

Q2 2009

Less Bad Is Good Enough

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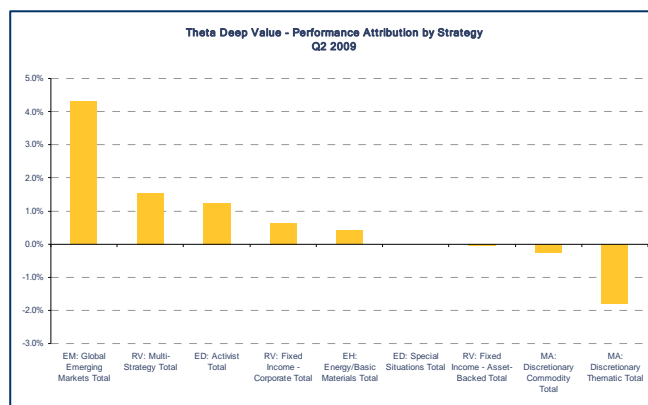
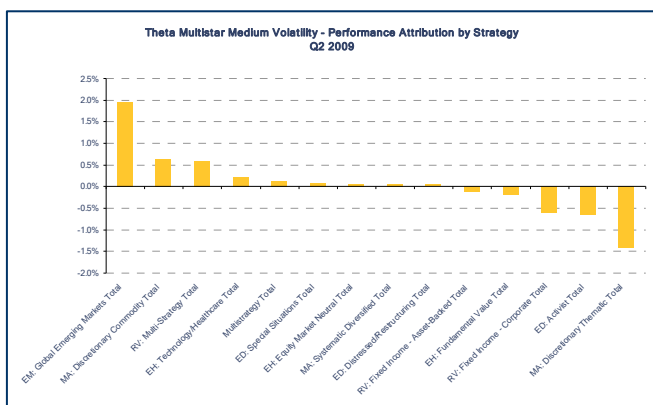
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Performance review

Performance Theta Funds

	Q2 2009	YTD 2009
Theta Medium Volatility	0.75%	0.47%
Theta Deep Value	5.47%	5.03%
Theta Low Volatility (Class A+B)	-2.09%	-3.93%
HFR Fund of Funds Index	0.43%	5.67%

The second quarter of 2009 provided more evidence that liquidity is still abundant in global financial markets. It only took a ‘little less bad news’ to send the prices of risky assets sky bound. The conservative positioning of our underlying hedge funds (which had served us well in Q1 2009) meant our portfolios did not participate sufficiently in the upside. That being said, our strategy will always underperform risky assets if the latter continue their aggressive bets on economic recovery.

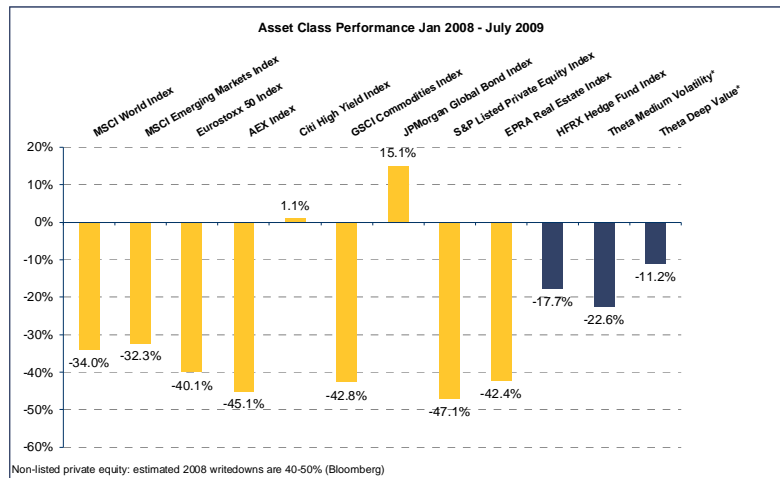


Our underperformance in comparison to the HFRI Funds of Funds Index year-to-date, we believe is a direct result of the deliberate decision taken late last year to maximize the liquidity of the portfolio, increase exposure to trading strategies and to avoid areas where further deleveraging could be painful. For example, we did not hold any significant long exposure to leveraged loans and high yield credit. It was especially the illiquid and most beaten-down segments of the markets that have rallied in Q2 2009 and, ironically, some fund of funds that were stuck in their positions and had suspended redemptions profited most from this rally. We believe however that our decision to play it safe will turn out to be the right one even though our performance has lagged in the short term¹.

Taking a slightly longer horizon, we note that many risky assets are still 30-40% under water compared to their January 2008 levels and our funds have provided considerably more downside protection (see chart 1 below).

¹ As we write this, performance in the months of July and August has provided further comfort for this point.

