# ETOLIAN CAPITAL

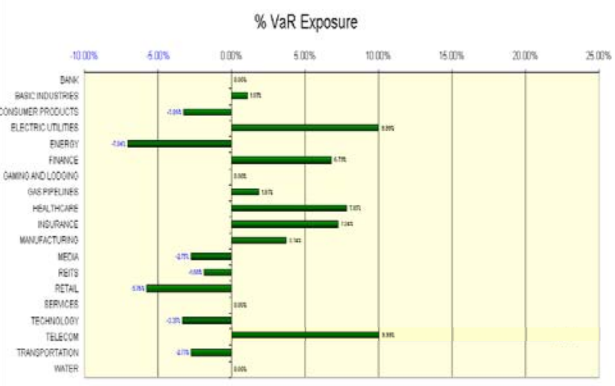
## Monthly Letter: October 2004

**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 |
|---|---|---|---|---|---|
| **October Return** | 0.77% | 0.77% | 1.40% | 1.20% | -0.03% |
| **October Daily Volatility** | 0.34% | 0.34% | 0.78% | 0.29% | 0.09% |
| **October Sharpe Ratio** | 1.52 | 1.52 | 1.30 | 3.06 | -0.31 |
| **October % of (+) Days** | 66.67% | 66.67% | 57% | 60% | 60% |
| **Year-to-Day Returns** | 3.82% | 3.77% | 1.64% | 6.37% | 0.30% |
| **Y-t-D Annualized Return** | 4.58% | 4.52% | 1.98% | 7.77% | 0.10% |
| **Y-t-D Annualized Daily Volatility** | 2.37% | 2.37% | 11.36% | 6.10% | 0.37% |
| **Y-t-D Sharpe Ratio** | 1.24 | 1.21 | 0.05 | 1.04 | 0.20 |
| **Y-t-D % of (+) Months** | 90% | 90% | 70% | 80% | 40% |
| **Y-t-D % of (+) Days** | 67% | 67% | 55% | 54% | 50% |

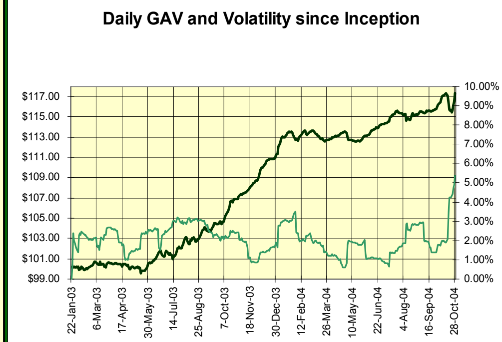
(*) Returns are net of fees (1.5% management fee and 20% incentive allocation of profits. October and Y-T-D gross returns for the Onshore fund are 1.02% and 6.10% respectively)
(**) S&P Index returns are gross returns
(***) The 7-10 year LUCI Corporate Bond Index is compiled by CSFB (ASW=Asset Swap)




**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% | 0.85% |
| July | 0.86% | 0.77% |
| August | 0.64% | 0.03% |
| September | 0.53% | 0.41% |
| October | 2.01% | 0.77% |
| November | 1.08% | |
| December | 2.00% | |
| Y-T-D | 8.25% | 3.82% |
| Since Inception | | 12.39% |

**AUM: $22.1 million**




## October Commentary

October did not provide any clues as to what the future has in store for the economy and the markets. Economic statistics continued to pour in, providing evidence for everyone. Non-farm payroll figures, industrial production and manufacturing and GNP growth were weaker than expected, while other indicators such as retail sales and corporate profits were stronger. Yet, markets were focused on oil and the elections, particularly the later and as oil prices soared during the first half of the month, equities nosedived and Treasuries rallied. Unsurprisingly, VIX - the uncertainty barometer - traded higher towards the 17 level, trending off the lows of last month (just below 13), but still within the decreasing trend it has been since 2002. Only during the last week of the month were these trends reversed, and signs of a "Bush-win"- inspired rally began to appear. Our view on the economy's outlook remains unchanged. That is, we still expect a positive but subdued economic growth path, yet a path mined by a number of potentially unsettling risk factors (trade and budget imbalances, consumer indebtness and others). And as we said in our last month's letter, a lot of the clues lie with the US consumers and if they are employed or not!

During October developments in the US corporate credit markets provided a lot of excitement. The very favorable technical conditions underpinning the US corporate credit (lack of availability of paper, continued strong demand for spread product, and unusually high synthetic CDO activity) continued to shape the corporate credit landscape, leading to spouts of significant spread tightening which has brought us to the lows of 2004 and near historical lows in spreads. High beta names with high 100 or 200+ spreads came in particularly hard, registering gains of 50+ basis points. Telecoms, Media and Auto parts lead the way (ATT, Citizens, Liberty, Cablevision, Visteon, etc.), but the rally touched nearly all sectors. However, there were exceptions, the most notable being the insurance sector which, following Spitzer's inquiry, went through a wild ride as spreads in selected names registered 100+ increases (Marsh and McLennan, Aon, Ace, UNUM) before they came back (but not all the way). Also, following the GM downgrade, the Autos underperformed the market and so did the Healthcare and Drug sectors for company specific reasons. Yet, we cannot help being amazed by the extent of the spread move (which continues as we write this report), and we are beginning to be concerned by the froth that seems to be prevailing in the market place. Obviously whatever goes up, eventually will have to come down, but we will not begin to try to anticipate the turning point. But do rest assured that we are monitoring the situation very closely and are keeping our exposures closer at home.

Etolian Capital recorded a 77 basis points net return to investors in October which, on its own, is a good outcome. However, below the surface, October was a true roller-coaster month as Etolian Capital hit unusually high turbulence because of its exposure to the insurance sector. We entered the month by being well positioned with long exposures to Telecom, Media, Technology and Utilities, combined with short positions in Consumer Products, Retail and Auto parts. As a result, we recorded strong gains in the early part of the month. This came to an end when, following Spitzer's inquiry in the insurance sector, we sustained losses in long positions we had in two insurance names (Liberty Mutual and UNUM). Exposure to the Healthcare sector did not help either. Despite our stop loss management procedures, losses were sustained because a lot of the spread tightening took place either overnight or very quickly. A combination of gains in the long Telecom positions, the trimming of some of the Auto part shorts (which came in sharply from their intra-month highs), and the rebound in insurance spreads following Spitzer's settlement with Marsh & McLennan, enabled us to come back. Given the conditions described above, the portfolio continues to be geared on the long side by being 183% long and 179% short (4% net long) but with a reduced leverage of about 3.6 times. The portfolio contains 47 names, of which 23 names are on the long side and 24 on the short side. Finally, we have initiated a portfolio protection program, designed to specifically address potentially disruptive market conditions.

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