

Q1 2009

The Next Phase

24 May 2009

Wouter ten Brinke



Theta Capital Management B.V.
Johannes Vermeerstraat 9
1071 DK Amsterdam
The Netherlands

Telephone: +31 (0) 20 5722733
Fax: +31 (0) 20 5722744
E-mail: info@thetacapital.com
Website: www.thetacapital.com

Performance Review

The first quarter of 2009 was clearly a period with two faces. It started with a continuation of last year's downward pressure on markets driven by deteriorating fundamentals. Then, in the second week of March, equity markets took a violent turn in sentiment and stocks clawed back half their year-to-date losses. This was not an easy environment to trade for most strategies and therefore we are quite pleased to have shown low volatility amidst violent market swings.

Performance Theta Funds

	Q1 2009	YTD 2009
Theta Low Volatility	-2.09%	-2.09%
Theta Medium Volatility	-0.27%	-0.27%
Theta Deep Value	-0.43%	-0.43%
HFR Fund of Funds Index	0.43%	0.43%

As the charts below show, contributions from the various funds and strategies were quite modest and winners balanced losers in terms of both number of funds and their contribution to performance.



In our Q3 2008 quarterly letter we noted: "Liquidity markdowns on many positions represent an increasingly compelling value that will eventually be realized, as liquidity returns to the market. In other words, we will see prices of many assets revert to the mean or some other notion of value." Following the sell-off in the first two months of the year (in which our portfolios held up very well and outperformed both equities and their peers), we have indeed seen the extreme overshoot in some credit markets change into more rational relative pricing.

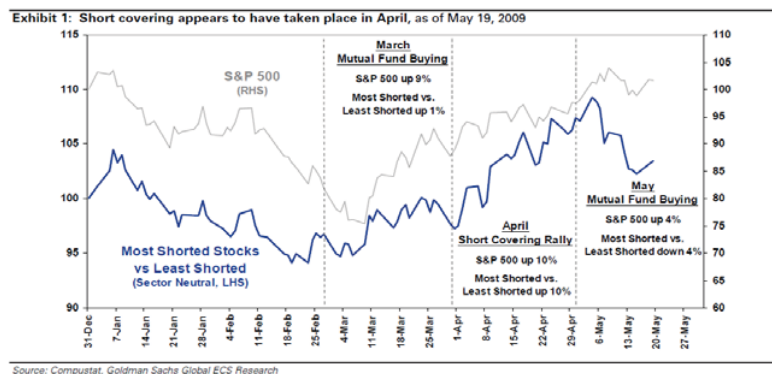
We define risk as a permanent loss of capital and are less concerned with month-to-month volatility of returns. We do appreciate that an investor's focus becomes exponentially more short-term oriented during times of stress, but we have accepted the mandate to generate strong absolute returns with a medium-term horizon.

That being said, we acknowledge that our investment results have not won us any awards last year. However, we have also learned that many of our best investment ideas were controversial and out of consensus at the time of

investment. We entered into dedicated short funds in subprime mortgages and corporate credit (investment late 2006) well before it became fashionable in mid 2007 and the European Divergence Trade (investment in February 2008) only became popular among other investors the second half of last year. We are confident that our recent actions to create balanced, well-diversified, and liquid portfolios will prove fruitful for our investors in the coming months.

Investment Environment

Many market participants seem to have been caught by surprise by the market rally since 9 March. Indeed, the speed and magnitude of the rally itself suggests many market participants were caught short or largely unexposed to the rally. Recent UBS data shows that long/short equity hedge funds' net exposure had fallen below 10% in February and that cash at mutual funds in Europe and the US were high at levels last seen in 2001 and 1998. Furthermore, the chart below shows that short covering was an important driver of the equity rally in April, but not in March and May.



So, why were so many investors “caught naked” during the recent rally? We need to realize that markets react only to *new* information. Asset prices adjust to reflect the impact of new (“surprising”) information on expected future values and risks. To the extent that newly available information merely confirms the *existing* market perception of future risks and returns, one would not expect significant moves in asset prices. In terms of the extreme concerns about the banking sector and uncertain economic outlook in the autumn of 2008, this means that one would expect markets to fall further only if new information becomes progressively worse. Indeed, it seems that the market bottom of 9 March coincided with *the lack of new negative information* about the global economy and the state of the banking sector. On top of that, as we explain below, fundamentals also showed improvement (or less deterioration).

