



Theta Quarterly Review

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Second Quarter 2008

Navigating violent markets

Wouter ten Brinke, CFA

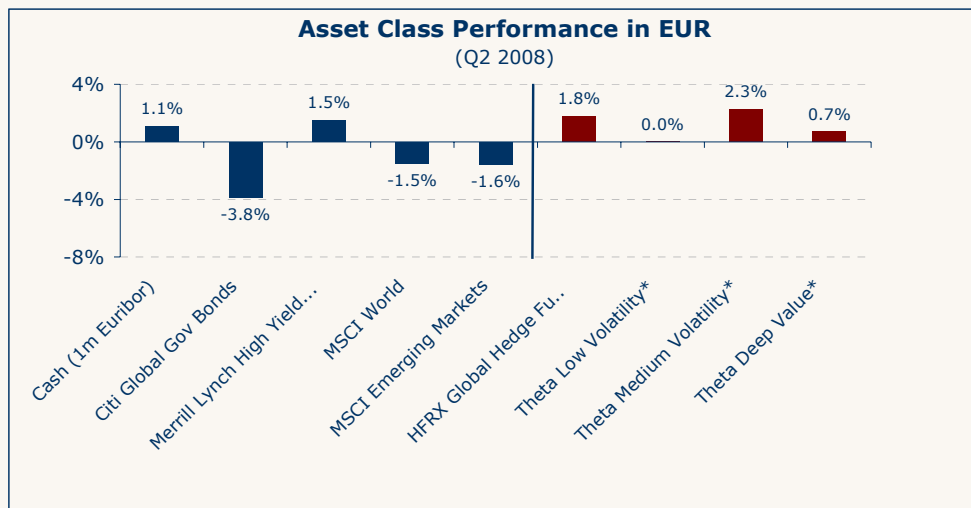
Theta Capital Management

August 2008

Market review

On the surface, the volatility in risky assets from the first quarter seems to have abated in the second quarter of 2008. However, there has been considerable volatility within the quarter (and indeed, within months, weeks and days). While global (emerging markets) equities had gained around 6% in April, in June this reversed into a loss of more than 8%. Interestingly, in the wake of the global inflation scare which took hold in the second quarter, bonds failed to act as a safe haven this quarter (see chart below). Hedge funds as a group recovered most of their losses incurred after the Bear Stearns bailout in March and gained +1.8% this quarter. Some observers note that in this environment, whenever the Fed moves (or some other bailout occurs), hedge funds loose money. Clearly a result of their - at times- sizable and aggressive short positions in sectors experiencing trouble. In the Q1 2008 Quarterly Review we wrote: *“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”*. Recent months have proven this is still the case and going forward, we believe that the turning point we were referring to is far from over.

Chart 1 Asset class performance in Q2 2008



Our Medium Volatility and Deep Value portfolios partly recovered from their first quarter losses and our Low Volatility portfolio managed to preserve capital. Despite challenging market conditions we are happy to note that our portfolios continue to see a steady inflow of new capital every month.

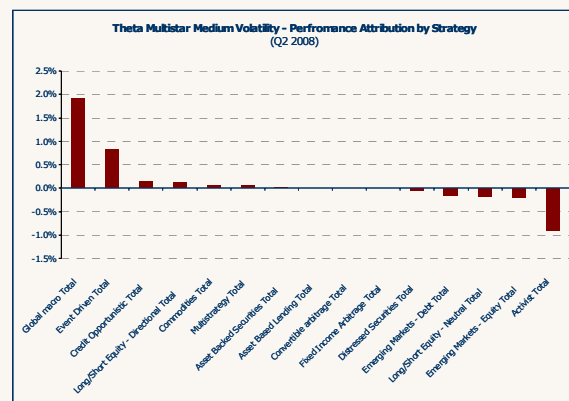
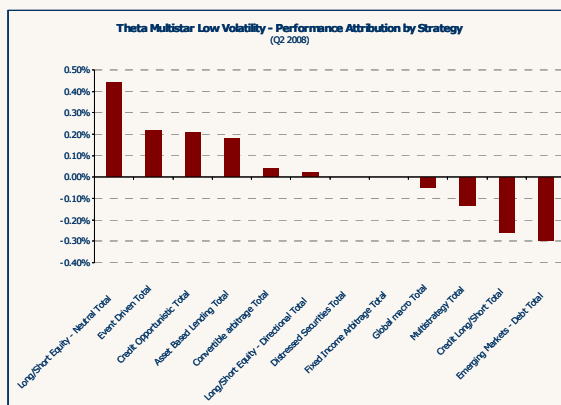
On the business front, we have expanded our research team with Mr Chen Wei who, as data analyst, will be responsible for further developing our qualitative database infrastructure as well as supporting our quantitative analysis on the hedge funds we evaluate. Please also note that we have moved offices and are now located next to the Rijksmuseum in Amsterdam. For more details, please visit our website (www.thetacapital.com), which has received a complete makeover. Reflective of our ambition to have an open and transparent communication with our investors, you can now find all relevant documents and reports for the Theta funds online (although some areas are restricted to investors in the relevant products). You are invited to have a look and note that the homepage contains the most important information of all: performance. Comments and suggestions for improvement are more than welcome.

