THETA
CAPITAL MANAGEMENT B.V.

Quarterly Review

Q3 2009

Strategy Focus: Event-Driven

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Performance review

Table 1 Performance Theta Funds

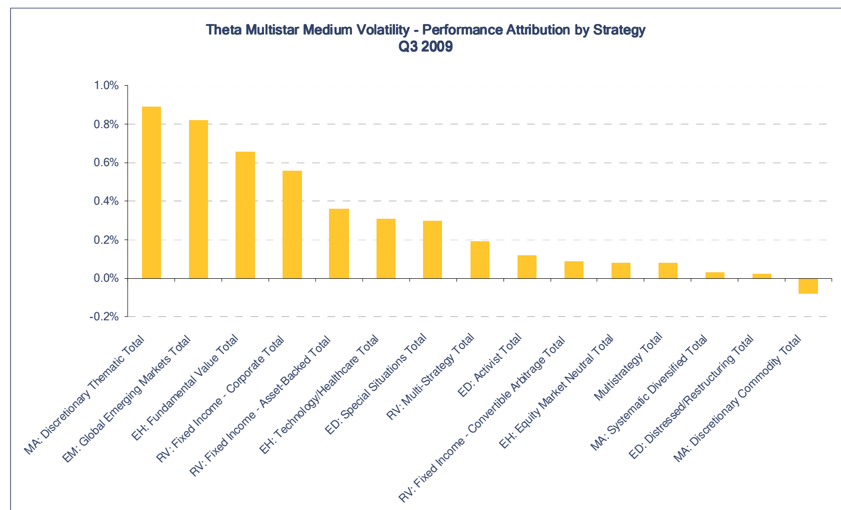
	Q3 2009	YTD 2009
Theta Medium Volatility	4.06%	4.55%
Theta Deep Value	4.91%	10.21%
Theta Low Volatility (Class A+B)	1.46%	-2.53%
HFR Fund of Funds Index	5.89%	9.86%

In many ways, the third quarter of 2009 was a repetition of the second quarter. Risky assets (equities, credit and emerging markets assets) continued to rally on the back of an unprecedented liquidity provision by governments and central banks. In contrast to the previous quarter, our portfolios captured a significant part of the upside and performed broadly in line with their peers in the 3-month period to 30 September.

Moreover, preliminary numbers for October point to outperformance: while the HFR Fund of Funds Index was down in line with equities and other risky assets, our portfolios preserved capital and actually generated positive returns (estimates are between 0.3% and +1.2%). We are pleased that our managers have in general been able to reposition their portfolios and participate to some extent in the rally, without taking outsized risks or directional bets.

Also satisfactory is the fact that the quality of returns has improved: almost all strategies posted positive returns this quarter, led by our global macro and trading funds. As you will recall from previous letters, we have increased the allocation to these strategies in late 2008 and early 2009 because they have the potential to do well in any market environment, including a challenging environment for risk assets. The breakdown of portfolio returns by strategy since July confirms our point (see Chart 1 below).

Chart 1 Q3 performance broad-based across strategies



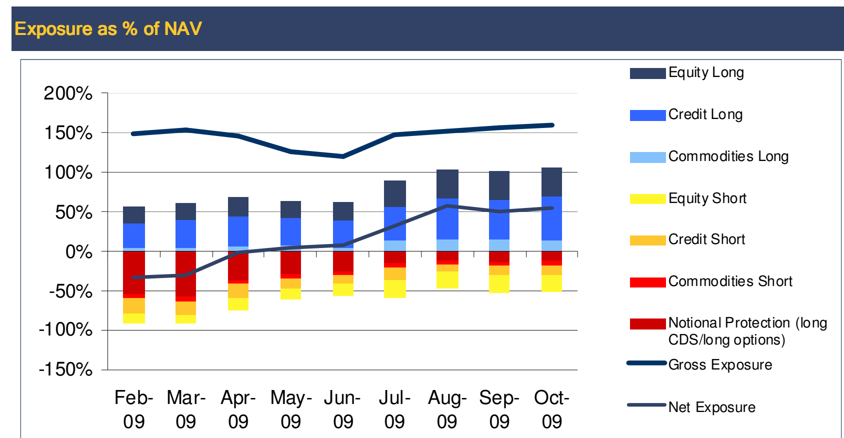
As described in our previous letter (see Less Bad is Good Enough), part of the reason we have some underperformance year-to-date in comparison to the HFRI Funds of Funds Index, is that we do not hold any significant long exposure to leveraged loans and high yield credit. Given the low trading volume in secondary credit markets (an observation which was recently confirmed during a series of meetings with US-based credit managers), the unprecedented $200bln of inflows this year into US investment grade and high yield mutual funds have been an important technical driver behind the rally in corporate bonds. Furthermore, the liquidity-driven rally of 2009 has mostly benefited the illiquid and most beaten-down segments of the credit markets, while equities and US treasuries have been lagging. We believe however that our decision to play it safe will turn out to be the right one even though we did not participate fully in the rally in the second quarter of 2009.

