ETOLIAN CAPITAL

Monthly Letter: January 2005

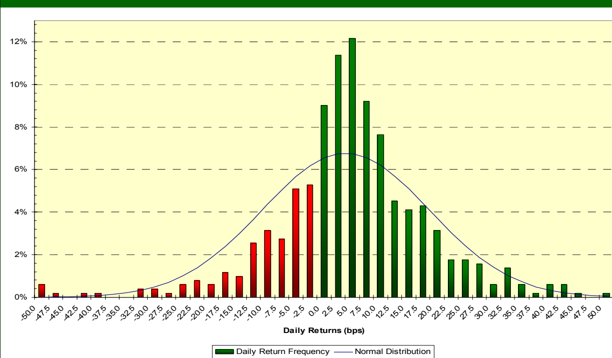
Etolian Capital Group, LP is a private investment management company, which focuses on US credit fixed income opportunities. Its objective is to generate above average, stable returns which are uncorrelated with major market indices by going long and short in cash and derivative fixed income obligations 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).

	Etolian Capital*		S&P 500 Index**	CSFB Indices***	
	Credit Fund (Onshore)	Offshore Credit Fund		LUCI	CDSI
January Return	0.55%	0.56%	(2.53%)	0.98%	0.09%
January Volatility	0.32%	0.32%	0.63%	0.96%	0.08%
January Sharpe Ratio	1.23	1.27	(4.27)	0.86	(0.91)
YTD Return	0.55%	0.56%	(2.53%)	0.98%	0.09%
YTD Volatility	0.32%	0.32%	0.63%	0.96%	0.08%
YTD Sharpe Ratio	1.23	1.27	(4.27)	0.86	(0.91)

(*) Returns are net of fees (1.5% management fee and 20% incentive allocation of profits. January / Y-T-D gross returns for the Onshore fund are 0.83%)
(**) S&P 500 Index returns are gross price returns
(***) The 7-10 year LUCI Corporate Bond Index is compiled by CSFB (CDSI=Credit Default Swap Index)

Distribution of Daily Returns Since Inception



Portfolio Performance

	2003	2004	2005
January	0.10%	1.26%	0.56%
February	0.25%	0.31%	
March	(0.14%)	(0.69%)	
April	(0.59%)	0.04%	
May	0.34%	0.03%	
June	0.90%	0.85%	
July	0.87%	0.77%	
August	0.64%	0.03%	
September	0.53%	0.41%	
October	2.01%	0.77%	
November	1.08%	0.54%	
December	2.00%	0.39%	
Year to Date	8.25%	4.79%	0.56%

Since Inception: 14.08%

AUM: $24.9 million

January Monthly

It has been said many times that the market will do what most people least expect and, indeed, this is exactly what happened in January. As we left 2004, the consensus view, across the board, was for a positive outlook for 2005 whether one spoke about the economy, equity markets, credit markets or, even fixed income markets, and all this despite the specter of higher interest rates. Indeed, during January, the economy continued to advance forward, albeit at a slower pace. Yet, the markets elected to focus on the negatives, particularly higher energy prices, the twin domestic and external trade deficits, and the sub-par level of job creation (hint – China). As a result, the S&P ended the month with a loss of 2.53%, while spreads in the credit markets widened, and equity volatility (as captured by the VIX Index) rose before subsiding by month end. The US Treasury market was the only market that rose, against of background of higher expected rates. From our perspective, we continue to see developments in the economic front as providing a positive backdrop to the markets.

More so than any other market, developments in the credit market surprised most participants during January. We, along with the rest of the market, entered 2005 with a positive outlook driven by a combination of factors (a robust economic environment, healthy corporate earnings, liquid balance sheets; and supportive technicals), and an expectation of tighter spreads as, typically, new money comes to the market in the beginning of the New Year to get invested. Well, the expected spread tightening lasted about one day and the market proceeded to widen by about 15% or about 20 basis points in indices such as the IG HVOL (from a low of 84.5, to as high as 104) before closing at month end at 95.5. The main event that drove the credit market wider was the possibility of down-grading GM from Investment Grade (close to $290 billion of outstanding debt). Indeed, such an event could create major dislocations in credit markets. Lehman's announcement to include Fitch ratings in determining investment grade status for inclusion in their indices, was the catalyst in turning around market sentiment by providing relief to existing and potential GM credit holders. Also, the merger announcement of SBC with ATT sparked a feeding frenzy in the telecom sector, driving spreads in names like ATT and MCI tighter by as much as 70 basis points. Finally, a spate of positive earnings announcements towards the end of the month provided the necessary fuel to carry the credit market tighter but yet wider than it was in the beginning of the month. As we look into February, there is clearly a change in the sentiment and an expectation that spreads are going tighter. Also, a stronger equity market and a falling equity volatility are providing additional justification and support for such an outlook. Yet, attention has to be paid to individual names as potential M&A activity (and its implications on credit) is on the rise.

Etolian Capital managed to face the challenges presented by the market in January in a rather satisfactory manner by recording a net return of 0.55% to investors. This result is best appreciated if one takes into account that we entered the month with a large (by our standards) - and wrong - position of about 15% net long. However, we quickly realized that buyers of credit - like ourselves - were either already positioned, or were not prepared to buy at those levels, leading us to a very quick liquidation of our long positions and saving us money. We spent the rest of the month finding the right opportunities to sell credit on individual names as spreads widened, and position new names as spreads moved wider. We made money by being short Autos and Auto-parts in the beginning of the month. We also made money in our long Telecom positions which we have largely liquidated as spreads moved at tight levels. Having cut our long positions early in January, we used the credit widening that took place as an opportunity to "re-load" our portfolio at more attractive levels. As we enter February, our current portfolio will remain unchanged. It is geared to the long side by being 239% long and 221% short. The portfolio contains 54 names, of which 29 names are on the long side and 25 on the short side.

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