Theta Quarterly Review

THETA CAPITAL MANAGEMENT B.V.
DE LAIRESSESTRAAT 180
1075 HM AMSTERDAM
THE NETHERLANDS
T +31 20 5 722 733
F +31 20 5 722 744
I WWW.THETACAPITAL.COM

Outlook 2008 & Recap 2007

Bubble Talk

Wouter ten Brinke, CFA

Theta Capital Management

February 2008

Company review

2007 was a rewarding year for Theta Capital Management. The investments we made in 2006 by adding senior staff to our team and implementing new software systems for various elements of our process, have further strengthened our portfolio management process and our risk controls. In January, we received confirmation for our approach by Standard & Poors, who have awarded Theta Multistar Low Volatility and Theta Multistar Medium Volatility with the "A" rating. This rating considers our investment team, process and performance. S&P notes that "Theta has a boutique flavor but risk controls are of institutional depth, backed by strong in-house systems". Please contact us if you wish to receive the S&P rating reports. Furthermore, we are glad to announce that Theta Deep Value Fund has been nominated for the 2007 InvestHedge Awards in two catogeries: Global Multistrategy $100-500mln and New Fund of the Year. Winners will be announced on 13 March 2008.

On the negative side, we have not been able to avoid some mistakes as well. Whilst our management of market risk -most notably as it relates to global credit- has worked well last year (and still is), we were less sanguine about the management of single manager risk, particularly in our Low Volatility portfolios. Therefore, we have taken various measures to improve our investment decision making process:

- Employing external specialists for background checks on new hedge funds before we make an allocation;
- Increasing the number of funds in our Low Volatility portfolios, to further reduce the single manager risk;
- Shifting some weights to seasoned hedge fund managers whom we have known for a long time and with the proven skills to navigate different market environments. The basis for these allocations is the outcome of our quarterly conviction exercise, in which our investment team scores all underlying hedge funds on investment strategy & team, operational structure and investment outlook;
- Gradually scaling our investment in new funds towards a full allocation, depending on pre-determined milestones, such as the publication of the fund's audited financial statements, specific market events, organizational and business requirements;

It is our experience that, in any given year in any given portfolio, there will always be a few big winners as well as losers. The measures described above are meant to minimize the impact of the latter on our portfolios' returns.

Market review

2007 clearly proved to be a year with two faces. During the first six months, risky assets across the globe continued to rally, albeit with higher volatility than seen in previous years. The month of July marked the turning point of what we believe will be a prolonged phase of de-leveraging in global financial markets. Global equities sold off and US credit markets lost almost 8% in the second half of 2007. Market pricing during these turning points in global market sentiment can be highly erratic and violent, as various market participants reassess the size and value of their exposures and seek to find a new balance between risk and return. The second half of 2007 proved to be no exception and hedge funds as a group were not immune to the dislocated markets in August and November, generating a negative return of -2% . Nevertheless, for the whole year they still outperformed most traditional asset classes (except emerging markets), as shown in Exhibit 1 below.

Exhibit 1 2007 returns by asset class (hedged into EUR)