Chart 1. Asset class performance Jan 2008 to July 2009



A striking feature of the rally is that credit spreads (over US Treasuries) on high yield bonds have narrowed from a wide of 2100bps to just over 900bps today. Impressive as this move is, 900bps is the just the starting level of the two strongest credit rallies in the past 20 years (1991 and 2003). In essence, rather than priced for a global financial meltdown and depression, market are now 'merely' pricing in an uncertain recovery. Noting that much of the growth optimism and, in turn, the rally in risky assets was in fact based on 'second derivative' arguments (i.e. less bad, but not particularly good yet), we now face three questions:

- What factors could trigger a potential correction in risky assets?
Answer: higher inventories and less accommodative monetary policy. Exit strategies from accommodative policies are well in motion now. While policy interest rates are likely to remain low for some time, it is clear that further central bank balance sheet expansion is not likely. Also, rising commodity prices or bubbles in other assets could easily trigger less accommodative policies, for example in China. This could be exacerbated by a sharp rise in short-term interest rates; a real threat given one of the more crowded trades in macro trading: being long Eurodollar futures;
- When will the global growth cycle be driven more by final demand in the global economy, rather than replenishment of stocks? Answer: we have no idea but suspect that an increase in global growth uncertainty will not mean a smooth and easy ride for risky assets;
- Where will default and recovery rates go from here? Interestingly, Moody's and S&P seem to have very different views: while S&P's default rate forecast for mid 2010 is still around 14%, Moody's has actually *revised down its forecast to below 4%* (following a peak of around 12% at the end of 2009).

*Focus on fundamentals:
monetary policy, global growth
drivers and default rates -
where next?*

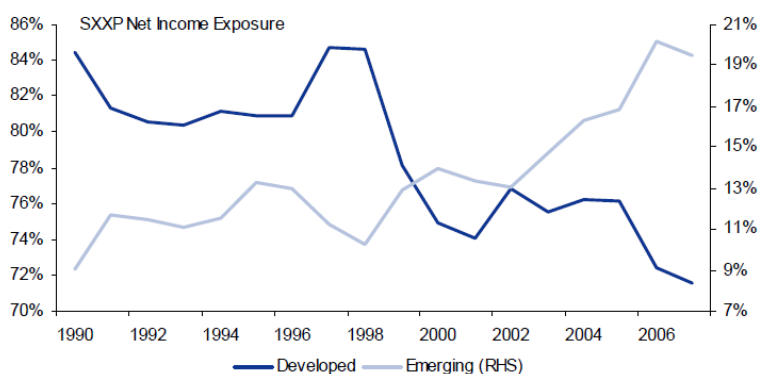
Economy - less bad is good enough

It is very likely that, around this time next year, the summer of 2009 will be pinpointed by NBER as the end of the US recession. The inventory-driven rebound is led by the corporate sector (industrial production, sales and GDP). A good sign comes from the most recent Fed Senior Loan Officers Survey, which shows that the supply of credit is less of a problem: credit standards continue to tighten but at a much lesser pace, and corporate demand for credit is stabilizing². However, consumer demand for loans is still falling rapidly (most likely on the back of rising unemployment, lower real incomes, and the still struggling mortgage sector). These developments have important implications for financial markets, most notably credit: default rates may peak lower but remain higher for longer in contrast to previous credit cycles (more on this below in the section about credit).

Credit and inventories act as second derivatives to growth, but less bad does not make it sustainable

Given that investors are now trying to justify current equity valuations by switching from near-term to mid-cycle earnings and multiples, we would become increasingly wary about a shift in sentiment once the certain growth outlook suddenly becomes less certain. Eventually, the market will have to focus on the long-term adjustment ahead of the US with further balance sheet de-leveraging for households and government restraining private activity. Still, emerging markets (most notably China) as a driver of global growth remains a very strong positive. As an example of how this impacts developed companies revenue streams, have a look at chart 2 below: the contribution of emerging economies to European companies' profits has doubled to about 20% in the past decade.

Chart 2. EM share in European companies' profits has doubles in a decade



Source: Worldscope, Datastream, Goldman Sachs Global ECS Research.

² Credit is like inventories when it comes to implications for economic growth. Because the change in inventories is a component of GDP, it is the change in change in inventories (and similarly, the change in change in credit) that contributes to GDP **growth**. Thus, a reduction in the rate at which credit is shrinking will help finance growth in spending and output.

