Theta Deep Value Fund

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Quarterly Investor Letter – Q3 2008

Theta Capital Management
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Dear investor,

The Theta Deep Value Fund lost around 10% in the third quarter, primarily driven by our exposure to various emerging markets. Although disappointing, the third quarter of 2008 was also a quarter which we hopefully will not often see again. In the long list of defaults, especially the Lehman default hit the financial and hedge fund industry hard as it led to a collapse in confidence and an extreme deleveraging across various asset classes. Only one of our funds had a small loss due to the Lehman default (the CQS Directional Opportunities fund which lost 3.8% in September) but others were indirectly impacted by the collapse. Especially disappointing during the third quarter was the performance of our base metals fund Red Kite which, after a stellar start to the year, gave back (nearly) all the gains in September. Although the fund has had a considerable rebound during October and November, we are reviewing our investment.

heta 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%	
	Jan	**Feb**	**Mar**	**Apr**	**May**	**Jun**	**Jul**	**Aug**	**Sep**	**Oct**	**Nov**	**Dec**	**2008**
Net Performance	0.17%	-0.45%	-2.39%	-1.18%	0.25%	1.69%	-2.80%	-4.48%	-3.94%				**-12.55%**
Cumulative Performance	45.39%	44.73%	41.28%	39.61%	39.96%	42.32%	38.34%	32.14%	26.93%				

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

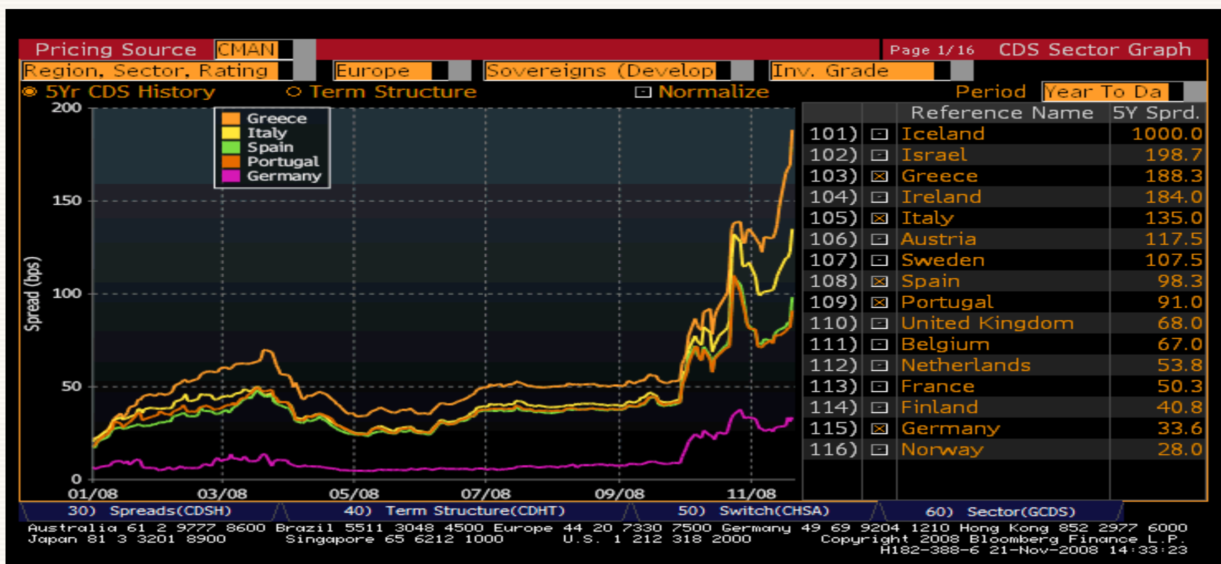
Although the performance is disappointing, it is worth remembering that the Deep Value fund focuses on managers that can generate idiosyncratic, outsized returns. As an indication, in October whilst the MSCI World was down around 18% for the month, the early indication is that the Deep Value fund will be down around 4.5% for the month as a result of strong contributions from the above mentioned Red Kite funds as well as Corriente's European Divergence Fund. At the time of writing this report when the MSCI World is down more than 19% for the month of November, we have again seen very strong contributions from Red Kite and the Gavekal/Corriente European Divergence fund in particular.