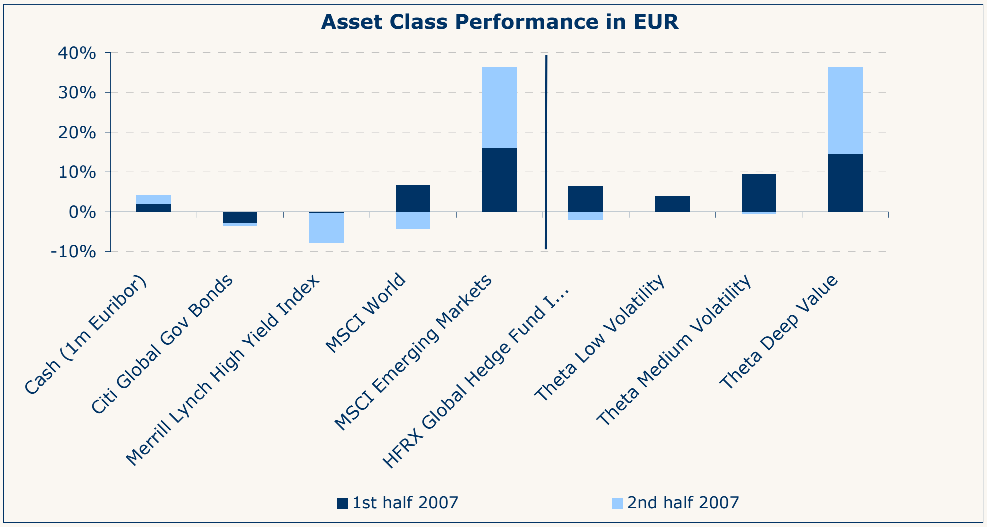


Exhibit 1 also shows that, following a strong first half of the year, the Theta portfolios broadly managed to preserve capital and outperformed their peers in the volatile second half of 2007. We believe this is partly the result of the active management of portfolio risk, as explained below.

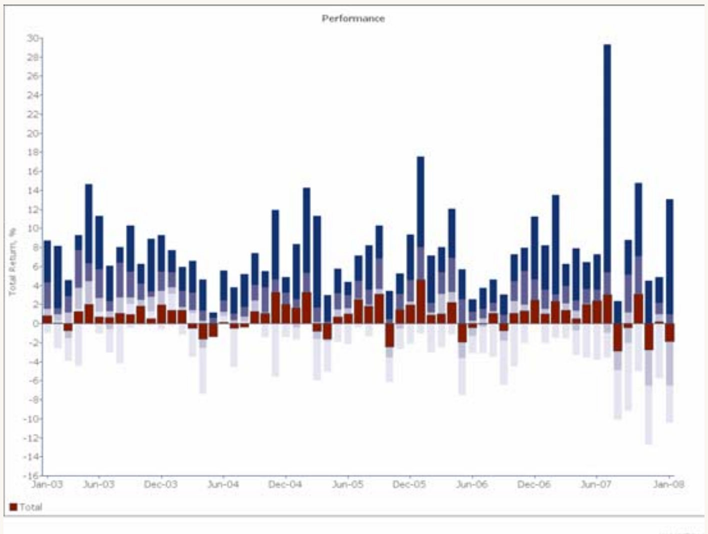
Portfolio Review

	4th Quarter	2007
Theta Multistar Low Volatility	+1.0%	+3.8%
Theta Multistar Medium Volatility	+0.3%	+8.9%
Theta Deep Value Fund	+6.5%	+33.4%

The volatile market environment is also reflected in the variation of returns of our hedge fund managers. To illustrate this observation, Exhibit 2 below shows the monthly performances of our Theta Multistar Medium Volatility portfolio (in red bars) and those of its underlying managers (in blue, in quartiles). In any given month, the top dark-blue stacked bar represents the performance of the best 25% hedge funds and the bottom light-blue stacked bar the performance of the worst 25% hedge funds in our portfolio.

The chart shows that the variance of returns of our underlying hedge funds is as high as we have seen it since launching the fund. It also clearly illustrates the benefits of holding a well-diversified portfolio of hedge funds: while the monthly returns of individual funds have ranged from -13% to +30% since July 2007, our Medium Volatility managed to preserve capital over that period with limited volatility. This can partly be attributed to our active approach towards portfolio risk management, as reflected in the conservative stance towards structured credit, corporate credit and emerging market debt. Our views have been discussed extensively in past issues of this Quarterly Review and we are satisfied that the measures we have taken to protect our portfolios have worked.

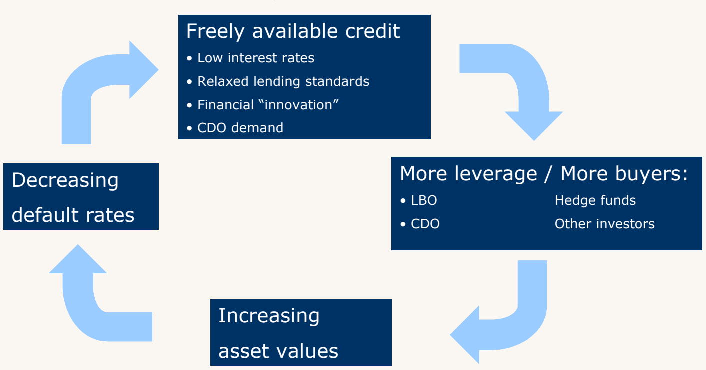
Exhibit 2 **Monthly performance Multistar Medium Volatiliy vs. underlying hedge funds**