Investment outlook & positioning

The single most important implication for our portfolio positioning is that we and our underlying hedge fund managers need to be flexible. Now is the time to prepare for a bout of growth uncertainty. This desire for flexibility drives our decision making process in both strategy allocation and manager selection (where we look at factors such as investment strategy, trading style, active exposure management, liquidity of traded instruments), as we will illustrate below. **That being said, the risk of opportunistic long-biased exposure to the global recovery (most notably in the US and emerging markets) has decreased significantly, and we expect most of our managers to capture a significant portion of the potential upside in risky assets and commodities, if and when it materializes.**

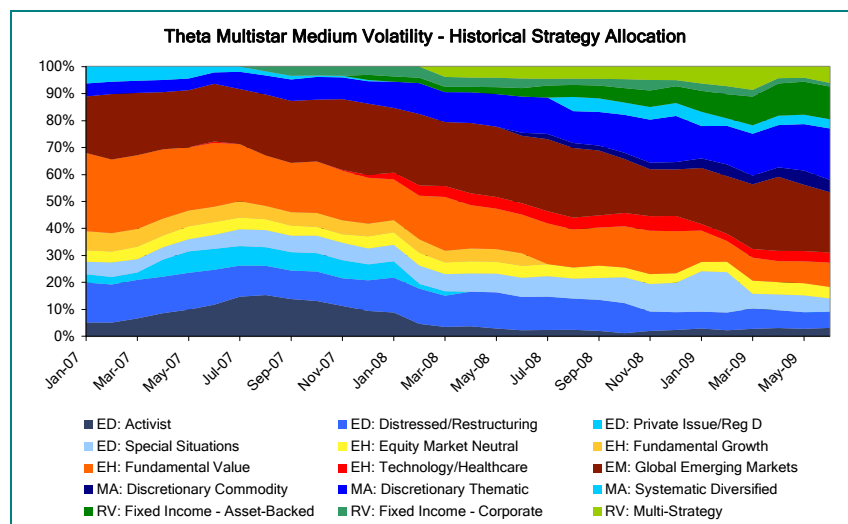
Flexibility and liquidity remain the watchwords for now

We have continued to add to liquid trading-oriented managers in the second quarter of 2009, a strategy that paid off well in July and August: a large part of our strong performance came from these strategies. In particular, we have added the following funds to Theta Multistar Medium Volatility:

- 4 fundamental global macro managers (combined allocation: 10% of NAV)
- 1 discretionary commodity trading fund in energy and agriculture (3%)
- 2 long/short equity managers dedicated to the financial sector and the healthcare sector, respectively (4.5%)
- 1 European long/short equity manager with very active exposure management (1%)

The historical strategy allocation of Theta Multistar Medium Volatility is provided below:

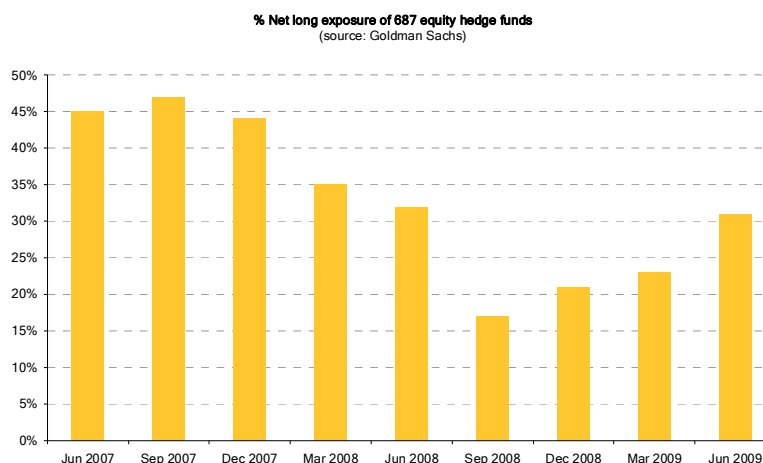
Chart 3. Historical allocation Theta Multistar Medium Volatility



The market exposure of the underlying hedge funds in Theta Multistar Medium Volatility has also changed significantly. Whereas at the end of Q1 2009 our net exposure was flat and gross exposure was around 130%, this is now around 35% and 165% respectively. This means that, in line with hedge funds

in general (see chart 4 below), our managers have increased their net long bias to risky assets, as well as their total portfolio risk. Recent data from Goldman Sachs reveals that hedge funds are no longer net short the Financials sector. Also, their rising net exposure has resulted from considerable buying, participation in equity capital raises, as well as significant short covering in the Consumer Discretionary and Industrials sectors.

Chart 4. % Net long exposure of 687 equity hedge funds



Going forward, our priorities remain with liquid long/short strategies in equity and credit. Because default rates may peak lower but remain high for longer, we think it is still too early to increase exposure to distressed and restructuring strategies. The opportunity set in this area will only expand further from here and the risk of defaults may be spread out over several years. Moreover, we are not willing to give up liquidity by investing in distressed strategies while there are still tremendous investment opportunities for skilled long/short managers in more liquid assets. To illustrate, the average correlation between individual stocks in the S&P 100 has fallen to around 0.4 from its October 2008 peak of 0.8. This implies that single-stock investment ideas will gain favour over the recent macro-driven market.

