Investor letter

Fourth Quarter 2008

February 2009

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Summary

Theta Deep Value Fund is well positioned to benefit from the dislocations seen in financial markets worldwide

Dear investor,

The Theta Deep Value Fund lost 8.0% in the fourth quarter bringing the full year return to a negative 19.6%%. The fourth quarter was frustrating as despite the good performance by some managers, there were a couple of managers who got hit by the rapid decline in the world's equity, credit and commodity markets and the unparalleled volatility in most currency markets. However, the Theta Deep Value Fund is well positioned to produce outsized returns from the current dislocations in the market. Our confidence going forward stems partly from a rebalancing in the portfolio where we are redeeming some managers who we think are unlikely to generate outsized returns in a more volatile environment. In that context, we have redeemed our investments in Marwyn, Camulos Special Situations and Ecofin Special Situations. More importantly, we see interesting opportunities for our existing managers and may selectively add some new managers. We invested in John Paulson's Recovery Fund and we partially reconsidered our intention to redeem our investment in the Red Kite funds.

Table 1: Performance Theta Deep Value Fund

Theta Deep Value Fund - Performance (Series July 2006)

2006	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	FY
Net Performance							-1.68%	1.19%	-0.75%	3.17%	2.90%	3.83%	**8.83%**
Cumulative Performance							-1.68%	-0.51%	-1.26%	1.87%	4.82%	8.83%	
2007	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	FY
Net Performance	-0.08%	6.60%	1.12%	1.36%	0.99%	2.80%	6.47%	1.26%	2.52%	6.65%	-0.45%	0.28%	**33.38%**
Cumulative Performance	8.74%	15.91%	17.21%	18.81%	19.99%	23.34%	31.32%	32.97%	36.33%	45.39%	44.74%	45.14%	
2008	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	FY
Net Performance	0.17%	-0.45%	-2.39%	-1.18%	0.25%	1.69%	-2.80%	-4.48%	-3.94%	-5.78%	-0.58%	-1.82%	**-19.57%**
Cumulative Performance	45.39%	44.73%	41.28%	39.61%	39.96%	42.32%	38.34%	32.14%	26.93%	19.60%	18.90%	16.74%	

Note: As the fund's independent administrator provides an official NAV on a quarterly basis, monthly numbers are estimates provided by the manager

During the fourth quarter, we made money through our investments in John Paulson's funds (both the Recovery as well as the Credit Opportunity Funds), the Red Kite Funds (both the Metal as well as the Prospect Fund) and in particular Corriente's European Divergence Fund. We lost money on our Emerging Markets exposure and in particular the Greater Europe Deep Value Fund, the Montpelier Fund and Autonomy all lost money. Only the Montpelier China fund managed to generate a small positive return for the quarter.

We will refrain in this quarterly from describing the overall investment climate as the general picture will be well known to our investors. Instead, we will highlight both the best as well as the worst performing funds during the quarter to give you an idea of how we made and lost money. And more importantly, how we think we can make money in 2009 and beyond. For more detail about our investment outlook, we refer to our upcoming Theta Outlook 2009.

The main contributors

GaveKal/Corriente's European Divergence Fund was the largest contributor

By far the largest contributor during the fourth quarter was Corriente's European Divergence Fund which was up around 80% for the quarter to finish the year up nearly 90%. Following the stellar performance of the fund during 2008, Corriente's European Divergence Fund (EDF) is now the second largest investment in our fund. This fund was set up towards the end of 2007 and we invested in early 2008, long before tensions between various Euro members became headlines stuff in the financial press. We took a modest position in the fund given the asymmetry of the pay-off. Furthermore, the overall protection this fund would provide in case we would see serious stress to world's financial markets in general and the European Euro linked system in particular appealed to us. The fund has bought protection (CDS's) on Italian, Spanish and Greek debt in particular as it believes that investors have been insufficiently rewarded for the risk they run on these sovereign bonds. Rather than all sovereign bonds being equal (which was the case until the middle of 2007), sovereign bonds within the Eurozone should perhaps trade more like the spread between US Federal and state government obligations. For example, the Germany-Italy spread could be compared to the spread between ten-year treasuries and California obligations which has traded anywhere between 65bps and 400bps. The financial environment during the first ten years of the Euro was characterised by a reckless search for yield and very high levels of risk appetite with spreads between Italy and Germany trading as tight as 20 bps. However, investors now have become extremely risk averse and the massive injections of capital by governments to support their banking sectors have exposed serious divisions between European governments.

Borrowing costs for some Euro members are now above where they were when they entered the Euro 10 years ago...

Graph 1: European Divergence over the last six months.