Inflating the credit bubble

It is now clear that in recent years we have seen the creation the largest credit bubble in financial history. We have held this view for some time and have positioned our portfolios accordingly, which has so far worked relatively well.[1] But what is the next shoe to drop? When trying to anticipate how the bubble may burst, it makes sense to look at how it was created in the first place. The enormous pool of liquidity in credit markets created by the technology of securitization has certainly played a crucial role here. CDO's, CLO's, SIV's and ABS are in effect highly levered balance sheets very similar to those of banks, and the proliferance of these securitization vehicles has in effect created a *non-bank* banking system (without the reserve requirements of banks) which provided the leverage needed to keep the credit bubble alive. This liquidity creation process and its impact on the credit markets are illustrated in Exhibit 3 below. It starts with freely available credit enabling investors to leverage, who then bid up the prices of financial assets. Higher valuations reduce perceived credit risk and lending standards. This makes credit available even more freely and, in turn, lowers actual default rates.

Exhibit 3 **Inflating the credit bubble**



[1] In our Quarterly Review Q2 2006 we wrote: "We believe it pays to be contrarian and that is why we have positioned our portfolios more conservatively by focusing on hedge funds that are *willing and able* to trade the market from the short side."

A critical element in this process is the ***new*** liquidity which supports the asset values and keeps existing investors happy[2]. As George Soros notes in *The Alchemy of Finance* (p 116): “The value of collateral is influenced by the availability of credit.” This introduces a feedback loop, a virtuous cycle, or in Soros’ words, an element of *reflexivity* into the process.

The late economist Hyman Minsky called this process the “Financial Instability Hypothesis”, in which he describes how the financial structure of a capitalist economy becomes more and more fragile over a period of prosperity along three distinct phases[3]:

1. **Traditional finance**. Rapid acceleration of corporate debt, mostly for productive use. Profitable companies take on more debt but pay back interest and principal at maturity;
2. **Speculative finance**. Companies only pay interest and debt is used to roll over existing debt;
3. **Ponzi finance**. Companies borrow more to refinance existing debt but also to make interest payments on their existing liabilities.

During the last phase, lending standards are relaxed to their extreme. In corporate credit, CDO’s and CLO’s were providing additional capital to weak lenders (or to strong lenders on weak terms), adding leverage to the system. *The worst loans are made in the best times*. Or as Minsky notes: “In prosperity, we are gradually testing the limits of the market by extending debt structures, but the adjustment and revaluation can be sudden and violent”. This moment of revaluation is called the Minsky Moment and it likely occurred in August 2007: lenders became increasingly cautious, prevailing debt structures were no longer accepted (or credit ratings were no longer taken for granted) and an increasing number of entities had to liquidate assets to cover their liabilities (Bear Stearns, BNP Paribas, quantitative equity market neutral funds, SIV’s, CLO’s). In many of these cases, it was the leverage of the lender that initiated the sell-off. In the current credit bubble (and partly in contrast to previous occasions), many lenders are more highly leveraged than the borrowers and this greatly influences the dynamics of the credit crunch going forward.

Deflating the credit bubble: the cycle in reverse

In essence, the dynamics of the credit crunch are similar to the feedback loop during the credit bubble inflation but in reverse (try doing the visual exercise with Exhibit 3 – it works!). However, it will also be at a much faster pace: bubbles don’t deflate; they inflate and then they burst. It is our observation that some segments of the credit markets are not dislocated, they are dysfunctional. Following the subprime mortgage market and its derivative products (ABS, CDO’s of ABS, CDO’s of CDO’s of ABS – are you still with us?), the high yield and leveraged loan markets as well as municipal bond markets have now come to a stand still. As a result, price discovery has been difficult. The question is: what can make credit markets work again? Here are some issues:

- **LBO debt.** It seems to us that the enormous overhang of LBO-related debt must be sold by banks before any new issuance will be picked up by end investors;
- **Transparency**. One of the main reasons for banks’ reluctance to lend to each other is that, so far, nobody can answer the question: “who is holding what and what is it worth?”
- **Default experience.** Clearly, the financial alchemy of securitization relied on ratings based on statistical default analysis, using short credit trading histories and only a few actual defaults.

