ETOLIAN CAPITAL

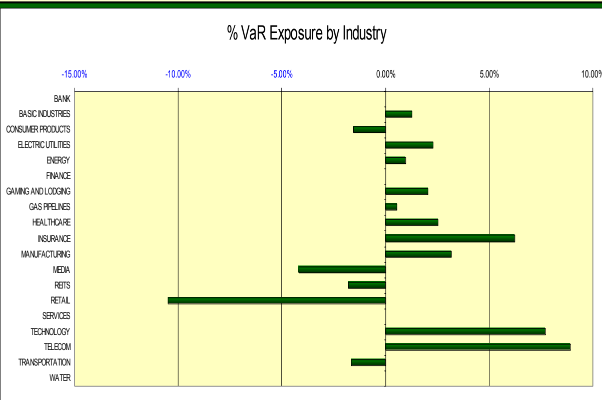
Monthly Letter: July 2004

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 (***) Tot Return	LUCI (***) ASW
July Return	0.77%	0.77%	-3.43%	1.58%	0.06%
July Daily Volatility	0.11%	0.11%	0.60%	0.38%	0.06%
July Sharpe Ratio	4.75	4.75	-3.75	3.18	0.70
July % of (+) Days	81%	81%	48%	71%	48%
Year-to-Day Returns	2.58%	2.52%	-0.92%	1.29%	0.20%
Y-t-D Annualized Return	4.49%	4.40%	-1.58%	2.26%	0.34%
Y-t-D Annualized Daily Volatility	1.97%	1.97%	11.54%	6.49%	1.62%
Y-t-D Sharpe Ratio	1.46	1.41	-0.24	0.16	0.12
Y-t-D % of (+) Months	86%	86%	57%	71%	43%
Y-t-D % of (+) Days	68%	68%	53%	50%	51%

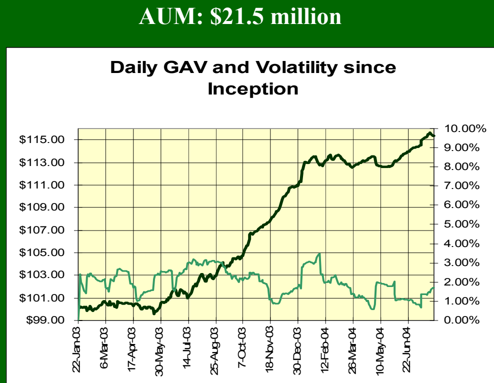
(*) Returns are net of fees (1.5% management fee and 20% incentive allocation of profits. July and Y-t-D gross returns for the Onshore fund are 1.19% and 3.06% respectively)
(**) S&P Index returns are gross returns
(***) The 7-10 year LUCI Corporate Bond Index is compiled by CSFB (ASW=Asset Swap)



Portfolio Performance

	2003	2004
January	0.10%	1.26%
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	0.86%	0.77%
August	0.64%	
September	0.53%	
October	2.01%	
November	1.08%	
December	2.00%	
Y-T-D	8.25%	2.58%
Since Inception		10.19%

AUM: $21.5 million



July Commentary

As we were beginning to build confidence that the economy is in pretty good shape, a spate of economic announcements in July came as a reminder that, at a minimum, this economic recovery is different than others before in many respects, with the most important being its ability to create jobs. As this report is being written (August 6th), an employment report gain of just 32,000 (versus an expectation of over 200,000) has come on the heel of several others, all pointing towards a slowdown in the economic growth. Consumers (who account of 70% of the GDP), in particular, seem to have "run out of fuel" as a result of a combination of factors including lack of new jobs, higher energy costs and sheer exhaustion after the spending spree over the past few years. The markets, being discounters of the future, have began to get whiff of these developments, with the equity market in particular taking it in the chin particularly hard. Even the bond market, which is facing the prospect of Fed-induced interest rates hikes, felt it had overestimated the strength of the economy and traded higher, while the volatility markets bounced off from their 8-year lows, registering increased risk in the horizon. Where does all this take us? Most likely in a period of increased volatility as markets re-evaluate the above facts and re-adjust themselves. Add to this, the increased probability for a Democratic win (and the potential repeal of a tax advantaged legislation), continued unrest in the geopolitical arena, and the environment in the next few months could get testing. Let us simply state that we are being very cautious.

These developments did not leave the credit market unaffected. The second quarter earnings announcements (which were indicative of the robust activity of the previous quarter) were the major drivers of the activity in the corporate credit market during July. Despite the overall increase in earnings reported, market participants either because they had built such high expectations for earnings or because they were forward looking, were unforgiving. And while they rewarded those companies that, indeed, reported blow out earnings and/or provided positive guidance, they were merciless to those companies reporting earnings at expectations and/or with a slight miss, and/or giving out lower guidance. In the former category, we saw significant tightening in companies in sectors such as Autos, Energy, Telecom, Basic Industries, and Utilities. On the other hand, the market hammered corporate spreads of companies in Technology, Retail, Auto-parts, Healthcare and other sectors which either reported below expectations or guided lower for the remainder of the year. While all these were in line with the above described levels of economic activity, in our view, the most noteworthy development was the turn of companies' management focus towards increasing share prices. Having repaired their balance sheets and flushed with a lot of liquidity, several companies have began to announce higher dividends and/or share repurchase programs. Some have gone a step further to announce leveraged buy-outs (LBOs). To the extend that increased payoffs to shareholders are not the result of an improvement in the business, such activity is typically considered detrimental to the interests of bondholders. We saw a couple of such examples during July (Citizens, Cox Communications). As a result of all those factors, the outlook for the corporate credit market has become much more murky with a number of cross developments at work, with some pointing to tighter spreads while others are laying the foundations for potential credit blow-outs either from natural or "man-made" credit deterioration. Again, our antennas are up and our individual credit scrutiny has been increased.

July was another month during which attention to individual credit action paid off, delivering another decent month for Etolian Capital which recorded a net result of 77 basis points. Again, we have stuck to our highly balanced (between longs and shorts) approach and sought to take advantage of many of the moving parts that were taking place during July. The portfolio benefited from exposure to the Autos, Energy, Utilities and Telecom, gaining from the tightening that took place in these sectors as earnings were announced. Similarly, the portfolio gained from short positions in Retail, Telecom and Auto Parts, either as a result of missed economic results, or as a result of corporate action (LBO's – Citizens). As we have been communicating to you, the current environment is conducive for the implementation of our investment strategy as volatility among individual credits provides us with the opportunity to make money both on the long AND the short side of the market. Yet, the re-emergence of corporate action increases the potential risk as there is no effective way to predict such developments. As a result, and in order to decrease the potential negative impact from individual corporate actions, we will make an effort to decrease the portfolio allocation to credits/sectors that are considered LBO candidates. Currently, the portfolio has 48 positions with a long exposure of 212% and a short exposure of 210%, and an overall leverage of 4.2 x capital.

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