The opportunity set for funds like the Theta Deep Value Fund that come through the current storm relatively unscathed is appealing. Fundamentals might not reassert themselves in the short term but the payoff for patient investors could be very substantial. Some concrete examples:

- The Gavekal/Corriente European Divergence Fund has generated solid returns this year (particularly in October and November of this year) through its portfolio in credit protection it bought on what it considers some of the weaker sovereign European credits. As credit conditions deteriorate around the world, investors have become more discerning and spreads on some of the government names have indeed increased significantly as can be seen in the graph on the next page.
- After the dramatic decline in value, John Paulson has now started buying mortgage backed securities. For example, the ABX index has halved since May 2008 and now trades around 36 which suggest the market is pricing in that one will get a recovery, on AAA securities, of around 36 cents in the dollar. Some securities will indeed do that, or even less, but some will pay out at par as they are of good quality. For those investors like John Paulson who have the money, the knowledge and the resources to buy these bonds, being able to buy those at 36 that will repay at 100 in a couple of years is obviously very attractive.

- The Russian market has seen a dramatic decline in value over two months due to a combination of political blundering and levered positions being unwound and obviously our Greater Europe funds have been impacted. However, valuations have become absurd. The overall Russian market has lost 74% since May 20 and trades on 2.9X this year's earnings. No other large emerging market is so cheap. Sure, there are risks but investors should at these valuations be well rewarded for taking on that risk. Gazprom for example trades at around 2.5X this year's earnings and around 0.7X book value. In the small and mid cap segment, cash generative companies trade below their net cash position.
- The largest position of Pershing Square, one of our Activist investors, is in Target. This is a well run retailer with a very sizeable real estate portfolio. On cautious assumptions (we have very detailed analysis and presentations by the manager on this company) he feels fair value of the shares is around US$80 (an upside of 116% from current levels). Pershing Square is an activist fund that has come through the turmoil extremely well thanks to his activist shorting (especially in the bond reinsurer area) and is now in excellent shape to take advantage of the distressed levels at which companies are trading (the fund had around 40% in cash when the correction in equity markets started).
- The Montpelier Fund has suffered as emerging markets declined sharply. However, it is also clear that valuations currently have little to do with fundamentals. Price to earnings ratios of 2 to 3 times seem to have become the norm and in some cases, companies are trading at a discount to the cash the company has on the balance sheet. Again, once fundamentals reassert themselves the upside is considerable and as the portfolio has nearly 70% in cash, the manager is well positioned to take advantage of the opportunities.

The European Divergence Trade: debt protection Greece, Italy, Spain vs Germany



Detractors to performance during the third quarter were the Greater Europe Deep Value Fund(which focuses on the Russian market), the Montpelier fund (which focuses on Emerging Markets worldwide), ZAIS Matrix V (an ABS fund which should benefit from the current distress but occurred significant mark-to-market losses and Sector Speculare, which was hit by the sell-off in the Energy sector during the month.

The largest positive contributor during the quarter was Corriente's European Divergence Fund which benefited as spreads on European sovereign debt widened considerably, especially in

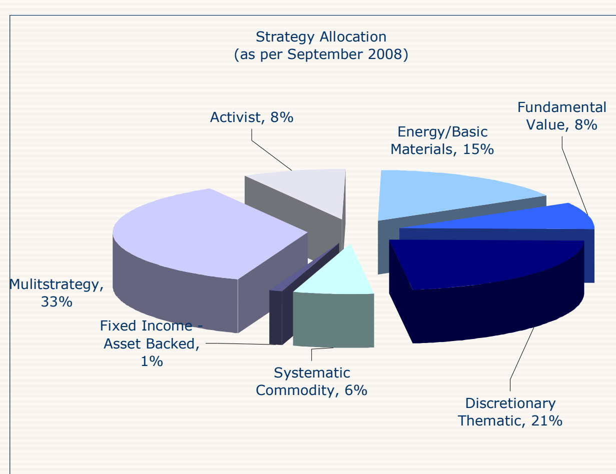
September. It has become clear to investors that Europe will not be insulated from the fall-out of the credit crunch and European governments will spend very significant amounts of capital in order to shore up their banking system. With the balance sheets of several European countries already stretched, Europe's relatively new unified monetary system will be tested in the near future and risk premiums of some countries have started to rise significantly.

Other positive contributors were Pershing Square and Paulson Credit Opportunities which benefited from their sizeable short positions in financial institutions.