---

[2] Note the analogy to a pyramid or Ponzi scheme, in which contributions of new entrants are used to pay off existing partipants. As with many bubbles, we fall in love with innovations - with no history (by definition).
[3] Minsky, H. P. 1975. *John Maynard Keynes*. New York: Columbia University Press.

It remains to be seen how the CDS market (and its documentation) will deal with the experience of actual defaults;

- **Funding risk**. This refers to the risk that liabilities reprice before assets do. 'Weak hands' are leveraged investors with short-term funding. They face the risk of their capital base becoming subject to erosion due to investor redemptions, margin calls or credit facilities being withdrawn. Examples are: SIV's, CDO's, CLO's, hedge funds and, to a lesser extent, banks. These weak hand investors are forced to liquidate assets (pushing down prices) which, in turn, may trigger further margin calls and so on. In this liquidity spiral, investment vehicles can go into default without any impairment of the fundamental value of their assets;
- **CDS counterparty risk**. The credit derivatives market has grown ten-fold in the last 4 years to about $ 45 trillion of outstanding credit risk[4]. About 60% of this risk is taken on by banks and insurance companies (which are regulated, have reserve requirements and can post collateral if the market moves against them) and the rest by hedge funds, brokers and other investment vehicles such as SIV's, CDO's and CLO's. To the extent that banks/brokers have hedged their long credit risk by selling it on to 'weak hand' investors with limited equity capital such as hedge funds, SIV's and CLO's, their insurance may turn out not to be there when they need it (i.e. when they have to pay under their written CDS contracts). In general, takers of credit risk (sellers of credit protection) post collateral margin for mark-to-market moves but when needed the most, 'weak hand' investors may not have adequate collateral available;
- **And finally,** even if the hedging practices are effective, combined with the sheer amount of leverage injected into the system in recent years, these risk management techniques may trigger a self-deflating downward price spiral similar to the one created by portfolio insurance in the late 1980s. Vast amounts of liquidity would be withdrawn from the market in a short time frame, causing many corporate credit market segments to come to a grinding halt. We have seen this starting to happen in August 2007.

So, how do we try to benefit from these developments? In essence, we see three phases (which we discuss in more detail in the next section):

1. During the credit unwind (current: hedge funds with short positions in):
    - Mortgage credit: residential and commercial, in the US and Europe
    - US consumer credit: credit cards and auto loans
    - Corporate credit: focus on high yield and lower rated CDO tranches which carry default risk, rather than spread risk
2. More volatility/price dispersion in all risky assets (current: long/short positions in):
    - Emerging markets sovereign debt
    - European sovereign debt
3. After the credit unwind (later in 2008: hedge funds with deep value long positions):
    - Distressed ABS and MBS
    - Distressed corporate credit

Investment outlook

We anticipate a volatile, challenging and hopefully profitable year ahead. Will inflation or deflation dominate in the years ahead? We have no idea and frankly, we do not need to. In both inflationary and

---

[4] Source: BIS. This number refers to the total gross notional amount of CDS outstanding. On a net basis (offsetting long and short credit risks on the same name), the amount is less than $ 1 trillion.

deflationary scenarios, leverage will decline and that will be an important general theme in our investment decisions going forward. Therefore, whether the world moves from a low inflation to high inflation or outright deflation, our preferred portfolio would consist of investments in funds with long positions in unleveraged assets and short positions in leveraged assets.

That being said, we will discuss some specific medium-term investment themes below. The factor all these themes have in common is that the flexible investment mandate of hedge funds is particularly well suited to benefit from these opportunities. This may be simply because hedge funds are efficient providers of capital where it is scarce (emerging markets and more specifically, frontier markets), or because shorting capabilities and flexible use of leverage allow them to benefit from falling markets and, with that, help protect investor capital.

