ETOLIAN CAPITAL

Monthly Letter: May 2005

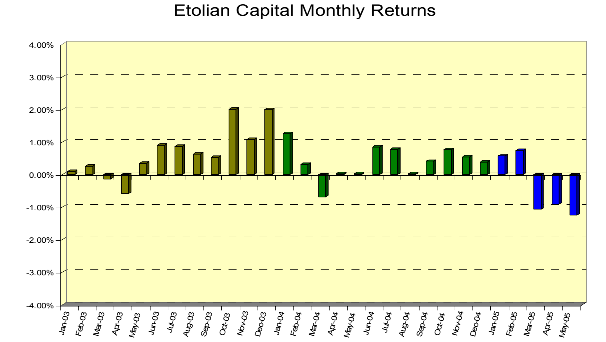
Etolian Capital Group, LP is a private investment management company, which focuses on US credit fixed income opportunities. Its objective is to generate above average, stable returns which are uncorrelated with major market indices by going long and short in cash and derivative fixed income obligations 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
May Return	(1.25%)	(1.26%)	3.00%	1.61%	0.36%
May Volatility	1.15%	1.15%	0.79%	1.05%	0.43%
May Sharpe Ratio	(1.23)	(1.24)	3.58	1.37	0.44
YTD Return	(1.95%)	(1.96%)	(1.68%)	1.91%	0.51%
YTD Volatility	2.45%	2.45%	9.65%	2.74%	2.44%
YTD Sharpe Ratio	(1.11)	(1.11)	(0.25)	0.42	(0.11)

(*) Returns are net of fees (1.5% management fee and 20% incentive allocation of profits). May/ Y-T-D gross returns were for -1.41% and -2.02% 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)

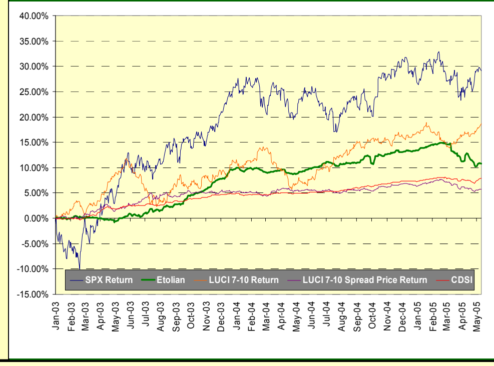
Monthly Gross Returns – as of May 2005



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%	(0.92%)
May	0.34%	0.03%	(1.26%)
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%	(1.96%)
Since Inception:	11.22%		

AUM: $24.6 million



May Monthly

Financial markets fluctuated widely in May as they tried to assess the strength and sustainability of the economic expansion, providing conflicting signals. While announced first GDP growth came out at 3.5%, the Government bond market was on a tear, with the 10-year note breaking through the 4% barrier on the way down. Probed by Fed official's comments that the Fed may be nearing its tightening course, the yield curve flattened, acting as if an economic slowdown is looming ahead of us. Equity markets were on an equal tear on the way up, with the S&P recording a 3.0% gain in May, obviously oblivious to any slowdown fears, while the credit markets were in a world of their own reflecting, at times, scenarios much bleaker than those of the interest rate market. What do we make of it? Not much! We continue to believe that, despite a slowdown, the economy will be growing at a 3%+ growth rate, providing a positive underpinning to the markets.

Within the above context, if one were to take the economic temperature from within the credit markets during May, he (she) could easily reach the conclusion that we are heading for not just an economic slowdown, but rather a recession! By month's end, however, the picture that was emerging from the credit market was widely different, and more in line with the other markets. During May, the credit market went through a wild roller-coaster which pushed credit spreads to the wides for 2005, and at levels which undid most of the spread tightening of the past 1½ year. With the benefit of the hindsight, one can identify two major forces that accounted for this volatility and, in effect, the creation of a very uncharacteristic "default-less" credit crisis; first, the unwinding of CDO tranche trades and, secondly, a preponderance of idiosyncratic risk. One of the consequences of the Auto-related problems was the realization that the correlation assumptions underlying the pricing of CDO tranches was incorrect (correlation assumptions were too high, and collapsed with the emergence of a highly idiosyncratic - i.e., specific - event, such as the Auto problems). A number of trades involving these tranches were forcibly liquidated, and in the process drove the CDX IG and HVOL indices to as high as 79 and 180 respectively (both indices were used for hedging these tranches). This event further highlighted the importance of idiosyncratic risk to credit portfolios which, in turn, led to a spate of individual credit spread widenings during which even a whiff of bad news (or absence of good news) was penalized by the market through a 30, 50 or a 100 basis points spread widening in any particular day. Towards the end of the month, and following GM's downgrade to junk by Fitch, the climate began to improve, sparking a sharp rally in credit spreads that is still continuing, in line with the positive sentiment that is present in other markets, with CDX IG and HVOL finishing at 60 and 132. It is now apparent that the credit market was out of line with equity and equity volatility markets which have been projecting a completely different outlook. Moreover, we believe that there is further room for convergence between the credit and equity and equity volatility markets, because of the improvements in the latter markets over the past few weeks. Having said that, one has to keep an eye on idiosyncratic risk, as the credit market continues to be wary of shareholder-friendly, bondholder-unfriendly actions.

May was a very disappointing month for Etolian Capital, leading to a loss of 1.25% for the month, our worse month since inception. We were not involved in any of the tranche trading. And we were cautious in taking corrective action (having learned from April). Despite our short bias, extreme market conditions and preponderance of idiosyncratic risk affected our portfolio in a random fashion (defying any logic and, therefore, rational response), and took a toll on performance. Long positions which, by our equity based valuation approach were grossly undervalued, had to be liquidated when P&L volatility exceeded our limits, despite the fact that they were screaming buys – an event that was confirmed a week later. In effect, we went though conditions that exceeded our risk estimates, and prudence dictated that we had to reduce risk. As we enter June, our portfolio is balanced, being long about 184% and 175% short, comprising 43 names of which 22 names are on the long side and 21 on the short side.

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