As of October 1, we switched a part of our investment in the Paulson Credit Opportunities Funds into the newly launched Paulson Recovery Fund. This fund will benefit from the extensive analysis that the team at Paulson has done on the financial sector over the last couple of years as part of their successful short subprime trade. John Paulson has made further significant hires over the last couple of months to further strengthen the expertise of the team. The Recovery Fund will focus on providing refinancing capital to financial institutions. Clearly, the financial sector has been hit hard as writedowns on subprime-related investments as well as other structured credits significantly eroded the capital base of many financial institutions. Whereas the US government has put aside a significant amount of money already, a lot more will still be needed by various banks over the coming years. The Paulson Recovery Fund is well placed to make outsized returns by providing capital to these distressed banks and we have considerable confidence in the team at Paulson that they will be able to find the right investments and execute the right transactions in the sector.

Portfolio Allocation

Strategy Allocation	Oct-08
Activist	**8%**
Marwyn Neptune Fund	
Pershing Square	
Energy/Basic Materials	**15%**
Sector Speculare III	
Sector Speculare IV	
Ecofin Special Situations Fund	
Fundamental Value	**8%**
Montpelier China Fund	
The Montpelier Fund	
Discretionary Thematic	**21%**
Greater Europe Deep Value	
Greater Europe Deep Value II	
European Divergence Fund	
Autonomy Class C	
Clarium Capital	
Systematic Commodity	**6%**
Red Kite Metals Fund	
Red Kite Prospect Fund	
Fixed Income - Asset Backed	**1%**
ZAIS Matrix V	
Fixed Income - Corporate	**8%**
Camulos Special Situations	
Eidesis Special Opportunities	
Mulitstrategy	**33%**
CQS Directional Opportunities	
Paulson Credit Opportunities	
Paulson Credit Opportunities II	
Total	**100%**



The portfolio remains well diversified as we continue to seek opportunities across a range of uncorrelated strategies as we believe this offers the best way to generate the 15%-20% average annual return over a three-to-five year period.

Third Quarter 2008 Performance Review

Paulson Credit Opportunities Fund I & II (Credit Opportunistic) generated a blended return of 5% for the quarter, bringing the year-to-date return to 17.1%. The funds continued to benefit from the protection it bought on various financial institutions which widened significantly during the quarter (and October). However, John Paulson has also been realising profits over the last months and slowly started to prepare the funds to start investing in both distressed asset backed as well as distressed financials and hence the funds by now have significant cash levels which help them navigate the current volatility in the markets well.

The Paulson funds have restructured over the last months as the two Credit Opportunities have been merged into one and the above mentioned Recovery Fund was launched which will focus more on direct equity investments in financials (whereas the Credit Opportunity Funds will focus on asset backed investments). The increased size of the funds have allowed Paulson to hire some of the best analysts and managers in the industry whilst also adding people such as Alan Greenspan and Dr. Altman to his Advisory Board. Given the fund manager's excellent track record and quality organisation we continue to have a high conviction on this fund. Once the funds will actively start investing in the distressed opportunities, there will be a lot more to write about.

The **Camulos Special Situations Offshore Fund** (Credit Opportunistic) lost around 1.9% for the quarter, bringing the year-to-date return to around -1.5%. The fund managers continue to work on various exits and capital events for the portfolio but unsurprisingly in this environment, little has materialised.

Clarium had a disappointing third quarter after a very strong start to the year, losing around 22% for the quarter bringing the year-to-date return to around 19%. The performance of the fund is especially disappointing as so many of their investment themes became reality during September or October with investors fleeing assets which had significant leverage. One of their major themes was to be long unlevered assets whilst shorting levered assets. However, the fund closed out a major part of that short book which consisted of financials after the new rules on short selling were introduced in July. Furthermore, the fund further reduced its shorts positions during September as the manager felt the correction in the market had gone far enough and that the enormous stimulus packages being presented around the world would provide a boost to the world's equity markets. However, this clearly did not happen during the month of September and the fund did not benefit from the further fall in the markets.

The **CQS Directional Opportunities** Fund (Convertibles) lost around 6.6% for the quarter, bringing the year-to-date return to +13.9%. The fund had small losses in July and September. The losses of the fund in September of around 3.8% were predominantly related to the failure of Lehman brothers as the fund exercised its rights and closed out the relevant counterparty agreement. Further losses were incurred in some long credit positions as spreads widened. The fund did generate profits from its equity book, arising from short positions in US and European financials and rating agencies. We are pleased with the strong positive performance this year.