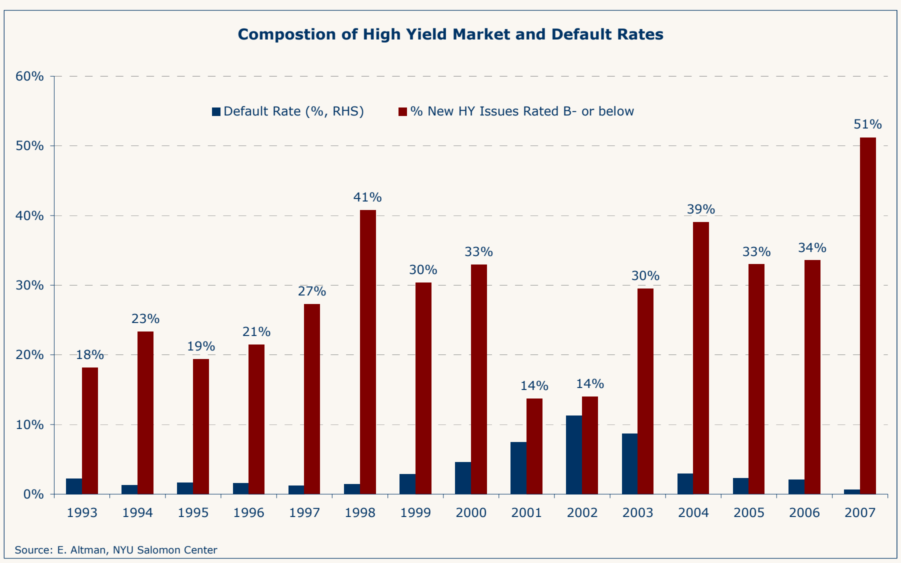
Distressed debt

Never before has the economic cycle turned with so much leverage in the system, as is illustrated by:

- Total issuance of high yield bonds, which reached record levels in recent years;
- Portion of the high-yield market rated B- or lower (see Exhibit 4 below);
- Covenant-lite loans as % of outstanding leveraged loans;
- Debt/EBITDA ratio on recent LBO deals.

The phase of deleveraging we foresee will inevitably cause corporate default rates to rise, which provides for a good outlook for distressed debt hedge fund managers, specifically those with strong legal backgrounds who are active in financial restructuring.

Exhibit 4 Composition of US high yield market

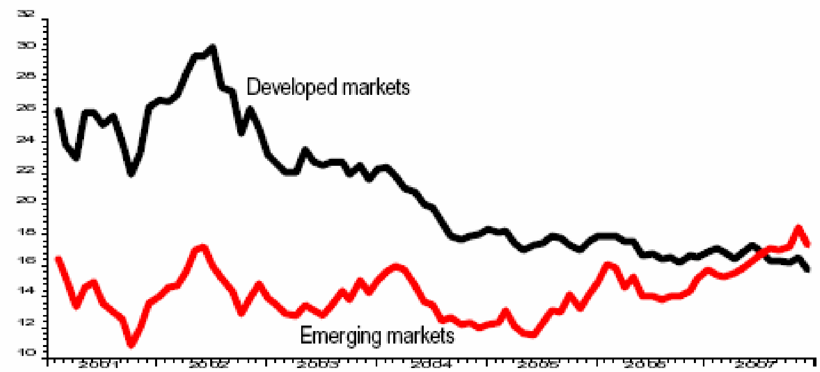


Emerging markets

In the past two years, investors had an enormous desire for low quality and risky assets, many of which are located in emerging markets. And even in the face of a US-led recession have investors refused to end their quest by embracing the great idea of “de-coupling”: due to strong internal demand, emerging economies are now less dependent on the US economy, so the argument goes. The result has been that emerging markets equities now trade at a premium to developed market equities, as illustrated by Exhibit 5 below.

