ETOLIAN CAPITAL

Monthly Letter: May 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
May Return	0.03%	0.03%	1.21%	-1.14%	-0.41%
May Daily Volatility	0.08%	0.08%	0.71%	0.44%	0.16%
May Sharpe Ratio	0.54	0.54	1.34	-2.10	-2.02
May % of (+) Days	55%	55%	60%	40%	45%
Year-to-Day Returns	0.95%	0.92%	0.79%	-1.06%	0.02%
Y-t-D Annualized Return	2.21%	2.16%	1.92%	-2.56%	0.06%
Y-t-D Annualized Daily Volatility	1.38%	1.38%	12.14%	6.61%	1.58%
Y-t-D Sharpe Ratio	0.43	0.34	0.06	-0.56	0.02
Y-t-D % of (+) Months	80%	80%	60%	60%	20%
Y-t-D % of (+) Days	65%	65%	52%	46%	52%

(*) Returns are net of fees (1.5% management fee and 20% incentive allocation of profits. May and Y-T-D gross returns are 0.17% and 1.52% respectively)
(**) S&P Index returns are gross returns
(***) The 7-10 year LUCI Corporate Bond Index is compiled by CSFB (ASW=Asset Swap)

VaR Exposure by Industry

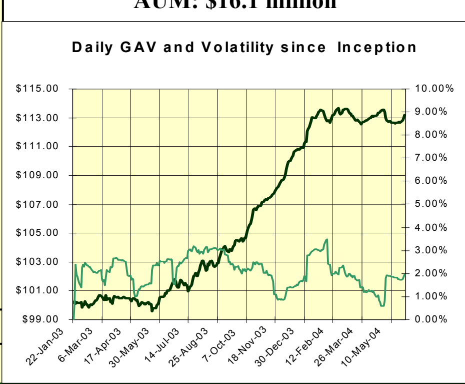
-15.00% -10.00% -5.00% 0.00% 5.00% 10.00% 15.00%

BANK, BASIC INDUSTRIES, CONSUMER PRODUCTS, ELECTRIC UTILITIES, ENERGY, FINANCE, GAMING AND LODGING, GAS PIPELINES, HEALTHCARE, INSURANCE, MANUFACTURING, MEDIA, REITS, RETAIL, SERVICES, TECHNOLOGY, TELECOM, TRANSPORTATION, WATER

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%	
July	0.86%	
August	0.64%	
September	0.53%	
October	2.01%	
November	1.08%	
December	2.00%	
Y-T-D	8.25%	0.95%
Since Inception		9.28%

AUM: $16.1 million



May Commentary

During May we continued to receive confirmation, through a string of economic releases, that the economy is in full upswing. Moreover, the economy continued to create jobs at a rate exceeding the markets' expectations and confirming the inevitability of higher interest rates which, most market participants now expect, should begin to get raised by the Fed in the upcoming June Fed meeting. The only questions remaining are as to how many of those rate hikes will occur and how severe will they be. Reflecting the above, interest rate markets have been trading lower in price. Yet the Fed, in an excellent expectations management, seems to have persuaded the markets that whatever changes it makes, will be "measured", limiting the upward pressure in interest rates. Equity markets seemed to take this at heart and, after selling off rather dramatically in the first part of May, recovered in the second half of the month. Similarly, equity volatility (as captured by the VIX Index) spiked intra-month, coming back rather dramatically towards the end of the month. All-in-all, it seems that the markets have "digested" the initial negative effects of higher rates and, instead, have began to focus on the benefits associated with a stronger economy. We are constructive about the prevailing market sentiment going forward, and only developments from potentially higher inflation (which, despite higher energy prices, does not seem to be currently a threat) would begin to undermine our view.

Developments in the US corporate market reflected the above, selling off in the first part of the month and recovering some of its losses towards the end of the month. In fact, for the most part, the credit market traded in a lock-step with movements in the S&P and the VIX index, widening with declines in the S&P (and spikes in the VIX Index) and coming back as equity markets improved. Interest rate sensitive sectors such as Financials, Homebuilders, REITS, Transportation and Autos in particular (which have been acting more like financials these days), bore the brunt of the credit spread widening. In addition, the fears of interest rates (which could lead to higher interest rate expenses) punished disproportionately the Emerging Markets and the High Yield sectors. As a result, the higher beta segments of the Investment Grade market were negatively affected, giving rise to some significant credit spread widening. Adding to the existing state of volatility were corporate specific news which, when negative, led to significant spread widening for these names. Intelsat and Bombardier were examples of credits subject to such bad news and both names were hammered in the market place experiencing spread widening of 100+ basis points. On the other hand, TYCO was an example of good news which, as a result of an upgrade from S&P, saw its spread coming in by 40 basis points. Diminishing liquidity seemed to exaggerate the effects of these developments. The dire state of affairs prevailing in the first 3 weeks, began to clear towards to end of the month, as the interest rate markets stabilized and equity and equity volatility markets began to signal signs of having digested the fears of higher interest rates. As we look into June we see room for further modest tightening in corporate spreads as the effects of a stronger economy are likely to trickle through to higher corporate earnings.

May was perhaps the most difficult month for the credit markets and for Etolian since our inception, leading to a small positive return of 0.03% for the month. The long/short nature of our strategy protected the portfolio but, at the same time, prevented us from making money. Below the seemingly stable and flat monthly result, we experienced high volatility in gains and losses in the portfolio and struggled to stay above water throughout the month. Starting the month with a small net long credit spread position (primarily through our exposure to Autos), we were punished early in the month. Our problems were compounded by pain in High beta leisure and wireless long positions which were disproportionably affected by the adverse developments in the High Yield market, triggering some stop losses. Gains in our shorts helped the situation, but not enough to offset the leakages we were experiencing in our longs. However as the month progressed, gains from short positions in Bombardier and Retailers, along with gains in long positions in TYCO, helped us recover. In the end, we finished the month flat which, while disappointing, it is not necessarily a bad outcome given the volatility that prevailed throughout the month. We emerged unscratched from a very difficult market and the portfolio is well positioned for the current state of the economy. Although we see further room for modest credit tightening in the near future, we are of the view that most of the credit tightening is behind us. Sector and specific name selectivity are increasingly important, and so is tight risk management of positions. We have spent a lot of time reviewing our positions, pairing exposures much tighter on the long and short sides, and being much more precise as to how and where to expose our portfolio. As we enter June, we are about 9% net long spreads but much more defensively constructed.

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