The **Greater Europe Deep Value Fund** (Emerging Markets Equity) was significantly impacted by the drop in the Russian market, particularly in September. The fund lost around 40% for the quarter and year-to-date as particularly the exposure of the fund towards the electricity

distribution sector hurt performance. The electricity distribution sector is going through a major restructuring wherein the market has been opened up and pricing has changed towards internationally accepted standards. Valuations are extremely compelling but the Russian market has suffered from a combination of foreign investors withdrawing money following the Georgian war, the comments Putin made with regards to Mechel and the TNK-BP internal row. On top of that, it seems that considerable leverage was used by some oligarchs to buy stakes in various companies and once they failed to meet margin calls, considerable forced selling took place in a market without a bid. However, the long-term nature of the Greater Europe Deep Value fund should ensure that the fund recovers these losses and take advantage of the situation.

The **Ecofin Special Situations Utilities Hedge Fund** lost around 9.6% for the quarter bringing the fund's year-to-date performance to -9.2%. Especially September saw indiscriminate selling within the utilities sector in line with the rest of the market. Regardless of valuation and quality of the underlying company, stocks were dumped into the market. The fund has a substantial amount of cash in the portfolio and the managers are not only convinced of the quality of the names in their long book but also that once investors have time to look at the fundamentals again there still is considerable value to be made from their short book as well. There are still a considerable number of companies out there with high levels of debt that matures in 2009, 2010 or 2011. Whereas until recently these high levels of debt were sustainable, given the stable nature of their revenues, the situation has clearly changed and companies might find it difficult to find refinancing at acceptable terms.

Autonomy Capital – C Class (Credit Opportunistic – Emerging Markets) lost 16.4% for the quarter, bringing the year-to-date return to a negative 19.7%. The fund was hit by the general downturn in the Brazilian market in the third quarter and the drop in real-estate related names especially. However, the fund does not use leverage and rather has a fairly large cash position right now and is structured to take advantage of the medium to long term growth trends in various Emerging Markets such as Brazil.

The **Marwyn Neptune Fund** (Activist Strategies) lost 10.7% for the quarter, bringing the year-to-date return to a negative -22%. As in the first half of the year, shares of their holding companies drifted lower on slim volumes despite the fact there was little new fundamental new. Or if there was positive news, it tended to get ignored. Especially September proved to be a difficult month for the fund despite the fact that core holdings such as Entertainment One or Zetar published positive operating developments during the month. It is clear that the fund managers at Marwyn are delivering on their operational targets for their various holding companies but in a bear market like we seeing right now, these kind of developments are not rewarded. Clearly frustrating but also here, the fund is structured to take advantage of medium term opportunities and should be able to benefit from the recent volatility.

Pershing Square (Activist Strategies) made a small profit of 0.5% for the quarter, bringing the year-to-date return to around 2.5%. The performance was very similar to that of the first half of the year with significant gains on his short financials book (MBIA, Ambac and FSA, mainly expressed through credit default swaps) compensating for losses on his long book, and the retailer Target in particular. Target is one of the fund's largest holdings and the manager also has a dedicated investment vehicle which invests exclusively in Target, making Pershing Square one of the largest investors in Target, owning around 10% of the outstanding shares. The fund manager

has recently given a detailed presentation as to how he thinks that Target could unlock a significant amount of value which includes a restructuring of the company's real estate holdings.

The **Montpelier Fund** (Emerging Markets Equity) lost 19.3% for the quarter, bringing the year-to-date return to -24.7%%. The manager sees very good opportunities in emerging markets worldwide but has maintained a very considerable cash pile in the fund as volatility remains extremely high and continued forced selling drives prices even lower in thin trading. The fund's major exposures right now are in Russia, the Middle East and China and the manager continues to concentrate on domestic-focused thematic areas. Although clearly the emerging markets will be impacted by the slowdown in the world economy, many emerging market economies have a far greater ability than their Western counterparts to stimulate growth trough expansionary fiscal policy in areas such as infrastructure spending (similar to how China spent its way clear of a significant slowdown after the 1998 Asian crisis). Additionally, the consumer in the Middle East and China is generally far less leveraged than in the West. The manager has started to invest part of his cash pile in some more liquid names where he has seen very compelling value emerge.

