WARRINGTON
ASSET MANAGEMENT

August 2014 Market Commentary

In early August, the stock market continued to be volatile due to the repeated clashes in the Russia-Ukraine conflict. After the steep drop on the final day of July, the S&P 500 index traded sideways in a 2% range for about a week. This churning action benefitted Warrington, as the fund held ratio put spreads which would appreciate in value should the market stay in that range or drift lower. This did not persist, and the S&P then embarked on a high-velocity 5.4% rally over 15 trading days with the largest daily loss registering a mere 0.1%. This straight up rally of more than 100 S&P points came with ever-dwindling trading volume. Rallies on strong volume can be very clear bullish signs, but rallies on low volume (especially when trading volume on down days is significantly greater) send a signal that market advances are getting stretched. Warrington's loss for the month was due to the accrued costs of adjusting the ratio put spreads to attempt to capture a retracement in the advancing stock market. Warrington entered September holding ratio put spreads to capitalize on a pullback in the market, given the overbought condition that many technical indicators were showing at the end of August.

Many market analysts will look at the Price to Earnings (P/E) ratio of the S&P 500 as a whole to determine whether the general market is overbought or oversold. One major flaw of this is that even if aggregate earnings of the S&P are constant, corporate stock buybacks will decrease the number of shares outstanding. This spreads the firms' earnings across fewer shares and causes the earnings per share to artificially grow. Adjusting the P/E analysis for this accounting quirk, the current P/E ratio for the S&P as a whole is 18.0, versus the long-term historical average of 10.3. This discrepancy distinctly points to the current market being overbought and due for a correction.

The most recent 10% correction in the S&P was in 2011, about 1,050 trading days ago. Corrections are a healthy part of market activity, which can act to "cleanse" the system of built-up speculative pressures, and not relieving this could lead to greater problems in the future. In the 2011 correction, Warrington was able to trade opportunistically, gaining a little under 10% net for the year, where the S&P index was essentially flat.