At the time of writing this letter, we have already seen a contraction in market risk appetite, partially driven by concerns of about what to expect as policy makers reverse their emergency liquidity measures and expansionary zero-interest rate policies. The spike in implied volatility (a good indicator for risk aversion in equity markets) is making the risk-reward ratio for risky assets as a whole less compelling. While we are not trying to forecast the future direction of financial markets, our portfolios need to be sufficiently balanced to perform well in both benign and more challenging and volatile market environments.

Chart 2 below shows that our net exposure has remained constant at 50% and gross exposure at 150% in recent months[1]. This is low by historical standards. Our gross short exposure of 50% is largely in equities and credit, and to a lesser degree in commodities. We believe our current positioning provides a good balance for a more challenging market environment, while maintaining upside potential.

Chart 2 Asset class exposures Theta Multistar Medium Volatility

Exposure as % of NAV



[1] These numbers are on a look-through basis. That is, we aggregate our asset class exposures on the portfolio level, based on the data provided by the underlying hedge funds.

Business update

Expansion of operations team

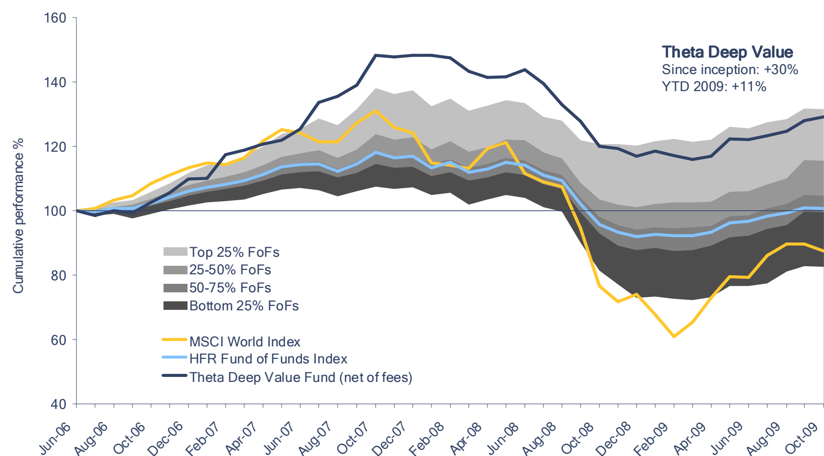
As we continue to strengthen our organization, it is our pleasure to announce the addition of Emma Razali to our operations team, which now consists of three operations professionals and one accountant. With an investment team of seven, one dedicated marketing professional and two support staff this brings our total head count to fourteen. As we grow our business, we expect to selectively add staff on both the investment and operational side.

New share class Theta Deep Value Fund

Theta Deep Value now has a track record of more than three years in which it has significantly outperformed not only other asset classes but also the majority of its peers. Chart 3 below shows that an investor who invested at inception of the fund in June 2006 would have seen a return of +30% over the period to October 2009, compared to -13% for the MSCI World Index and +1% for an investment in the HFR Fund of Funds index. The 43% outperformance versus equities confirms that good hedge fund managers can find deep value opportunities on both the long and the short side.

Given the tremendous investment opportunities we are seeing, especially for deep value strategies with a medium-term investment horizon, we have decided to re-open Theta Deep Value Fund to new investors and introduce more liquid share classes per 1 January 2010.

Chart 3 Performance Theta Deep Value Fund to October 2009



Source: Bloomberg, Theta Capital Management, HFR FoF database. FoF peer group comprises all FoFs from HFR Hedge Fund Database, adjusted for duplicate share classes (704 FoFs in total). **Outliers of top 5% and bottom 5% FoFs are omitted for illustration purposes.**

In recent months, we have found that (prospective) investors in Theta Deep Value Fund have rather different preferences regarding liquidity terms and fee structures. At the same time, investment terms of many underlying hedge funds have improved significantly and therefore see currently no need to lock up our investment capital for multiple years to achieve our target return. In contrast, the current opportunity set for deep value investment strategies is as wide and deep as we have ever seen it.

In order to adapt to changing hedge fund industry dynamics and investment opportunities, we have decided to move away from one-size-fits-all investment terms and offer investors in Theta Deep Value Fund three choices, each with its own liquidity profile and fee structure. The most liquid Class A shares will be offered in a separate sub-fund, subject to a sufficient level of investor interest for this share class. These changes are summarized in Table 2 below.