As Nobel laureate Robert Engle writes in a recent FT comment (26 May 2009): “The fundamental causes of financial market volatility have improved and this is naturally leading to a reduction in the observed volatility.”

From systemic financial risk to cyclical economic risk

The decline in financial systemic risk is not just attributable to animal spirits and improved sentiment, but we have also witnessed a true improvement in the fundamentals of the global financial system:

- Availability of liquidity backstops for banks
- Successful capital raises and re-capitalizations
- Most of the losses on toxic mortgage assets have been recognized and bank profitability (due to the very steep yield curves) will help cover more regular loan losses in the coming years
- Counterparty risk is less prevalent after the de-leveraging cycle and the introduction of exchange-cleared credit derivatives

So where does this leave us in terms of our investment outlook and portfolio positioning? We presented a “Phase 1-2-3 framework” in our Outlook 2009 ([see here](#) and in the Appendix to this letter) and to determine when Phase 1 (De-leveraging) would be over, we identified several indicators to watch. By means of a check-list, we give our updated view on these indicators below.

Indicator to watch (from Outlook 2009)	Updated Theta view
House prices stabilize and asset write downs are over, banks start to recapitalize	House prices continue to decline: S&P Case Shiller Home Price Index -19% in March Banks' recapitalization has started
Redemption pressures from hedge funds and banks recede	Tentative signs from prime brokers that redemptions are slowing, inflows are growing; banks' prop desks have been closed down
Interbank lending resumes and Libor-OIS spreads narrow	Libor-OIS spread narrowed from 90bps in Sep08 to 45bps currently
Real money starts buying beaten down assets	Clear indications of real money buying IG credits and convertibles in recent months (see chart on page 8 of this letter)
USD decline and the world worries about US debt position again	USD fell by -11% and 10yr UST fell by -6% since Feb, on worries about US government debt
News flow and sentiment stops getting progressively worse	“Green shoots” in the economy, emerging markets outperforming developed markets, FX carry trades are back, risk aversion declined significantly

Based on our analysis, we believe the worst of the de-leveraging cycle is behind us and markets will start to trade more on fundamentals. In macro terms, the systemic financial crisis has migrated into a cyclical economic crisis for which we identify four main themes:

1. Financial systemic risk (tail risk) has eased:
 - Broad retracement across asset classes, risk aversion, declined, FX carry strategies are back
 - Extreme correlations between asset classes will be lower
 - Fundamentals will matter again;
2. Secular bear market in risky assets, with sharp relief rallies; price trends will remain short to medium-term;
3. Default cycle will be vicious (credit constrained, low growth, high unemployment);
4. Relative financial positions & policies will drive global capital flows; country/currency selection and sector rotation will be more important.

Current portfolio positioning

We believe we are gradually moving from Phase 1 (De-leveraging) to Phase 2 (Market Normalization), but the two phases are overlapping¹. The implications for portfolio positioning are that we are no longer looking for downside protection through a short bias or long volatility positions, as the tail risk of another liquidation wave has decreased significantly.

We continue to focus on liquid trading strategies (Phase 1) such as discretionary global macro and fundamental commodities traders. However, more in line with our Phase 2, we have recently made additions to long/short equity funds (including a long/short fund dedicated to the healthcare sector). Going forward, we will further increase our exposure to fundamental global macro managers and liquid long/short equity and multi-strategy credit managers (including convertibles).

Most of our underlying hedge funds have reduced short positions and/or increased net long positions during the first quarter. Also, gross exposures are higher than at the start of the year. Furthermore, we have redeemed from our dedicated short credit manager, a position which has served our portfolios very well in 2007 and 2008.

We are agnostic on the timing of a turning point in risky assets, and have thus oriented our portfolios to minimize directional exposure to short term fluctuations in risk appetite. Instead, we expect our hedge funds to focus on fundamental relative positions in fixed income, equities, currencies and commodities. Figure 3 below provides the latest snapshot of market exposures for Theta Multistar Medium Volatility (as per 30 April 2009).

