

Letter to Our Investors - August 2007

“Current market volatility is driven by the credit quality of the marginal investor rather than the marginal issuer” - Michael Mechas, Senior Credit Analyst CQS (UK) LLP

Given the recent turbulence in global markets, we believe it may be worthwhile sharing some of our views and observations with you. To be clear, following a strong first half of the year and a very strong month of July for all our strategies (see table below), the month of August is considerably more challenging and our portfolios will probably be down this month unless a dramatic reversal occurs in the global capital markets during the second half of the month. However, all our funds are performing within our risk tolerances being down about -1% for Low Volatility and -2.5% for Medium Volatility portfolios, based on mid-month estimates from the underlying hedge fund managers. While our funds have fared very well this year both on an absolute basis as well as relative to their peers, it has nonetheless been very difficult to deliver positive returns in such dislocated markets.

	Low Volatility	Medium Volatility	Deep Value
July	+0.85%	+2.90%	+6.43%
2007 year-to-date	+4.86%	+12.53%	+20.36%

How can we witness such violent moves in global credit markets while actual default rates are still at all-time lows and the global economy seems in pretty good shape? The answer is **financial engineering**.

Collateral damage

A critical driver of the recent sell-off has been liquidation of positions by leveraged investors of various types: hedge funds, banks, special purpose vehicles, special investment vehicles and ABS conduits financed with commercial paper. While the financial media mostly look at the subprime exposures of top US investment banks, we are more worried about the implication for the more traditional commercial banks, also in Europe. In fact, the ECB's emergency injections of liquidity into the banking system (accompanied by a large USD swap with the Fed) illustrate the presence of a potentially serious liquidity issue. Core to the problem are the US-based asset-backed commercial paper conduits (ABCP's); vehicles that issue short-term debt instruments to invest the proceeds in longer term and higher yielding mortgage pools. To guarantee liquidity towards their commercial paper investors, many conduits have credit facilities guaranteed by large commercial banks. Now that losses on the mortgage pools mount, the appetite of commercial paper investors effectively evaporates and conduits will start calling these credit lines.

Through this transmission mechanism, financial institutions with no direct investments in subprime mortgages can be impacted in an indirect way. Many banks have already become more risk averse and have restricted lending activity, especially to financial institutions and leveraged investment vehicles. *It is the credit quality of the investor rather than that of the underlying asset which drives current market prices and, this being so, technicals outweigh fundamentals.*

This is illustrated by swap spreads (effectively the risk premium of bank paper over risk-free government bonds), which have doubled in the last two months, both in Europe and the US – a move similar in both speed and size to August 1998. Note that by virtue of the sheer size of the commercial paper market (\$2.2 trillion in the US, of which about \$ 1.2 trillion backed by mortgages, credit card receivables, car loans and other bonds), the potential impact on the availability of credit through the banking system is significant.

Who is holding the bag?

We view the current market turmoil as a de-leveraging phase which was necessary, inevitable and anticipated but nonetheless very hard to time properly*. *The crowd is always right during the trend, but usually wrong at both ends.* What makes the current de-leveraging phase different from earlier ones is the added layer of complexity introduced by financial engineering, notably in (structured) credit markets. The effect has been that previously separate segments of international financial markets have now become more integrated. In short, fears of losses are rising in unexpected places as troubled banks, proprietary trading desks and leveraged investors are not selling what they *would like to* sell, but what they *can* sell (generally more liquid and higher quality assets). Due to these perverse movements, even perfectly sound investment strategies may take a significant hit, as we are witnessing in our portfolios today.

Another effect of the complexity of instruments is that valuations are hard to establish. Nobody knows who owns which financial asset and who sits on how big a loss. Furthermore, markets have become more vulnerable due to the increasing *similarity* of trading models and risk management practices. Witness the carnage across quantitative market-neutral (sic!) equity funds and some bank's proprietary trading desks in the first week of August as an illustration of this point. The dynamics of the current de-leveraging phase seem very similar to those created by the technique of portfolio insurance during the crash of 1987. Richard Bookstaber's '*A Demon of Our Own Design*' provides an excellent illustration of the mechanics involved.

Payback time

While the turmoil started in the US subprime mortgage markets and the Theta funds have actually benefited substantially, having eliminated long positions and established short positions (through underlying funds) in subprime mortgages and credit markets in general as early as the second quarter of 2006 (please refer to our Quarterly Review Q2 2006 for more details), we are now seeing spillover effects to other risky assets: investment grade and high yield credits, global equities (notably emerging markets and Asia), emerging market currencies and the unwinding of the carry trade (JPY appreciation against all other major currencies). Moreover, lack of investor

* A rare exception to the rule that academics (most notable economists) have no edge in calling the markets was John Kenneth Galbraith who, having lived through the 1929 crash, wrote an article in January 1987 titled "The 1929 Parallel". He attributed the market's rise to "the present commitment to seemingly imaginative, and eventually disastrous, innovation in financial structure". Another exception confirming the rule was Robert Shiller's publication of "Irrational Exuberance" in October 1999, just four months before the blowup of the Internet bubble. The book's second edition, published in the spring of 2005, added a chapter on the housing market bubble...

appetite for bank loans is forcing many banks to postpone or even cancel deals, creating an enormous backlog of transactions hanging over the market. Many investors suddenly realize that their returns over the past years were nothing more than *cash borrowed from destiny with some random payback time* (as Nassim Taleb puts it in his humbling must-read for investment professionals '*The Black Swan*' – go buy it or borrow my copy).

The huge volatility of the current market breaks down fundamental relationships between market securities. As the market moves into crisis, the correlations of movements between various assets approach either plus or minus one. However, one cannot always predict which one it will be. A particular asset might end up compensating another, providing a hedge or it might end up doubling your exposure. Indeed, we are seeing many of our underlying hedge fund managers struggle with this challenge these days.

Conclusion

Violent markets like this always create interesting opportunities for investors who are long rather than short cash, but one has to buy at the moment of maximum uncertainty. As you know, we profoundly believe that our hedge fund managers are well equipped to identify opportunities and capitalize on varying market conditions, which puts us in the fortunate position not having to make ourselves that call of timing markets.

That being said, we anticipate considerable volatility going forward. Due to the complexity of financial instruments, trading models and risk management systems, we do not believe all problems have come to surface yet. At the end of September, financial markets will be in a completely different shape. For sure, the state of complacency which has characterized global markets in recent years will make way for a more balanced and less leveraged financial landscape, with more price dispersion between related financial assets. *We believe that the creative and diverse ecology of hedge funds is particularly well suited to benefit from the investment opportunities that the current bout of volatility inevitably will produce.*

We aim to participate in these opportunities through our high conviction managers, while in the meantime trying to minimize any adverse impact of the current market environment by maintaining a well-diversified portfolio of hedge fund managers who are willing and able to go short and take risk off the table by moving to cash, should market developments warrant such adjustments.

As always, we are open to questions, comments and investments.

The Theta Team

20 August 2007