The **Montpelier China Fund** lost 17.2% during the quarter, bringing the year-to-date loss to 37.7%. The Chinese stock markets has been one of the hardest hit markets this year with the Hang Seng China Enterprise Index 44% down through the end of September. The Montpelier China Fund has also been hit as their focus on medium sized state owned enterprises meant some of their holdings came down even further. We went through the portfolio with the manager in extensive detail and it is clear that there is considerable value in the portfolio. Price to earnings ratios of just 2 to 3X seem extraordinarily cheap but some companies trade even lower than that. As an example, one of the fund's holdings that has been sold off relentlessly over the last months is now trading at a discount to the cash the company has on its balance sheet. This is a healthy, profitable and cash generative company but in the indiscriminate sell-off of the last months, nobody seems to care that you can buy this company at a negative price earnings ratio if you were to strip out its cash position. In the medium to long run, these kind of mispricings should revert to something more normal.

Sector Speculare III and IV (Long/Short Equity – Directional) returned -8.3% and -12.4% respectively during the quarter, bringing the blended year-to-date return to -9.3% (Sector Speculare IV was launched on July 1 of this year). Although disappointing, the negative return in the fourth quarter should be seen in the context of one of the biggest drops ever in the commodity complex in general and oil in particular. Over the third quarter, the price of oil fell by 31%, from US$140 to US$97. Although this does not immediately impact the actual operations of Sector III and IV which focus on oil exploration and production developments with multi-year time horizons (and which are still highly profitable even at current prices), the decline in the oil price has led to a sell-off in the oil & gas segment as well. We visited the Sector Investor day in Oslo and met with the key portfolio managers there. The portfolio is protected by puts on oil if the price were to fall below US$80 (which has happened and which thus have started to pay off). Furthermore, apart from the non-listed investments the funds have made, the managers have also made some investments in listed upstream and oil service companies where they think the indiscriminate sell-off leads to a situation where for those companies with attractive assets, there is likely to be a bid. One promising sign is that Sector managed to exit one of their larger holdings at a premium of 140%, even in the challenging environment in October.

Eidesis Special Opportunities Fund (Structured Credit/Distressed CDO's) was flat for the quarter, keeping the year-to-date return at -15.2%. The fund has been looking at distressed opportunities in the past year and it now looks like the default of Lehman has provided a catalyst to a broad repricing of the market, towards levels where the manager would start to feel comfortable buying. The manager has therefore made a further capital call as over the remainder of the year and early next year the opportunity seems to be there to pick up some of these assets from the distressed buyers.

The **Zais Matrix V Fund** (Structured Credit / Distressed CDO's) lost 24.9 % over the quarter, bringing its year-to-date loss to 27.0%. The fund is a very small part of the Deep Value portfolio (less than 1%) and its negative contribution is less than 0.5%. Despite the quality of the Zais organisation we will not be increasing our investment in this fund further and as the fund pays out as it completes deals the size of this fund will decrease further.

Red Kite Metals Fund (Commodities) was down 47% this quarter and **Red Kite Prospect Fund** (Commodities) was down around 22%, bringing the blended year to-date return for our portfolio to around -4%. We were heavily disappointed by the performance of the manager during the third quarter and are actively reviewing our investment. What does give us comfort is that the manager has traded out of his positions fairly quickly rather than stick with them once they started to move (sharply) against him. Furthermore, in October the fund has had a very solid positive return as the fund benefited in particular from the sharp drop in the price of Copper, 35%, during that month. We will review the fund over the coming months and it will be crucial to see how they handle the current volatility in the commodity markets. We think the drastically changed environment in commodity trading could potentially be beneficial to Red Kite as a lot of hot money has left and the market is now trading more on fundamentals.

The **GaveKal/Corriente European Divergence** Fund generated 17.8% for the quarter, bringing the year-to-date return to -12.4%. Spreads widened significantly over the third quarter, coming up from the incredibly tight levels earlier this year. The widening occurred as investors became (more) aware that the credit crunch could have very differing effects on those countries with a fairly healthy balance sheet and those that already had weak balance sheets going into this credit crunch. Although for example Italy and Greece are under the same monetary system as Germany, it would be fair to say that the risk for a buyer of sovereign debt of Greece is considerably higher than that of Germany just looking at the official debt to GDP. After quarter-end, spreads widened considerably in October and November and the fund has made very substantial gains.

For more information, please contact us at:

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