Source Bloomberg, GaveKal

This in turn has highlighted some of the serious strains the Eurozone now faces. Although the chances of a current member of the Euro leaving the

single currency to revert to its old currency are still remote, the sheer notion that this could happen has pushed borrowing costs for some nations such as Ireland to very high levels. In fact, borrowing costs for Ireland are now 200bps higher than when it joined the Euro in 1999. As the Euro appreciated strongly against Ireland's main trading partner, Great Britain, the country has been injected by a nearly-lethal cocktail of high borrowing rates, a real estate bubble which has burst, a currency which is highly overvalued vs. its main trading partner and no ability to lower interest rates or print money to 'solve' these issues. A scenario which seemed far fetched only recently, could suddenly become reality. In the current financial environment, investors demand significantly higher rewards for any level of uncertainty and the divergence between various European sovereigns reflects this.

John Paulson's Credit Opportunity Funds were significant contributors...

The largest exposures in the Deep Value Fund include a significant position in the Paulson Credit Opportunities Funds as well as the Paulson Recovery Fund. The Paulson Recovery Fund was up 0.1% for the quarter and year-to-date (the fund was launched on October 1). The Paulson Credit Opportunities Funds were up around 0.2% for the quarter and 17% for the year. Clearly we have considerable confidence in John Paulson's ability to generate very good returns not only from the distress in the financial sector itself (the Paulson Recovery Fund will invest in the equity of distressed financials such as the announced Indymac transaction) but also within the MBS segment which he invests in through the Credit Opportunity Fund. What distinguishes John Paulson is his timing. He went short at the right time in 2007 but also remained short throughout 2008 and withstood the temptation to start buying distressed assets. Other funds that did do so were badly burned when they started prematurely buying at what seemed attractive valuations (see Table 2 below).

Table 2: Timing is everything

Date	Target	Buyer	Amount (US$m)	Losses to date
July 2007	Bear Stearns	Joe Lewis	1,100	-95%
July 2007	Barclays	China Dev. Bank	4,971	-93%
August 2007	Countrywide	Bank of America	2,000	-95%
November 2007	Citigroup	Abu Dhabi	7,500	-89%
December 2007	UBS	Singapore	11,500	-72%
April 2008	Washington Mut.	TPG	7,000	-100%
April 2008	Wachovia	Investors	8,050	-88%
April 2008	Merrill Lynch	Investors	9,832	-78%
June 2008	Fortis	Investors, Ping An	1,500	-100%
September 2008	JPMorgan	Investors	10,000	-42%
October 2008	Bank of America	Investors	10,000	-74%
November 2008	Wells Fargo	Investors	11,000	-44%

. Source: Paulson, Bloomberg

What John Paulson seems to have understood very well is that something that is attractively valued according to a mark to model means absolutely nothing in a world where the financial sector is in complete disarray. Risk appetite of investors has changed completely, aversion of illiquidity is universal and so is investor's view of levered products. Mortgage backed securities combine all of the above which means they have sold off to levels which have nothing to do with what they should be trading on based on a model of cash flow payments. Rather, they simply trade at the distressed level where a forced seller wants to get these products off their balance sheet. However, for investors such as

Paulson who have bided their time and have significant cash levels, we are optimistic that returns could be significant over the coming years.

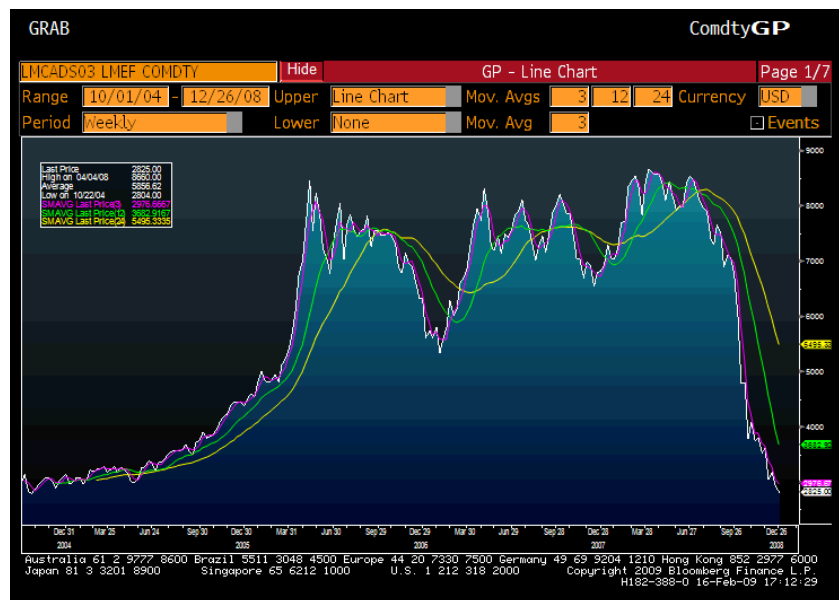
The Paulson Funds still have a net short bias