Portfolio Review

	2 nd Quarter 2008	2008 YTD
Theta Multistar Low Volatility	+0.0%	+0.5%
Theta Multistar Medium Volatility	+2.3%	-4.5%
Theta Deep Value Fund	+0.7%	-1.9%

Our portfolios started the quarter on a weak note, mostly due to the implicit short credit bias we maintain across all our portfolios. Credit saw a strong rally while most of our managers were positioned conservatively and still held considerable CDS protection in their books to protect against further market weakness. As we have communicated on various occasions (see the Bubble Talk presentation in the download section of our new website), our take on the credit crunch is that it will lead to a prolonged phase of de-leveraging in global financial markets with severe consequences for the global economy. Also, it will take considerable time and effort for the financial sector to move away from the originate-and-distribute model and evolve into a new system with new checks and balances and a new balance of power. That is why we and our underlying hedge funds maintain a conservative positioning, as expressed in low leverage (we never use leverage on the portfolio level), considerable short exposure to equity and credit, as well as significant cash positions. As a result, our portfolios performed strongly when equity and credit markets sold off in June and managed to generate a decent return for the quarter. We believe this positioning helps protect investor capital and could even make an investment in our funds a true “hedge” against potential losses in other parts of our investors’ portfolios, most notably (emerging markets) equity and credit. That being said, as we expect the speed and magnitude of losses in credit to slow down, we have slightly reduced our short credit exposures towards the end of the second quarter.

Performance attribution Theta portfolios



Whilst we strive for positive returns and our Medium Volatility and Deep Value portfolios are still underwater year-to-date, we re-iterate that we are medium term investors and no investment portfolio can be judged on a monthly or even quarterly basis. Even more so in the extremely volatile and dislocated markets we are experiencing this year. Moreover, note that Theta Deep has a 2-3 year investment horizon and has generated over 40% in its first 2 years of existence. Protecting investor capital is paramount these days and we patiently look forward to the compelling investment opportunities this market environment creates.

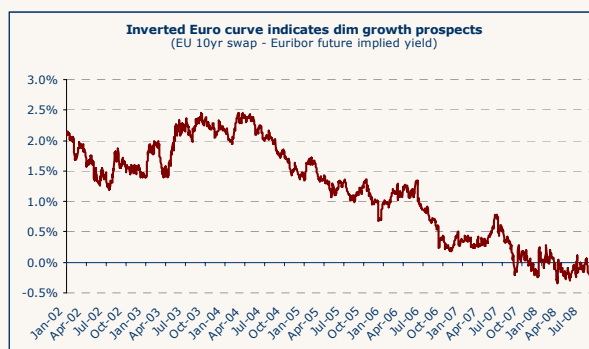
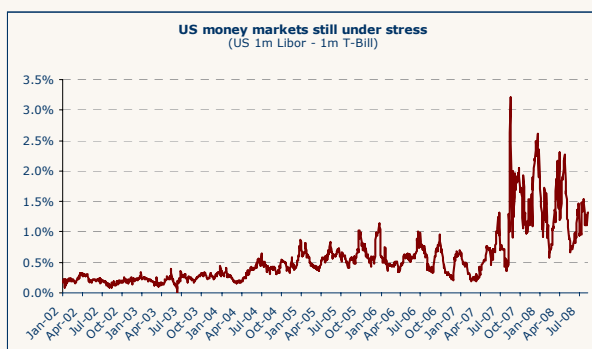
Outlook and investment strategy

So, how do we know when the worst is behind us? And how bad will it be? As for the latter, estimated losses from the credit crunch range from USD 1 trillion (IMF) to USD 3 trillion (Nouriel Roubini), which equates to 7-14% of US GDP! It is hard to see how this would not have a serious impact on the US (and global) economy. Indeed, a recent NBER study by Ken Rogoff comparing many post-war financial crises, suggests that the growth contraction may be over 5% and growth may remain below trend for more than three years¹. They also find stunning parallels between the pre-crisis developments in the current US situation and previous financial crises, among which a significant run-up in housing and equity prices, and enormous capital inflows (remember how much of the US current account deficit is financed by Asian and Middle Eastern countries). Clearly, the unwind of this bubble into the prolonged phase of deleveraging that we anticipate will have serious consequences for economic growth, asset prices and the US dollar. Judging from recent growth figures (which we still relatively strong) and the USD rally to 1.50, it seems that we've only just begun.

That being said, it is important to note that financial markets always *lead* rather than *lag* developments in the real economy. Thus, waiting for default rates to peak or the US economy to climb out of recession (if any) is not a viable investment strategy. Indeed, the Rogoff study mentioned above finds that, despite the fact that following past financial crises the economy and the fiscal situation struggled for many years, equity prices rallied on average almost 50% in just two years, starting right at the onset of the financial crisis...