Table 1. Market exposure Theta Multistar Medium Volatility as per June 2009

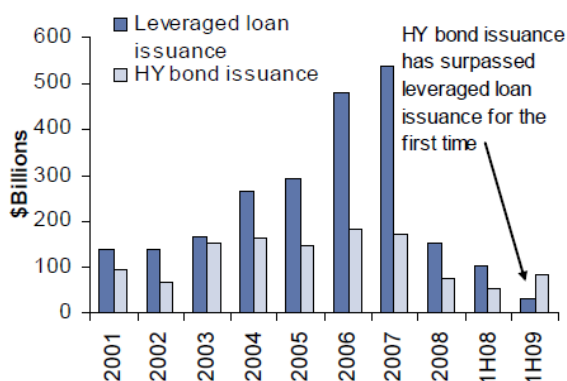
Asset class exposure	% of NAV
Equity Long	38.5%
Equity Short	25.2%
Credit Long	46.8%
Credit Short	14.5%
Commodities Long	16.9%
Commodities Short	6.32%
Notional Protection (long CDS/long options)	19.4%
Market Value Long Protection Book	0.1%
Gross Exposure	167.7%
Net Exposure	36.9%

Default rate outlook - peak or plateau?

The fundamental outlook for credit has improved significantly, based on:

- We are close to the bottom in the growth cycle and a peak in default rates;
- Companies have been very aggressive on cost-cutting. This is a short-term positive for credit quality, although possibly at the expensive of future earnings growth;
- Supply of bank credit is falling less rapidly and new issuance in bond markets is booming, partly driven by record inflows into high yield mutual funds. This significantly reduces the refinancing risk. As we wrote in our previous quarterly: "As we have witnessed in previous credit cycles, debt capital markets (bond issuance) will replace bank lending but at elevated risk premiums". Chart 5 below provides a good illustration of this trend.

Chart 5. HY bond issuance has surpassed leveraged loan issuance for first time in years



Source: Goldman Sachs Credit Strategy, Bloomberg

The ability to refinance efficiently will help reduce default rates in the short term, but fundamentally it does not change the fact that a lot of highly levered companies are trying to survive a severe and probably extended downturn. Refinancing may serve to push some problems into the future, but it does not address excessive debt levels or adverse economic operating conditions. This argues against a high peak in default rates followed by a rapid recovery (as currently projected by Moody's and implied by market pricing). Rather, default rates may peak lower but remain higher for longer in contrast to previous credit cycles. For our portfolios, this means that we will continue to focus on credit managers with strong fundamental credit skills, a solid infrastructure and proven shorting capabilities.

Default rates may peak lower but remain higher for longer

Taking a closer look at the US mortgage markets we note that defaults, downgrades and foreclosures may rise significantly in the coming one to two years. Subprime was the first wave, but the second wave of defaults brings high income households into problems, with severe consequences for consumer spending and the real economy. Just a few facts and observations:

- Default notices on prime mortgages are now surpassing those on subprime mortgages;

- Delinquencies on Jumbo loans (mortgages of high-income households representing the top 10% of US households, 23% of consumer spending and 70% of US tax income payments) are rising well beyond those on conforming prime mortgage loans;
- Mark-to-market losses showed up first in securitized mortgage assets and most US government support programs focused on these securitized assets, which are predominantly on the books of large banks. However, now the underlying non-securitized assets are starting to realize actual losses, and these are largely held by smaller and mid-sized regional banks;
- Commercial real estate is in even more dire straits with \$1.5 trillion of mortgages coming due in the next five years, after property values have fallen 35% from their peak. This will have dramatic consequences for the US regional and commercial banking sector.

On the positive side, US home prices seem to have bottomed out. However, this positive 'second derivative' may not be enough to get the US real estate and mortgage markets back on its feet again. Our point is that we can still expect significant fundamental stress in the US real estate, mortgage and (regional) banking sectors in the coming years. For example, the FDIC has already closed down 45 depository-insured banks this year, double the number of failed institutions last year.

Our first priority in distressed investing is in ABS and the banking sector

While troubles in the mortgage and real estate sector will have a lasting negative effect on the consumer sector as an engine for economic growth, it also provides many compelling investment opportunities for corporate and ABS credit managers with strong fundamental credit skills. At this stage, we have about 20% of Theta Multistar Medium Volatility exposed to these opportunities. In addition, failed banks may be an interesting investment opportunity for private equity and hedge funds and, interestingly, the FDIC has recently issued guidelines to facilitate the role of private investors in the bidding process. Theta Deep Value has about 10% of its portfolio dedicated to these opportunities.