but the ongoing diversification of Asian currency reserves will mean less buying for European bonds;
- Following the collapse of the Stability Pact (Italy has been allowed to breach the limits ever since inception of the euro), there are no more restrictions on the growth of budget deficits;
- The ECB will not come to the rescue of troubled governments by printing more euro's: in light of already rising inflation, the ECB will do nothing to jeopardize its credibility and independence;

The logical outcome would be that the market will differentiate between 'good' and 'bad' governments by increasing the risk premium (credit spread) of the latter. Indeed, Chart 5 below shows that CDS spreads have widened significantly since September last year (although April saw a significant compression).

Chart 5 European credit spreads diverging



The lack of dominant technical trends in many markets also implies a more trading rather than trending market environment. Successful investment managers in this environment will have the following attributes: flexible, independent thinking, fundamentally focused and willing and able to take contrarian bets. At Theta, we have always had core positions in global macro funds managed by independent and fundamental thinkers and today's market environment provides a very compelling case to increase our allocations to the strategy. We aim to share our views on global macro investing with you in the near future.

3. Natural Resources

Central banks will continue to use their entire toolkit to provide monetary stimulus (most notably lowering interest rates) supported by fiscal stimulus packages, with the ultimate effect that inflation will continue to rise. As for the outlook for commodities, this means that nominal dollar prices of commodities will continue to rise (it will take more units of USD to buy one unit of a hard asset, as the money the Fed creates happens to be the same currency of denomination for most commodities). Therefore, barring a meaningful change in the structural supply/demand imbalance for commodities, energy and precious metals, the cyclical driver of increasing currency issuance (inflation) makes a compelling case for remaining constructive on commodities.

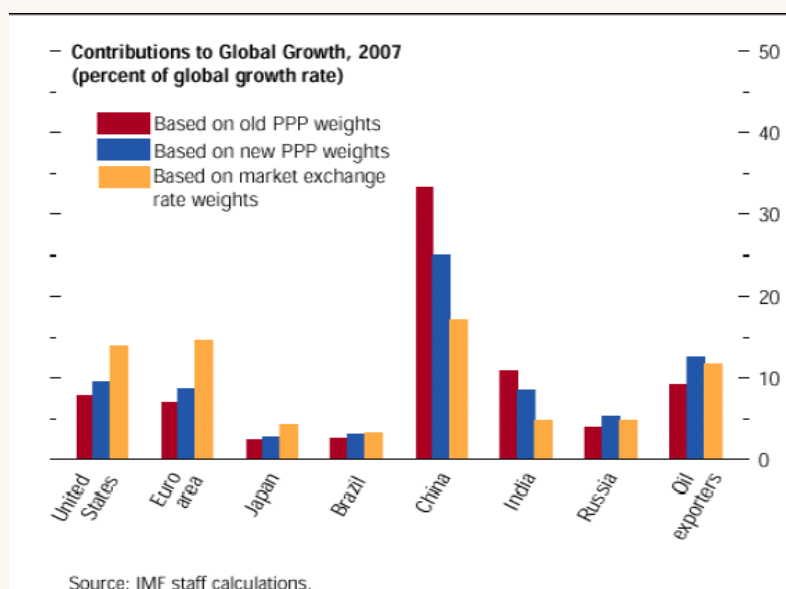
So while, high inflation tends to be unkind to equities, strong earnings growth can be obtained by business sectors involved in the production of materials that are causing the inflation: natural resources. That being said, the presence of speculative money does make global commodities markets a treacherous place. Nothing goes straight up (or down) and it seems the precipitous drop across precious and base metals, agriculture and energy markets is a natural flushing of weak hands (leveraged speculators) that occurs periodically in long-term trending markets. That is why we are actively researching a small group of commodities hedge funds, with a focus on trading skills rather than long-term fundamental trends. We plan to make a first small allocation in the coming months.

4. Shift in global economic leadership

In a recent article in the Financial Times, George Soros stated that “the deflation of the credit bubble will hurt the US more than other economies and this may end the global dominance of the US dollar and shift the balance of power in the world economy to the creditor countries of Asia and the Middle East”. While we, in our humble opinion, would not argue with this insight, we also note that the underlying drivers of this shift in the balance of global economic power were already present well before the credit crunch started. In fact, the US consumer and corporate credit boom is partly founded on Asian and Middle East savings being invested in the US. Chart 6 below paints an interesting picture: China's contribution to global GDP growth in 2007 exceeded the contributions of United States and the Euro area combined (using the IMF's new PPP weights)! Also, China and a group of oil exporting countries combined generate about half of global GDP growth. We are witnessing a structural change in the composition of the global economy, driven by three developments:

- The arrival of 3 billion new workers and consumers in the world economy;
- The global division of labor which results from almost universal free trade;
- The reduction of transport, communication and data processing costs.

Chart 6 Shift in global growth picture



Regardless of when this shift of global economic power was started, it is providing tremendous investment and trading opportunities for global hedge fund managers with a fundamental focus. Increased divergence between regional economic cycles creates strong movements in global currency, equity and bond markets which can be captured by skilled global macro traders with a focus on economic fundamentals as well as capital flows. In addition, while we believe the opportunity set in Asia is tremendous, we have selected two managers with proven shorting skills. These investments worked very well in the first quarter, as both funds managed to preserve capital in Asian equity markets that lost more than 10%.

In conclusion, we note that dispersion of returns across individual hedge funds is increasing in the current market environment, but we believe our portfolio is well positioned to generate positive returns in the challenging times ahead. Moreover, we are running significant cash levels both to mitigate volatility and to benefit from opportunities that these markets inevitably create. Periodic retreats in prices do present opportunities for patient investment managers who focus on longer-term fundamental trends, such as the ones described above.

The Theta Team

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