Exhibit 5 **Emerging markets valuations have now surpassed developed markets**

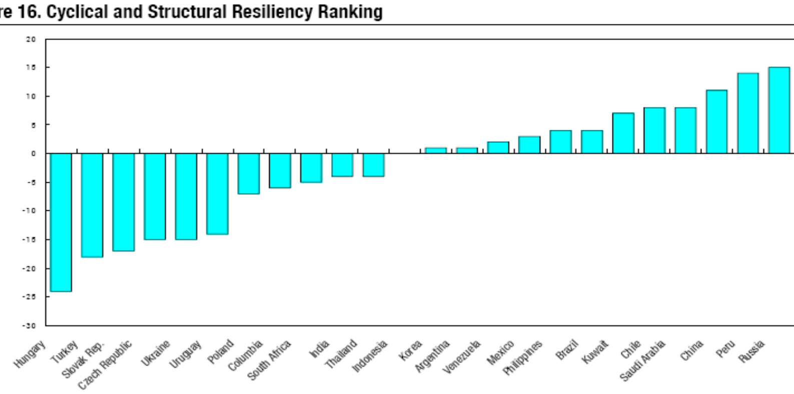
Simple trailing 12-month PE on developed and emerging markets



Source: SG Equity Research

We would argue that from the perspective of a long/short (hedge fund) investor, the question of de-coupling is less relevant. The unwinding of the credit bubble provides great investment opportunities for those who do not rely on uniform outperformance of emerging markets versus the US or Europe but rather focus on increasing divergence between countries. Simple decoupling arguments mistake the improvement in structural and cyclical positions of emerging markets for insulation from shocks originated in the G3 economies. Significant improvements in current account balances and FX reserves, a strong cyclical position and government policy, and healthier balance sheets of government, banks and corporates, all give some countries more degrees of freedom to counter external economic shocks than others. To illustrate our point, the chart below provides a ranking of structural and cyclical resilience of emerging markets countries against a shock in global economic growth, as devised by Citi[5]

Figure 16. Cyclical and Structural Resiliency Ranking



Source: Citi

The countries most exposed to external economic shocks are all located in Central and Eastern Europe, have large current account deficits and have become dependent on foreign credit in recent years. For

[5] The index ranks internal and external cyclical and structural measures, such as inflation, fiscal balance, debt/GDP ratios, current account balance, FX reserves and trade and FDI as a share of GDP.

example, Hungarian and Turkish banks have borrowed heavily in Swiss Francs and Yen to finance the domestic consumer boom in recent years. However, with the re-pricing of risk in global financial markets now well underway this source of liquidity is drying up quickly. By contrast, the least vulnerable are oil producers with strong reserves (Russia, Saudi Arabia), Asian countries (China, Taiwan, Hong Kong) and the better-managed hard and soft –agricultural- commodity exporters in Latin America (Chile, Peru). In between are countries with deepening trade and financial linkages with the G3 (Mexico, Argentina, South Africa). To benefit from this divergence between emerging markets countries, one could easily devise a portfolio of long and short positions in sovereign debt instruments. In fact, the portfolio exposure report of one of our underlying hedge funds (up +14% in the last 6 months) looks very similar to the chart above, providing a clear example of the benefits of long/short investing.

Conclusion

Looking ahead to 2008, we see markets trying to find a clear direction characterized by bouts of volatility and we caution our investors that our portfolios will not be immune to these developments. It is our objective to preserve and grow investor capital but the true impact of our portfolio decisions can not be judged on a single day, week or month. In the absence of short-term visibility, it makes most sense to focus on the long term: if everyone else is focused on the immediate future, mispricing of the long term may well result. Valuations are a poor determinant of short-term returns, but a good one for long-term returns. Moreover, valuations tend to matter more in bear markets than in bull markets. Therefore, we maintain our positions in a few funds with a clear and consistent value strategy in the belief that, with the right mindset and long term view, these managers should be able to identify value regardless of general market valuations. Moreover, some of them have the proven skills to generate strong returns on the short side as well. Although one never knows the short-term direction of markets, we are confident that our managers will benefit from the many opportunities that these volatile and at times dislocated markets inevitably create.

The Theta Team

Theta Capital Management B.V.
De Lairessestraat 180
1075 HM Amsterdam
The Netherlands
Telephone: +31 (0) 20 5722733
Fax: +31 (0) 20 5722744
E-mail: info@thetacapital.com
Website: www.thetacapital.com