WARRINGTON
ASSET MANAGEMENT

February 2014 Market Commentary

February began with a very strong down day for markets, with the S&P 500 declining 2.5%. This was the worst single day for the S&P since early November 2012, but the rest of the month was reminiscent of 2013: grinding rallies with very little selling pressure. After the initial down day, the S&P 500 futures rallied 7.7% to all-time highs on the final day of the month. In between, there were only three negative days, with two of them registering losses of less than 0.25%.

This essentially linear advance proved counter-productive to Warrington's positions for the month. The expectation was for continued volatility similar to January, and Warrington held ratio put spreads in the portfolio for the regular and end-of-month expirations. Those positions expired out of the money, resulting in essentially flat performance.

At the end of February, the S&P 500 displayed a number of overbought indicators, implying that the market was at its most extreme upside reading since October 2011. While history does not always repeat itself, the market did decline about 10% in a month after the late 2011 overbought condition. With the dynamics of markets and the economy being substantially different now versus a few years ago, the past is not necessarily prologue, but historically high readings such as this can often be a harbinger of turns in the stock market.

However, what if the market continues to climb relentlessly, as it did during most of 2013? This trading pattern has proved difficult for Warrington's strategy to capitalize on recently, for a number of reasons. One of the key tenants to Warrington's trading strategies is to employ low-cost put and call ratio spreads, and to often use them simultaneously. Using ratio spreads is often significantly less expensive than utilizing regular spreads, and having minimal cost exposure limits the losses for a given position if the manager is wrong on the direction of the market.

With the steadily climbing stock market of the last year-plus, one might think that ratio call spreads would be the ideal trade, but this has not been the case. Because of the extremely depressed prices of out-of-the-money calls (those which the manager would like to sell in ratio spreads), the range of the low-cost spreads has been compressed to the point where the manager feels the risk/reward

ratio is imprudent. Low-cost call spreads are now half the range of what they were just a few years ago, forcing the manager to either pay significantly more for a wider range, or accept a much tighter range for little cost. Neither option is compelling from the manager's point of view. Warrington has historically sought out trades whose risk/reward relationships have potential gains that far outweigh the potential losses, and in the absence of such trades will patiently wait for better opportunities while seeking to preserve capital.