

# ETOLIAN CAPITAL

## Monthly Letter: August 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	S&P	LUCI	CDSI
August Return	0.15%	0.15%	(1.12%)	1.64%	0.33%
August Volatility	0.59%	0.59%	0.56%	1.32%	0.11%
August Sharpe Ratio	(0.11)	(0.11)	(2.41)	1.09	1.04
YTD Return	(0.65%)	(0.63%)	0.69%	3.71%	2.08%
YTD Volatility	2.73%	2.73%	21.66%	3.70%	2.73%
YTD Sharpe Ratio	(0.73)	(0.72)	(0.03)	0.64	0.27

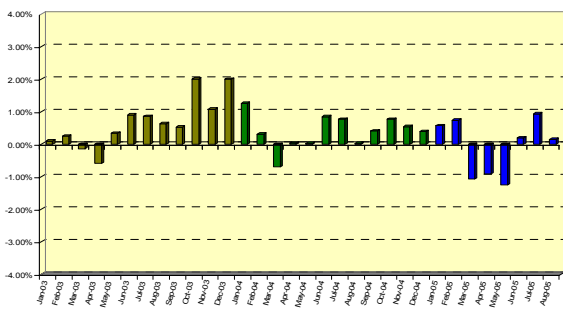
(\*) Returns are net of fees (1.5% management fee and 20% incentive allocation of profits). August/ Y-T-D gross returns were 0.33% and 0.085% respectively.

(\*\*) 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 July 2005

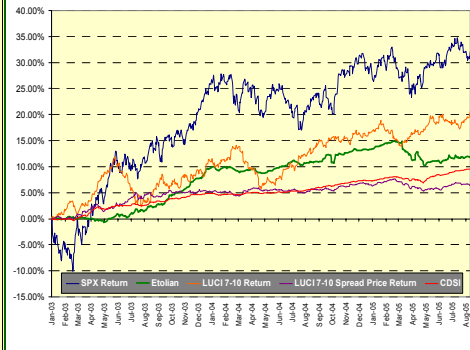
Etolian Capital Monthly Returns



### 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%	0.25%
July	0.87%	0.77%	0.95%
August	0.64%	0.03%	0.15%
September	0.53%	0.41%	
October	2.01%	0.77%	
November	1.08%	0.54%	
December	2.00%	0.39%	
<b>Year to Date</b>	<b>8.25%</b>	<b>4.79%</b>	<b>(0.63%)</b>
<b>Since Inception:</b>	<b>12.73%</b>		

### AUM: \$15.9 million



### August Monthly

Concerns about the effects of climbing energy prices, be they the result of supply shortages, higher demand, or from the catastrophic forces of Katrina, took a center stage during August, providing a higher than expected degree of volatility for a month that otherwise is in the midst of summer doldrums. The government bond market took these events in and professed the end of Fed tightening, causing 10-year interest rates to come in by another 35 basis points. Most importantly, short-term interest rates came in even more causing the yield curve to return to its normal positive slope from the almost inverse slope state that was in, suggesting a major reassessment of the economic outlook on the part of major market participants. Similarly, the equity market seemed to share some of these concerns by giving up 1.12% during August, while VIX rebounded from its lows ending the month at around 13, after reaching a level of 14 during the month. Is the economy slowing down to the point that the Fed is done? We think not! Despite the economic uncertainty caused by Katrina, we are of the opinion that the Fed, focusing on rising prices, will stay the course, particularly in light of the extra \$150 billion plus that the Katrina clean-up requires and despite the expected economic slowdown.

If there was one market that showed little reaction to all of the above developments was the credit markets. If nothing else, it seemed to be more preoccupied – and rightfully so - with Delphi's problems, its intricate negotiations with the unions and their potential impact on GM and the other Auto and Auto-parts providers. Apart from that, it was almost business as usual – as usual business can be in the midst of peak vacation time for most Americans. There was some minor profit taking during the month in line with the declining equities and rising equity volatility, but not significant enough to either change the trend or induce investors sitting on the sidelines to come in and buy. Credit indices such as CDX IG and HVOL fluctuated within a narrow range and closed the month at 51 and 112, recording modest back-ups in spreads from last month's closing levels of 51 and 103 respectively. Apart from the Auto-related woes, other sectors that attracted attention was the Media sector with Icahn's forays towards Time Warner, the Pharmaceuticals sector where Merck lost the first VIOXX trial, and towards the end of the month, sectors that were directly affected by Katrina's effects, such as Gaming, Retail, Energy and Utilities. As we enter the Fall season, we are adopting a more cautious stance. The signals we get from the other markets are conflicting (recovering equities, yet rising equity volatility, lower interest rates) and, for sure, not strong enough to form a firm opinion as to the credit market's direction. We do expect spreads to tighten as we approach the later part of September and the expected CDS rollover to the new contract, yet the market does not seem to possess the leadership to push through to tighter levels, and the Fall season has traditionally been a volatile time for financial markets.

August was a relatively lackluster month for Etolian during which we recorded a modest gain of 15 basis points. The market place simply did not provide us with enough opportunities to make money. The small gain was derived primarily from revaluations in existing long and short positions, and mostly through the later. Gains and losses in positions that we have in the media sector were the primary driver of our gains. Also, towards the end of the month, we were negatively impacted by the effects of Katrina in some of our energy positions. Given our near term outlook for the credit market, our strategy remains unchanged, namely we will continue to look for opportunities to source shorts while maintaining our modest overall long exposure through credit indices, being weary of the increased idiosyncratic risk. As we enter September, our portfolio is fairly balanced between short and long positions with about 182% long and 179% short, comprising 46 positions of which 22 are long positions and 24 are names on the short side.