The Paulson funds continue to be positioned defensively, with a net short bias which reaped significant benefits from the fall in worldwide equity markets during January, in particularly in the financial sector. However, these funds have also been using the carnage of the last couple of months to slowly start investing in both the equity of some financials as well as some investments in MBS structures. John Paulson believes there will be further significant writedowns by the banks which is reflected in the fact he is keeping his gross exposure extremely low as he awaits the right time to start buying more aggressively. A key factor in that decision will be to what extent losses will have been recognised by the major banks (something he has quite a clear view on given the work he has done over the last three years when building up his short exposure to the subprime market). We are not there yet in his view.

The Red Kite Funds performed well during the fourth quarter, gaining around 33%.

As mentioned in our last quarterly, we were reconsidering our investment in the Red Kite funds after a poor third quarter. During the fourth quarter, we met the manager twice to analyse what went wrong in the third quarter and how this would change going forward. The fund's risk limits have been cut which should bring volatility of the fund more in line with our expectations. Furthermore, the fourth quarter once again proved what we have always liked about this highly experienced team of commodity traders: that they can generate good returns in any market environment. During the fourth quarter, the price of copper (one of their most important contracts) fell by 50% from US$6,160 per contract to around US$3,053. The Red Kite funds were up around 33% for the quarter, leaving them up around 24% for the year. Following the collapse of Lehman, it became clear to the investment team (partly through their physical shipping activities which give them excellent insight into for example Chinese demand) that although there still may be a long-term bull case to be made, demand was collapsing dramatically in the short term. Prices had moved down somewhat but were nowhere near where the managers thought they should be trading and hence they moved their portfolio from a net long bias towards an aggressive net short bias. Clearly this paid off nicely during the fourth quarter. What also was an important consideration for us to remain invested is that this is a team that has been investing in base metals since the early 1980s and have been together since the 1990s. They have seen a lot of participants come in the commodity segment over the last years but now they have also seen most of them go again. This means that commodity markets now provide excellent investment opportunities as we should see a return towards supply/demand fundamentals as well as a return to the commodity bear market of the 1990s in which the Red Kite also made very attractive returns.

Graph 2 The rise and fall of copper 2004-2008



Source Bloomberg

The Montpelier China Fund was slightly positive for the quarter (+0.3%), still leaving it down 38% for the year whilst the Chinese local market was down 65% for the year. This does show how the cautious stance of the manager in maintaining a significant cash portion in the fund, and increasing that as markets became more uncertain, helped to limit losses to some extent. The local Chinese market saw an interesting recovery during the fourth quarter, particularly in December. This meant the performance of the local Chinese market was in stark contrast to equity markets around the world. The reasons for the relatively strong performance are possibly found in the massive stimulus package the Chinese government has announced to kick-start the economy. Whereas most Western governments' balance sheets are stretched already coming into the crisis, the Chinese government has been accumulating very considerable reserves and has now shown its willingness to use those reserves to start for example sizeable infrastructure projects.

The main detractors

Emerging Market exposure led to significant losses for the quarter

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So, where did we lose money in 2008? Our Emerging Market exposure cost us dearly during 2008 with both the Greater Europe Funds (focussing on Russia) as well as Autonomy (a fund with significant exposures to other emerging markets) suffering significant losses during the quarter. Clearly, we are annoyed by the inability of these managers to limit losses. Hardly anyone could have forecast the kind of financial meltdown we have seen during the fourth quarter, but capital preservation is something we also expect and various managers within our Global Emerging segment have not lived up to that expectation. Despite the disappointing performance, we expect our managers to do better going forward, recoup losses and generate profits for their investors.

