ETOLIAN CAPITAL

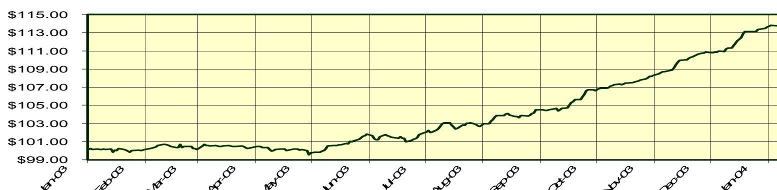
Monthly Letter – January 2004

Etolian Capital Group, LP is a private investment management company, which focuses on US credit fixed income opportunities. Its objective is to generate above average, stable returns which are uncorrelated with major market indices by going long and short in cash and derivative fixed income obligations issued by primarily US investment grade rated corporations. What differentiates Etolian Capital from other similar efforts is its credit selection process which is based on an options-based quantitative methodology and relies, among other things, on information from the equity and equity option markets to assess credit. This methodology is used to identify undervalued and overvalued situations and accordingly create long and short positions in them. Interest rate risk is hedged and moderate leverage (up to 5 times) is deployed to achieve objectives. The long/short approach, combined with the use of leverage, as well as other risk management techniques, reduces the probability of a major capital loss.

Currently, Etolian Capital offers two funds; the **Etolian Capital Credit Fund, LP** (a US domestic partnership), and the **Etolian Capital Offshore Credit Fund, Ltd** (a Cayman exempted company).

	E Capital (*) Onshore	E Capital (*) Offshore	S&P (**) Index	LUCI (***) Index	3-month LIBOR
January Returns	1.26%	1.23%	1.73%	1.29%	0.10%
January Daily Volatility	0.22%	0.22%	0.71%	0.47%	0.00%
January Sharpe Ratio	4.08	3.97	2.13	1.79	
January % of (+) Days	65.0%	65.0%	55.0%	65.0%	100%
Year-to-Day Returns	1.26%	1.23%	1.73%	1.29%	0.10%
Y-t-D Annualized Returns	15.12%	14.76%	24.09%	17.55%	1.16%
Y-t-D Annualized Daily Volatility	3.44%	3.44%	11.30%	7.52%	0.00%
Y-t-D Sharpe Ratio	4.08	3.97	2.13	2.18	0.00%
Y-t-D % of Positive Months	100.0%	100.0%	100.0%	100.0%	100.0%
Y-t-D % of Positive Days	65.0%	65.0%	55.0%	65.0%	100.0%

(*) Returns are net of fees (1.5% management fee and 20% incentive allocation of profits. January and Y-T-D gross returns are 1.71% and 1.71% respectively
(**) S&P Index returns are gross returns
(***) The LUCI Corporate Bond Index is a 7-10 year total price return index compiled by CSFB



Net Portfolio Performance (Net of 1.5% management fee and 20% incentive allocation of profits)

Month	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Y-T-D	Since Inception
2004	1.26												1.26	9.61%

January Commentary

We entered 2004 with a broadly optimistic outlook that rested on a positive economic outlook, projecting further gains in the economy, the stock market and the credit markets, and higher interest rates. Indeed, during January a spate of economic reports confirmed the strength of the economy (ISM Manufacturing, Construction and Housing Starts, Auto Sales, Consumer confidence, and a healthy 4Q03 GDP reading of 4.0%). The news provided support for equity markets which registered (until the 3rd week of January) strong gains. Paradoxically, the Treasury markets instead of heading lower, also rallied strongly in tandem with equity markets. The clue reconciling this paradox was provided by reports of the unprecedented (in size) buying of US dollars by foreign central banks, and subsequent investing of such reserves in US Treasuries. The Bank of Japan, alone, bought more than $60 billion in the first 10 days of January. A great money machine indeed! Wider US domestic deficits => more spending => more imports => lower dollar =>more intervention => more US dollar buying => lower US interest rates! Until when? The answer to this continues to be elusive. But, in a sign that even the Fed is cognizant of the potentially disruptive nature of this spiral, it signaled the markets that the "considerable period" of lower interest rates was not considerable anymore. Hence, towards the end of the month we saw reversals in most markets, albeit nowhere close to the magnitude one would expect from such a signal.

The markets for credit joined in the rally right out of the gate in January registering very strong gains, supported by gains in equities and reductions in volatility as evidenced by the VIX index. Led by the Autos, there were significant reductions in credit spreads by as much as 30-35 basis points particularly for higher beta BBB and BB names, 15-20 basis for higher rated names, and significantly more for high yield names which had price gains in the vicinity of 5% (yes, in a month!). Yet, the strong credit rally came to a halt after the first week in January. Despite continued gains in equity markets, reductions in VIX and lower interest rates, credit markets diverged and began to give up the strong gains registered during the first week on the month. The Fed's first signal that the "easy money" era may be coming to an end, further reinforced these trends, and by the end of the month, the credit market had given up all its gains plus more, ending the first month of the year in a negative territory (in terms of spreads), albeit still positive in price terms because of lower interest rates. Autos, Manufacturers, Utilities, Healthcare, Diversified and Telecoms led the back up in credit spreads with names like Ford, GM and ATT widening as much as 35, 30 and 25 basis points from their lows, respectively. Strong new issue activity in the first couple of weeks did not help the technical conditions in the market, particularly since it was not met by demand from real money investors who bulked at the tight spreads. Finally, hedging activity from CDO dealers added to the negative tone of the market. When put in the context, the changes in the credit markets were far wider than those experienced in either the equity markets, volatility or interest rates. Obviously, the $64,000 question is, which market is correct in its assessment of the future. We lean towards the view that the credit market has overreacted in its widening, driven to some extend by the activities of (and/or lack of) the leveraged players in the synthetic CDO markets and is likely to come in line with the other markets.

Meanwhile back at Etolian Capital, we entered the New Year with a net return of 1.26% (1.23% for the Offshore Fund). To some extend, January presented the opportunity to demonstrate some of the most desirable dimensions of our long/short credit strategy, enabling us to record decent gains during the first half of the month through individual credit selection, and protect such gains during the second half of the month by the very nature of its long/short strategy. More specifically, we entered the month with a very modest long positions of about 8% net long in credit spreads. Yet, the portfolio benefited from gains in specific names such as Dow, Tyco, GM , Altria, and Kodak. Similarly, on the short side, we benefited from spread widening in names such as Sears, Centex and ATT. Sensing that the credit market was running out of steam, we took some of profits off the table from the long side of the portfolio while modestly adding to the shorts, bringing the portfolio closer to about 5% short by the third week of January. The significant spread widening that took place in the last few days of the month, following the Fed's announcement did have a negative impact on Etolian, primarily due to our long exposure to the Auto sector. Yet, it was limited as the gains experienced in the short portfolio helped keep losses in the long portfolio under control. Admittedly, the move towards the end of the month surprised us by its strength and its "out-of-line" character with regard to the other markets. And as stated above, we lean towards the view that the credit market has overreacted and will resume its tightening trend. As a result, we finished the month with net long exposure of 18%, comprising of 2.14x AUM in long positions, 1.96x AUM in short positions, and overall leverage of 4.

ETOLIAN CAPITAL GROUP LP, 67 Wall Street, 10th Floor, New York, NY 10005; Phone (212) 659-2430, Fax (212) 659-2443, info@etolian.com, http://www.etolian.com

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