Table 1. Market exposure Theta Multistar Medium Volatility

Asset class exposure	% of NAV
Equity Long	25.4%
Equity Short	21.6%
Credit Long	30.4%
Credit Short	5.1%
Commodities Long	7.2%
Commodities Short	6.2%
Notional Protection (long CDS/long options)	32.4%
Market Value Long Protection Book	1.6%
Gross Exposure	130.0%
Net Exposure	-0.8%

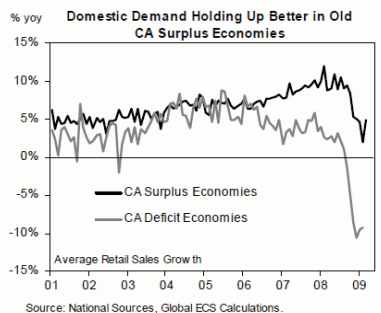
¹ Note that our main indicator-to-watch for Phase 3 (Economic Recovery) is a peak in default rates and we are nowhere near that point yet.

Strategy Outlook

In the remainder of this letter, we will give our outlook for some hedge fund strategies. In short, we see tremendous investment opportunities arising from continued elevated market volatility, dislocations within and between asset classes and outright fundamental value. For the moment, a key element in all our investments remains a preference for liquidity.

Global macro

The dynamic between the conventional belief in a V-shaped recovery and the dismal reality of a severe and prolonged recession will provide a lot of trends that will be quick to develop and then quick to short circuit. Flexible long/short investment managers with strong trading skills should be particularly well equipped to benefit from this environment. Trading opportunities are particularly present in the global macro space:

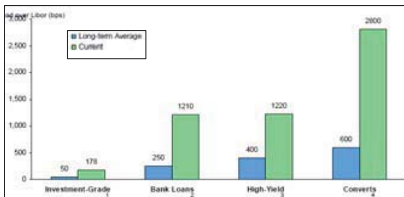


- Relative financial and policy positions between countries, currencies, and sectors will drive global capital flows. For example, global trade imbalances are declining (as a result of different growth rates in domestic demand between current account surplus countries and deficit countries) and fundamentals are driving FX-crosses again. At the same time, the risk of disruptive FX corrections has decreased significantly. This presents tremendous trading opportunities for discretionary macro/currency traders;
- Differentiation across countries with respect to the speed of economic recovery is increasing. Recent economic data shows large differences in PMI indices, inflation rates and financial conditions between the G3 and the larger emerging markets, such as China, India, and Indonesia. This leaves ample scope for trading opportunities in currencies, interest rates and equities;
- In a recent *Foreign Affairs* article², Richard Haass described the move from a uni-polar world dominated by the US, to a “non-polar world” characterized by numerous centers of gravity with meaningful political and economic power. The growing economic strength of China and India brings with it increased global influence and competition. At the same time, this geopolitical setback for the US and Europe may lead to increased protectionism and political influence on the economy, especially in times of economic recession (a process which one of our global macro managers calls “the bull market in politics”;
- With much of the hot money having left the commodities market in late 2008 (hedge funds, banks’ proprietary trading desks, and index trackers on behalf of institutional investors trying to gain access to this supposedly new asset class), these markets are now trading more on supply/demand fundamentals and this is where discretionary commodities traders have their edge. Therefore, we are further increasing our exposure to commodities traders (some of which trade both futures and physical commodities). As the underlying markets are very volatile, allocations to individual funds are kept relatively small.

² The Age of Nonpolarity, *Foreign Affairs*, May/June 2008

Convertible arbitrage

Together with bank loans, convertibles are the most oversold part of the credit markets (see box to the left for some indications). In our recent convertibles study, we considered three strategies for investing in convertibles: arbitrage, value investing, and the pull-to-par strategy. In our view, even after the recent rally, the best risk-reward is to be found in shorter maturities (pull-to-par strategy), for the following reasons:



- Large universe of eligible bonds: 80% of the convertible market will mature in the next 3 years;
- Assuming a buy-and-hold strategy, returns are not dependent on a recovery in equity or credit markets;
- Barring defaults and refinancing issues, the pull-to-par of these bonds can be substantial;
- Valuations are still extremely low:
 - 1 out of 5 is trading below 40% of par
 - 1 out of 2 has option priced at 0%
 - Assuming historical recovery rates, market pricing suggests 100% of convertible market will default in next 5 years
 - Credit spreads remain wide at 2800bps

Further opportunities can be found in special situations (tender/exchange offers, buybacks as companies try to lengthen the maturity profile of their debt) and primary issuance. Combined with the fact that the recent equity rally has raised convertible deltas, increased primary issuance suggests that traditional convertible arbitrage investing (trading the bond against its components) will become interesting again. However, credit will be the main driver of convertible returns in the short to medium term.

