# ETOLIAN CAPITAL

# Monthly Letter: March 2005

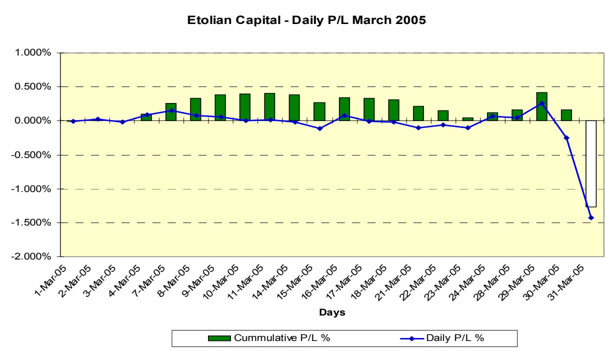
**Etolian Capital Group, LP** is a private investment management company, which focuses on US credit fixed income opportunities. Its objective is to generate above average, stable returns which are uncorrelated with major market indices by going long and short in cash and derivative fixed income obligations 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 |
| March Return | (1.07%) | (1.08%) | (1.91%) | (1.58%) | (0.16%) |
| March Volatility | 0.31% | 0.31% | 0.68% | 1.56% | 0.29% |
| March Sharpe Ratio | (3.94) | (3.98) | (3.06) | (1.11) | (1.11) |
| YTD Return | 0.21% | 0.22% | (2.59%) | (1.22%) | 0.37% |
| YTD Volatility | 1.60% | 1.60% | 9.65% | 2.22% | 1.59% |
| YTD Sharpe Ratio | (0.14) | (0.14) | (0.31) | (0.75) | (0.04) |

(*) Returns are net of fees (1.5% management fee and 20% incentive allocation of profits). March/ Y-T-D gross returns were for -1.21% and 0.365% respectively.
(**) 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)

## Daily Gross Returns – March 2005




## Portfolio Performance

| | 2003 | 2004 | 2005 |
|---|---|---|---|
| January | 0.10% | 1.26% | 0.56% |
| February | 0.25% | 0.31% | 0.75% |
| March | (0.14%) | (0.69%) | (1.08%) |
| 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% | 0.22% |
| Since Inception: | 13.69% | | |

## AUM: $26 million


## March Monthly

Fears of higher inflation created waves - and in some cases tsunamis - that ripped through the markets during March, leading to unusual volatility which has persisted as of this writing. With an economy that seems to be on a trajectory to about 4% annualized growth rate, markets' attention shifted to rising commodity prices and oil, which in particular made new highs during March. But it was the possibility of an acceleration in the "measured" pace of interest rate increases, implied by the inflation reference in the Fed's minutes, that began derailing the markets, causing a drop of 1.91% in the stock market, an increase in equity volatility as evidenced VIX from the 10-year lows of around 11% to around 14%, increases in observed market interest rates and a sharp widening in credit spreads across the board. It is now becoming evident that the markets look to potentially stronger headwinds ahead of them, as the chance of getting larger than the 25 basis points increments by the Fed has increased.

It is not an exaggeration to state that the credit markets bore the brunt of the above described effects, registering their worse monthly performance since October 2002. Broad indices such as the CDX IG and HVOL retreated, recording new highs for the year, and reaching levels not seen since August 2004. Apart from fears of higher interest rates, there were two more factors that caused the spread widening; problems in the Auto and Auto-related sectors and a new round of LBO fears. GM's announcement that it will miss first quarter earnings by a wide margin during the second week of the month came at a point when the credit market already felt tired, having been on a tightening spree since late January. GM credit spreads widened by over 200 basis points, causing every other spread in the Auto and Auto parts sectors to widen proportionally. This gave the signal for the rest of the market to widen in sympathy, although the spread movements in the other sectors were much more subdued. And while the market was in the process of digesting the Auto-related events, the Fed's mention of potential inflation brought on another wave of spread widening. This time, however, the widening was more widespread, with the higher beta, high yield and emerging market credits (that is, all interest rate sensitive) leading the way. Financials, REITS and Homebuilders also received a disproportionate share of credit widening. It was also the first time that we saw signs of panic in the street, with liquidity beginning to get impaired, bid-ask spreads becoming unreasonably wide, and in some cases, bids disappearing all-together. Yet, the market rebuilt its composure towards the end of the month as real money buyers emerged and began buying. Finally, LBO concerns, focusing on the retail (department and supermarket stores) and driven by real estate holdings of these entities brought another round of widening which, given the fragile state of the market, pushed spreads even wider. Despite the severe spread move, we are of the view that this does not signal the end of the credit cycle and represents a much needed correction. A supporting equity market and a rather stable equity volatility behavior (as evidenced by VIX) seems to support this view, but time will tell which of these markets (credit, equities, equity volatility) is correct.

March was a painful month for Etolian Capital, as we recorded a net loss of 108 basis points. Looking at this outcome, one would have guessed that we suffered from the widening that took place during the month. On the contrary. The balanced long/short nature of the fund enabled us to sail through the market's turmoil in a stable and profitable manner. In fact, until the last day of the month (see graph above), we were looking for a small gain of about 40-45 basis points. Unfortunately, on the last day of the month, one of our long positions – JC Penney – was severely affected by LBO rumors when spreads moved against the position by about 250 basis points – a move that was several standard deviations from the levels of the previous day, leaving us no room to take any defensive action or time and space to recover the loss. As we enter April, the portfolio is fairly balanced by being long about 196% and 201% short. The portfolio contains 49 names, of which 24 names are on the long side and 25 on the short side.

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