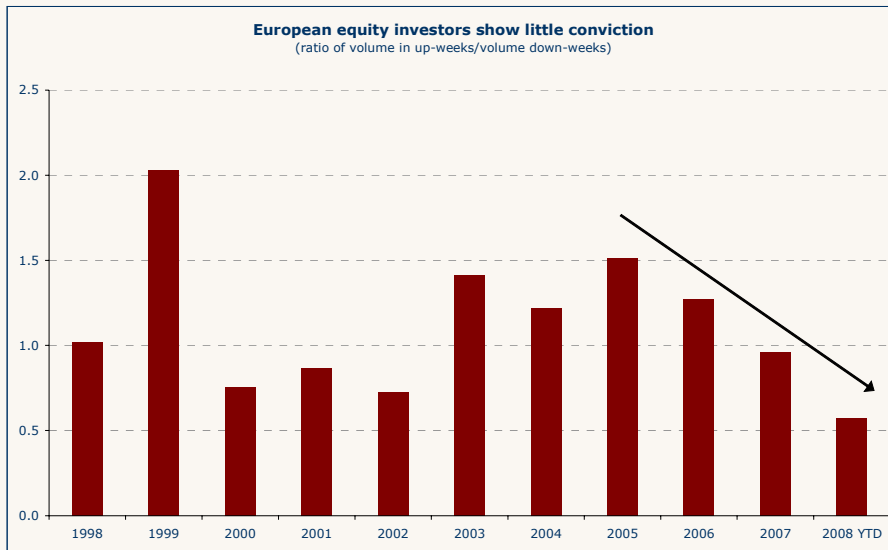
Below we provide some (financial market) indicators to watch.

1. The spread between US interbank rates and T-Bills is still at elevated levels (see chart below), indicating that banks are highly reluctant to lend to each other as long as the "trillion dollar question" remains unanswered: who owns what and what is it worth?



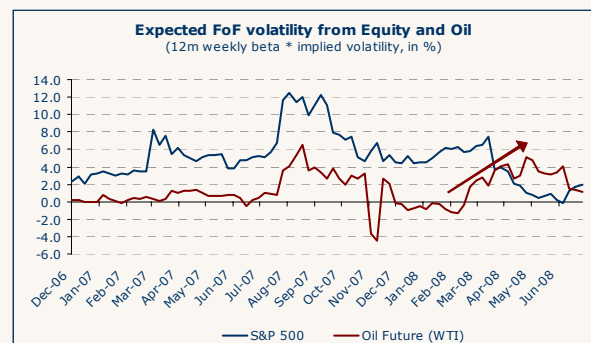
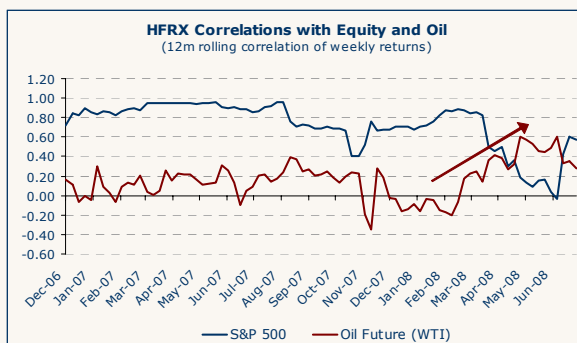
2. The European yield curve is still inverted, which points to dim growth prospects, or indeed recession.
3. Equity investor sentiment is at extremely depressed levels. The chart below shows that average trading volumes in down weeks of the DJ Eurostoxx 50 way surpassed volumes in up weeks. This implies equity investors still have very little conviction that the worst is behind us.

¹ "Is the 2007 Sub-Prime Financial Crisis So Different? An International Historical Comparison", by Carmen Reinhart and Kenneth Rogoff of NBER, February 2008. This study draws on their upcoming book "This Time is Different: Six Centuries or Financial Folly".



The bottom line is that markets will continue to highly volatile and, at times, dislocated going forward. This will also impact hedge funds as even those with an active trading style have a hard time trading a market which is down -10% one week and up +20% the next.

The charts below show where the volatility of hedge fund returns is expected to come from. The left chart shows how hedge funds as a group (represented by the HFRX Global Hedge Fund Index) have built up (indirect) exposures in energy this year. Throughout 2007, the largest exposure was still to equities, but this has been reduced significantly. We then determine the anticipated risk from this exposure by calculating the product of the HFRX's equity beta and the implied volatility of the equity index. The same calculations are performed on the front-end oil futures contract.



Since so many securities have been impacted by the 45% rally in oil futures this year, this exposure also shows up in hedge fund strategies. For example, many long/short equity managers are long commodities/oil through their individual stock holdings, while some global macro managers are long oil futures to express their bearish view on the US dollar. At the same time, some trend-following CTA's are also long oil because their models indicate that's where the strongest trend is. Our analysis shows that the expected volatility of the HFRX Index from its exposure to oil was around 4% in the second quarter of 2008. At the same time, it is comforting that hedge funds have significantly reduced equity risk this year (partly by shorting financial stocks). On a longer-term basis our analysis shows that these risk

exposures are by no means constant and can be significant at times. That is why our risk models constantly monitor the exposures to various risk factors in which hedge funds take their exposures. This becomes all the more important in today's extremely volatile market environment. For more information on our investment process, please visit our website.

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