Table 2 below illustrates the average drawdown and subsequent recovery potential of four strategies (long-only unlevered convertible bonds, convertible arbitrage, equities, credit) following several stress periods for convertible bonds (1990, 1994, 1998, 2000, 2002, 2005, 2008). It shows that performance recovery can be substantial both for long-only and for convertible arbitrage strategies. Interestingly, convertible strategies can outperform the underlying equities during the recovery, because of the delta and volatility component.

Table 2. Drawdown and recovery in subsequent 18 months

	ML US Convertible Index	HFR Convertible Arb Index	MSCI World Index	ML High Yield Index
Average drawdown	-17.2%	-4.7%	-17.1%	-10.2%
Average recovery	+32.0%	+18.1%	+14.7%	+23.7%

Long/short equity sector funds

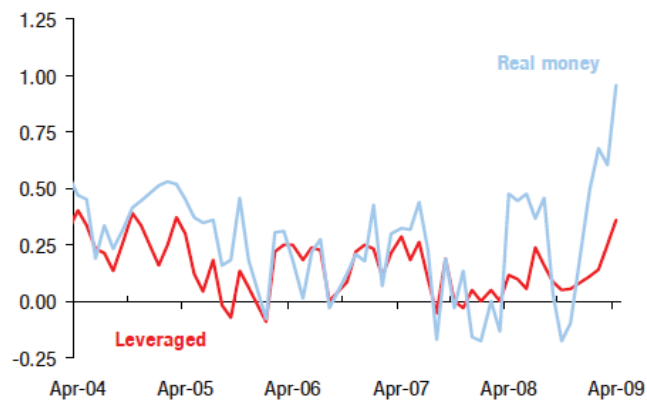
The bad news in 2008 for fundamental stock pickers was that stocks were driven more by sentiment towards industry groupings and perceived macro sensitivities rather than by fundamental variables. The good news is that sentiment-driven rather than information-driven moves in stock prices are a necessary condition for the creation of value opportunities. The broad scope of mispricing currently present even in the liquid large cap sectors of global equity markets calls for a greater allocation to fundamental long/short equity

managers with strong trading skills, and that is exactly what we intend to do in the coming months. We have recently added a long/short fund dedicated to the healthcare sector and we are finalizing our search for a long/short fund focused on the financial sector.

Credit strategies

Banks will further reduce their balance sheets as default rates pick up and actual loan losses materialize. As we have witnessed in previous credit cycles, debt capital markets (bond issuance) will replace bank lending but at elevated risk premiums. Historically, strong primary bond issuance has supported credit spreads. Indeed, strong inflows into credit by real money accounts (from equities and cash) seem to have put a floor under the market, particularly for investment grade corporate credits (see chart below).

Figure 8. Cash Inflows, Real Money and Leveraged Accounts into Credit (+2=Very High, -2 = Very Low)



Source: ONS, Datastream, CIRA.

Even with primary issuance and real money buying, the recession is likely to weigh heavily on high yield credit. We note the following issues:

- Default rates will continue to rise from the current level of 8% and recoveries will be low due to aggressive underwriting and a surge in covenant-lite issuance in recent years;
- Based on cash flow projections, many high yield companies seem to be OK for 2009, but refinancing risk increases significantly in 2010: defaults may be “backloaded”;
- The surge in bank loan issuance in recent years will lead to many inter-creditor disputes. E.g. will second-lien (secured) bank loans turn out to be truly senior to the unsecured bonds of the same company?
- Only now are we starting to see CLO structures break down: almost 50% of all BBB-tranches of US CLO's are failing the overcollateralization tests (up from 10% at the end of 2008);

- Ratings migration will be higher, as rating agencies adjust to public criticism for being too late. This will create forced selling by ratings-driven investors such as insurance companies³.

This provides good opportunities for credit managers with strong legal and structuring skills and skills in trading the capital structure. Besides these qualifications, we will focus on credit hedge funds in good shape with no legacy positions and limited use of leverage.