Table 2 Investment terms Theta Deep Value Fund per 1 January 2010

Class	Initial lock-up	Investor gate/limit	Redemption penalty	Management fee (p.a.)	Incentive fee (p.a.)
A	None	None	5%	1.00%	15%
B	None	Maximum 25% of investor holding per quarter	None	0.50%	15%
C	2 year	Maximum 25% of investor holding per quarter	None	0.50%	10%

In addition, Theta Deep Value Fund will become fully regulated under the Dutch Financial Supervision Act (Wft) and the valuation frequency will be increased to monthly from quarterly, both per 1 January 2010. If you wish to receive more information about the re-opening of Theta Deep Value Fund, please do not hesitate to contact us.

Investment Outlook

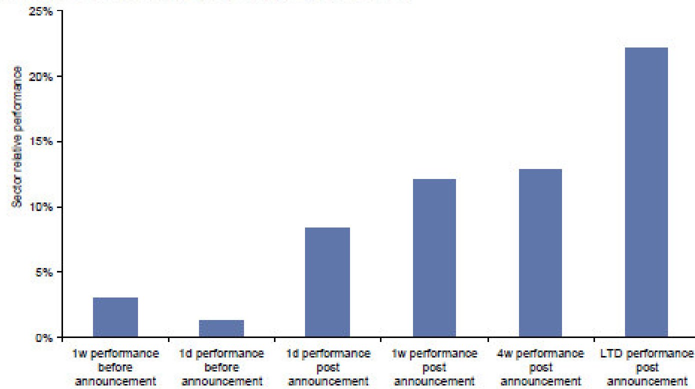
Below, we discuss opportunities in two hedge fund investment strategies:

- Event-driven equity strategies (mergers & acquisitions, special situations)
- Commodities

Trading the M&A cycle with a long/short strategy

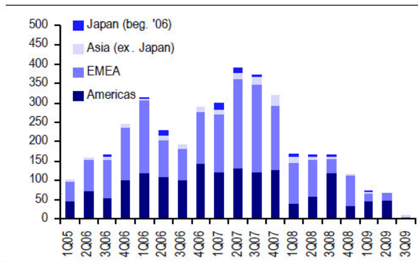
First, let us define event-driven equity strategies. The purest form is merger arbitrage, in which the hedge fund manager takes a long position in the target company and a short position in the acquirer following the announcement of a merger. The reasoning behind this long/short position is that acquirers tend to overpay (i.e. the takeover premium paid is higher than the synergy benefits of the combined company). This clearly benefits the shareholders of the target company, while aggressive acquirers are punished by the market. Typical bid premiums in 2009 were 30-40%, which is the potential return for a long/short investor before announcement of the merger. After announcement of the merger, the deal spread typically falls to around 10-20% but the risk of the deal breaking is obviously much lower than before the announcement. This "arbitrage" is widely confirmed by academic research and it is the reason why stocks of M&A target companies tend to outperform the market following takeover announcement (see Chart 4 below for some examples). Other event-driven strategies focus on special situations such as asset disposals, spin-offs, financial restructurings, etc.

Chart 4 M&A target stocks outperform their peers after announcement



We are fairly positive on the outlook for event-driven strategies, as increased M&A volumes create more trading opportunities for skilled long/short and merger arbitrage hedge funds. We currently have about 10% of our Medium Volatility exposed to this investment theme and are likely to add one or two funds in the coming months. Below, we discuss our stance in more detail.

Chart 5 Global M&A lending



Source: Thomson Reuters LPC

Firstly, M&A activity moves with economic growth. Despite this pro-cyclicality, M&A volumes do not adjust themselves as instantaneous and frictionless the equity and bond markets. M&A is a "late-cycle" phenomenon: once earnings visibility is restored after a recession, companies should be able to direct some of the effort away from cost cutting and financial management and focus again on growth. In a world of sluggish economic growth, companies will have to acquire to grow rather than achieve growth organically. Also, there is currently a substantial backlog of pending asset disposals: data provider Dealogic estimates more than 50 pending deals, with a combined value of $80 billion.

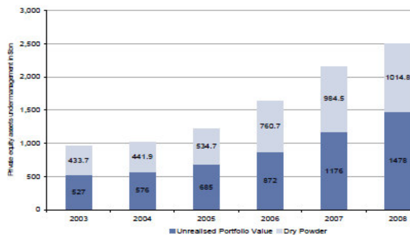
Indeed, we are seeing M&A volumes already picking up in 2009, albeit from low levels. Within equity markets, stocks of potential LBO target companies have already outperformed the overall market since April this year and we anticipate this trend to continue.

Recovery in new loan issuance will be critical to start of the next M&A cycle

Secondly, internal and external "buying power" are improving. According to some estimates, the average net cash position of US corporates is around 5% of their market capitalization. Financing conditions have improved considerably, with around $1.3 trillion of corporate bond issuance in the first half of 2009 and, although global M&A lending is at historical lows (see Chart 5 to the left), we see anecdotal evidence of bank loan issuance picking up. Businesses with strong free-cash-flow generation (such as healthcare and technology) will be able to access financial markets. This is one reason why we recently added two long/short equity managers to our portfolios, one active in the financials sector and another in the healthcare sector.