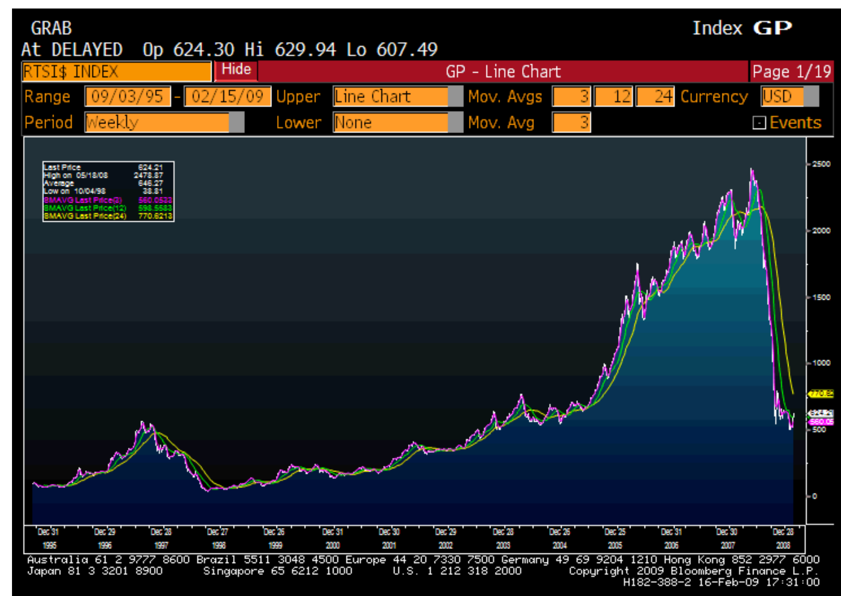
The Russian market was down 48% for the quarter

The Greater Europe Fund suffered significant losses as the the Russian equity and bond markets fell sharply. The Greater Europe Funds were down around 50% for the quarter which left them down around 70% for the year. The situation in Russia was worse than in most other markets as on top of the “normal” panic selling, the following factors also played a role:

- A spat between BP and its Russian partners over its joint venture
- A war between Russia and Georgia spooking investors
- Local oligarchs had been using a lot of short term debt to finance their crossholdings.

When the world’s commercial and investment banks started to call in their loans and started to sell collateral when the oligarchs could not meet their obligations, a near-total destruction of the Russian market took place. For example, the main RTS index was down 36%(!) in October, another 15% in November and again 4% in December and trading was halted frequently when prices moved down too sharply. The Greater Europe Funds have significant exposure to the utilities sector where post the UES brake-up, there are now a raft of power generation and transmission companies which will be managed along more Western lines. Valuations were attractive already but have gone to absolutely rock-bottom levels as shares were sold off regardless of news flow or fundamental value with investors needing cash.

Graph 3 The rise and fall of the Russian market 1995-2008



Source Bloomberg

The Autonomy Fund suffered as its investments in various emerging markets got sold off heavily during the fourth quarter. A lot of the arguments mentioned above also apply to the Autonomy Fund. The fund was down 45% for the quarter and 31% for the full year 2008. Disappointing but this loss should be seen in the context of Emerging Markets worldwide falling around 55% for the year.

The Camulos Special Situations Fund lost 23% for the quarter, leaving it down 24% for the full year. The fund suffered serious writedowns on a number of the investments it made during 2007. We had already put in our redemption request and expect to exit this investment in July 2008.

Pershing Square lost 14% for the quarter bringing the full year performance to a negative 12%. The majority of its losses came from some of its core long positions, in particularly its investment in Target which hurt the fund. However, the fund is also in a very good position to take advantage of some of the current opportunities in the US equity market. As an example of their willingness to act aggressively when it's interesting, Pershing Square bought a significant stake in Wachovia when the initial deal with Citigroup was announced and the shares were massively undervalued in the eyes of the investment team. Based on their work, they thought the shares were worth somewhere between US$8 and US$11. However, the shares were trading at around US$1.84 on the day of the announcement. Pershing bought 178million shares (approximately 10% of the outstanding shares) at an average price of US$3.15 during late September and early October after which Wells Fargo announced a counterbid valuing Wachovia around US$7 per share on October 3.

The Marwyn Neptune fund lost 30% for the quarter, bringing the full year losses to around 46%. Although there were no significant adverse operational developments in the portfolio of holdings, their holdings continued to be sold off given negative sentiment. Despite the considerable confidence we still have in the ability of the investment team to bring around value-added operational changes, we see better opportunities for our capital elsewhere and have decided to redeem our investment.

Even in this environment, Sector has realised an exit.

The Sector Speculare Funds were down 5% for the quarter which brings the full year return to around -17% (the quarter figures represent the blended figures of the Speculare III and IV funds whereas the full year figure represent the Speculare III Fund). The losses should be seen in the context of an unprecedented drop in the price of oil (at least at the front-end of the curve) which led to some losses on their listed investments in particular. However, we remain convinced of the ability of the managers to generate attractive returns and they have experienced management teams working in various projects which should pay off handsomely. It is very encouraging that even in this environment, Sector managed to create an exit for one of its holdings, Revus, which was listed on the Oslo Stock Exchange. Sector invested around US$25m in this Norwegian based E&P company which focuses on the UK and Norwegian continental shelves at an average price per share of NOK 76. During the fourth quarter, Wintershall Holding AG announced its attention to acquire the company at NOK 110 per share and Sector as the largest shareholder indicated its intention to approve the offer.