³ Because most insurance companies do not operate in a mark-to-market environment, they will only start selling when ratings are downgraded or actual losses materialize.

Appendix

Theta Investment Outlook

Phase 1 - De-leveraging

Phase 2 - Market Normalization

Phase 3 - Economic Recovery

Market environment

Price drivers	Markets trade on technicals: de-leveraging, redemptions	Hedge fund redemptions could re-inforce selling pressure (in illiquid market segments)	Global government stimulus will be reflationary; long risky assets (asset class selection)
	Fundamentals, valuations irrelevant	Fundamentals do matter again, growth dominates value	Valuations and earnings growth are key return drivers
Risk drivers	Macro risk dominates, government interventions, extreme risk aversion	Idiosyncratic risk more relevant	US consumer and financial sector will not re-leverage quickly
	High correlation among asset classes	Asset classes trade more on own fundamentals	Higher yields provide more downside protection
Trading environment	Liquidity is key, on-run/off-run spreads and bid/offer spreads remain wide, basis trades are killed	Country/sector risk	Idiosyncratic company risk, equity and subordinated creditors may still suffer impairment
	Responsive trading in bear market with short relief rallies	Markets bottom, rallies more pronounced	Buy-on-dip strategies
Liquidity	Highly volatile without clear direction	Short-term trends are back, but volatility remains high	Long-term trend and momentum trades, volatility subsides
	Liquidity is key, causing dislocations between want-to-sell and can-sell	Corporate balance sheets are OK, but earnings still under pressure	Compelling risk-reward for illiquid assets, cautious on levered assets

Investment opportunities

	Long: unlevered assets Short: levered assets, corporate credit, selective financial institutions, countries with weak fiscal and reserve positions	Mean reversion trades in dislocated markets, mostly debt. • Senior vs. junior ABS • Loans vs. bonds • Converts, swap spreads	Recovery of financial institutions, distressed corporate & ABS credit Debt-for-equity swaps
	Trading volatility and short-term trends across currencies and liquid asset classes	Long short credit & equity in liquid names. Government-guaranteed bank debt	US assets will outperform Europe in a recovery
		Long-biased equity (including emerging markets) still too early	Reflation trades: commodities, emerging markets, gold
		Asia still too sensitive to global slump	Asia: low leverage, strong growth, high savings rates
		Investment grade debt outperforms equity in early stages of economic recovery (pull-to-par effect)	Infrastructure/industrial commodities: low valuations, fiscal stimulus in EM and entry at bottom of energy cycle

Hedge fund strategies

	Cash (to facilitate redemptions and have ammunition)	Equity market-neutral (factor models work better on fundamentals)	Long-biased deep value equity
	Focus on managers with no leverage, independent of banks' risk aversion	Long/short credit & equity Multi-strategy credit, convertibles	Distressed debt (corporate & ABS)
	Downside protection through short bias, long volatility	Sector funds (long/short equity): healthcare, technology, financials	Emerging markets debt & equity
	Overweight liquid macro and short-term trading strategies, CTA's	Increase short+long term trend following trading strategies	Overweight long-term trend followers
	Commodities traders with fundamental focus	Global macro: dollar vs. gold, commodities, relative value between countries, sector and asset classes	Global macro: dollar vs. gold, commodities, relative value between countries, sector and asset classes
	Consider 'overlay' hedge against tail risk of another liquidation wave		

Favoured manager attributes

	(Government) event risk high - trading skills important	Event risk remains high and volatility remains elevated - trading skills	Skilled managers who understand the new financial landscape
	Long/short managers with macro view in liquid markets	Dislocation all across the credit spectrum - Multi-strategy credit managers with strong infrastructure	For distressed: restructuring specialists. Other risky assets: fundamental value investors

When the phase is over - indicators to watch

	House prices stabilize and asset write downs are over, so banks' recapitalization can truly start	Peak in default rates - bottom in economic cycle (2010-2011?)	
	Redemption pressures from banks, hedge funds, CLO's recede	When deflation scare turns into inflation concern	
	Interbank lending resumes and Libor-OIS spreads come down	Leveraged investors start buying assets	
	Real money starts buying beaten-down assets	Insider buying (share/debt buybacks, corporate insiders)	
	USD declines (the world worries about US debt position again)		
	News flow and sentiment stops becoming progressively worse		