# ETOLIAN CAPITAL

# Monthly Letter: March 2004

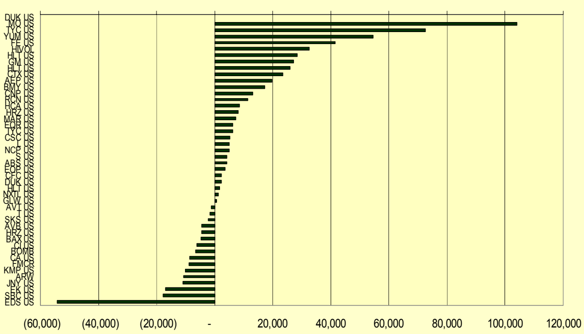
**Etolian Capital Group, LP** is a private investment management company, which focuses on US credit fixed income opportunities. Its objective is to generate above average, stable returns which are uncorrelated with major market indices by going long and short in cash and derivative fixed income obligations 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 |
|---|---|---|---|---|---|
| March Return | -0.69% | -0.69% | -1.64% | 1.15% | -0.41% |
| March Daily Volatility | 0.076% | 0.076% | 0.95% | 0.39% | 0.10% |
| March Sharpe Ratio | -7.95 | -7.95 | -1.17 | 1.99 | -2.75 |
| March % of (+) Days | 43% | 43% | 43% | 43% | 43% |
| Year-to-Day Returns | 0.873% | 0.833% | 1.29% | 3.96% | -0.58% |
| Y-t-D Annualized Return | 3.25% | 3.10% | 5.33% | 17.08% | -2.33% |
| Y-t-D Annualized Daily Volatility | 2.41% | 2.41% | 12.14% | 6.16% | 1.33% |
| Y-t-D Sharpe Ratio | 0.83 | 0.77 | 0.35 | 2.59 | -0.44 |
| Y-t-D % of (+) Months | 67% | 67% | 67% | 100% | 0% |
| Y-t-D % of (+) Days | 60% | 60% | 50% | 56% | 50% |

(*) Returns are net of fees (1.5% management fee and 20% incentive allocation of profits. March and Y-T-D gross returns are -0.73% and 1.49% respectively)
(**) S&P Index returns are gross returns
(***) The 7-10 year LUCI Corporate Bond Index is compiled by CSFB (ASW=Asset Swap)

**Individual Companies' Performance: (absolute value, Weighted) better than the LUCI corp. bond index**

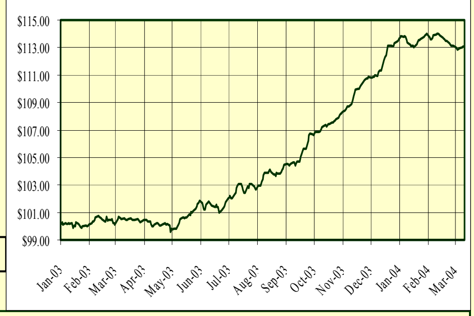



**Portfolio Performance**

| | 2003 | 2004 |
|---|---|---|
| January | 0.10% | 1.26% |
| February | 0.25% | 0.31% |
| March | -0.14% | -0.69% |
| April | -0.59% | |
| May | 0.34% | |
| June | 0.90% | |
| July | 0.86% | |
| August | 0.64% | |
| September | 0.53% | |
| October | 2.01% | |
| November | 1.08% | |
| December | 2.00% | |
| Y-T-D | 8.25% | 0.87% |
| Since Inception | | 9.18% |

**AUM: $10.75 million**

**Daily GAV Since Inception**




## March Commentary

March more than made up the lack of volatility witnessed during February. The main drivers for the volatility were uncertainty as to the sustainability of the economic recovery, and terrorism abroad. Last month's disappointing Nonfarm Payroll numbers triggered worries about a faltering economic recovery, unsettling the markets. The massive rally that followed, drove US Treasury bond yields significantly lower (10-year yields below 3.68%); equity markets nosedived, trading in a lockstep fashion with the Treasury market; and Equity Volatility, as captured by the VIX Index (another indicator of business uncertainty) exploded upwards. Credit markets, which were having trouble to begin with since the 3rd week of January, widened sharply outdistancing, in reaction, the other markets. The terrorists acts in Madrid brought another wave of selling in equities, creating a new spike in equity volatility, and a widening in credit spreads. Market volatility subsided during the last week as the month (and the quarter) came to a close. But the ride during the month was wild and the damage it caused, extensive. To put things in perspective, when it was all said and done, the US equity market finished the month with a loss of 1.53% (having been as low as 4.57% for the month), the VIX Index ended at a level of 16.75 (having been as high as 23), and the Treasury bond market (10-year note) ended up at 3.81%(having been as low as 3.68%). Lower interest rates boosted total returns in the US corporate credit market which registered a gain of 1.26%, but the credit spread component (as measured by the LUCI index widened by at about 7 basis points, finishing the month at 78.1, having registered an intra-month high of 80.6. And to put things in perspective, the LUCI index finished 2003 at 69.4, traded as low as 67.3 during the second week of January, and was at 69.8 at the end of January and 71.9 at the end of February.

The above figures convey the degree of the moves that took place during March. They also highlight the degree to which the credit market, fed by excess leverage and momentum players who have been riding the market since last year, led the other markets in the correction since mid January, and only joined in the recovery last, during the last week of March. Moreover, the above figures mask the much higher volatility that prevailed in the "high-beta" sector of the market as captured by the IBOX-HVOL index (another, credit default-based index of BBB-type credits). Using the same date references as above, the IBOX-HVOL Index finished 2003 at 90, registered a low at 84 during the second week of January, was at 100 and 106 and the end of January and February respectively, and finished in March at 116, having registered an intra-month high of 123. Autos led the retreat in spreads in a fashion that was very similar (but in reverse) to the leadership they provided to the market by driving spreads tighter in the later part of 2003. Other recovery sensitive sectors such as Technology, Utilities, Retail and Consumer Products also suffered along the way, while interest rate sensitive sectors that looked vulnerable from potentially higher interest rates had a reversal of fortunes, performed well in the credit widening environment. And then, there were the single name credit stories (EDS, CZN, TOY, etc) which received additional punishment from the market.

Etolian Capital had a rough time in this environment recording a net loss of -0.69% to investors. We entered March with a net long spread exposure of about 5%. In addition, reflecting our constructive outlook on spreads, the portfolio had a higher beta orientation on the long side aimed at capturing gains from contracting spreads. The ensuing credit widening ran against our portfolio position and the individual credits that comprised our longs and shorts. Our long positions under-performed (widened more) the market while our shorts over-performed (widened less). Unconvinced that the developments surrounding the economy presented a material deviation from our base case, we "stuck to our guns" and tried to preserve the structure of the portfolio utilizing (with some success) market indices to hedge the portfolio. The terrorist attacks, which led to another wave of market volatility, combined with our specific exposures, on the long side, to the Autos and EDS in particular, undermined the success of this strategy and, for risk management considerations (capital preservation), we decided to partially restructure the portfolio with the view to establish a more defensive stand and yet retain some upside. Although clearly unhappy with the month's result, we would like to draw the attention of our investors to the fact that this outcome took place in the midst of extreme interest rate volatility (which we, again, navigated successfully), major credit spread widening and a general reshuffling among credits. As we enter April, we continue to maintain a modest long credit spread bias, with much less embedded sensitivity, comprising 1.62 AUM in longs, 1.54xAUM in shorts and a net long position of about 8%.

**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**