Next to improved access to lending, private equity funds have over $1 trillion of “dry powder” available for investment (see Chart 6 to the left). Indeed, credit managers we speak to are seeing private equity funds becoming increasingly active in buying the senior debt in distressed companies, with the ultimate aim of restructuring the debt into equity and take control of the company.

Chart 6 Dry powder: private equity AuM

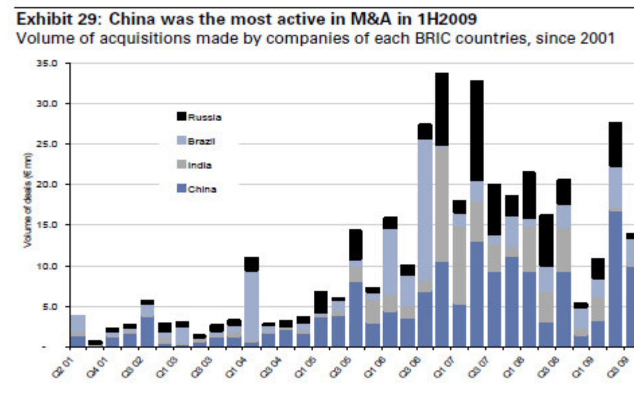


Source: Preqin Private Equity Review

Finally, BRIC countries (Brazil, Russia, India, China) and sovereign wealth funds are becoming an increasingly dominant force in global M&A. Combined, the BRIC’s have already executed more than $50 billion of acquisitions in 2009, with China being the most active player (see Chart 7 below). According to IMF estimates, sovereign wealth funds currently have $3.5 trillion in assets under management, which will increase to $10-13 trillion by 2012. The same IMF research also shows that SWF buy actions or announcements have a strong positive impact on the target company’s share price.

The combined developments described above create a good market environment for skilled long/short equity managers with an event-driven focus to generate outsized returns going forward.

Chart 7 Volume of M&A transactions by BRIC countries



The value of active trading in commodities

We expect our commodity traders to capture a significant part of the Super Cycle, if and when it materializes

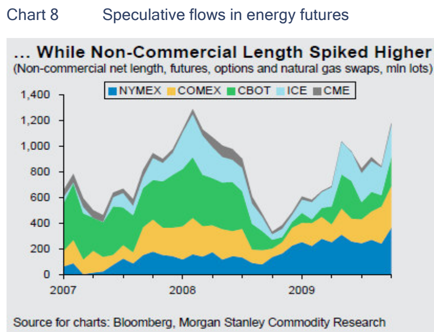
Global trade imbalances are declining and relative domestic demand fundamentals are driving currency and commodity movements again (see The Next Phase - Q1 2009). This provides tremendous opportunities for discretionary macro and commodity traders. This year, we have added three funds which are actively trading the commodity futures space (energy, metals, and agriculture), which have already made significant contributions to our performance.

With much of the hot money having left the commodities market in late 2008 (hedge funds, banks’ proprietary trading desks, and index trackers bought by institutional investors), these markets have traded more on supply/demand fundamentals and this is where discretionary commodities traders have their edge.

A more fundamental driver of commodity returns is a possible return of the “Super Cycle”, where strong demand (from emerging markets) meets

constrained supply and this pushes commodity prices higher. We expect our managers to capture a significant portion of the upside if and when this materializes.

Chart 8 Speculative flows in energy futures



Source for charts: Bloomberg, Morgan Stanley Commodity Research

Still, we are not interested in a long-biased exposure to commodities, which is part of the reason why we chose not to allocate to funds that invest in the equity of commodity producers (these funds tend to be long-biased). Rather, we acknowledge the value of active trading in commodities futures, as these markets can be highly volatile. This is illustrated by Chart 8 which plots the net long exposure (longs minus shorts) in non-commercial commodity futures. It is a good indicator of speculative flows and shows that long exposure is close to its peak of June 2008.

Chart 9 below shows how one of our commodity funds has traded in this highly volatile environment. It shows the month-end net exposures (long or short) of the fund versus monthly returns on the spot Brent Crude oil contract. In summary, the fund was long oil in the first half of 2008, short oil in the second half of 2008 when prices collapsed (generating a return of more than 200% in 2008), and has been long oil since February 2009, benefiting from the rally and generating an additional return of more than 50% this year.

This is the type of active exposure management we expect from skilled commodity traders. Clearly, due to its high volatility of returns, our allocation to this fund should be kept limited and requires frequent rebalancing.

Chart 9 The value of active trading in commodities