WARRINGTON
ASSET MANAGEMENT

February 2007 Market Commentary

February can be looked at as one month, with two very distinct periods. The first part spanned the first of the month through the 26th and had all the hallmarks of the prior six months: low volatility, general complacency, and very little market movement on a day-to-day basis. Through this period, Warrington was having good performance. However, on the 27th the S&P 500 experienced a very strong down day, the strongest in years in percentage and point terms, which was marked by an extreme rise in volatility.

This single day move exhibited some characteristics that the market had not seen in decades. The most glaring, in our opinion, was the day-over-day change in the CBOE Volatility Index (the VIX). The VIX measure of volatility increased 64.13% on a close-to-close basis, which is the highest change that we are able to find on record, with our data going back through January, 1990. This statistic is important because volatility is a key component in determining the price of all options, with options that are deep out-of-the-money being more sensitive to changes in volatility. With large changes in volatility, options that are far out of the money also experience a large change in price. Coming into the 27th, we had a full component of put spreads on. As the VIX spiked up so dramatically, so did the price of the deep out-of-the-money puts that we were short relative to positions held long, thus negatively impacting our mark-to-market balances.

While the market was dropping on February 27th (and as it continued to gyrate in the days after), we continued to hedge our exposure, moving some of our short puts further away from the market and moving some out to April positions. The hedging actions would act to mitigate our exposure, but would not fully insulate our portfolio from dramatic swings in mark-to-market pricing. Those swings were brought about both by the wild moves in the market and the outsized changes in the VIX.

This change in the volatility characteristics of the market has both positive and negative implications for our positions going forward. Negatively, the positions that we had on were adversely impacted on a mark-to-market basis, but over the longer term while the VIX remains high, we are able to enter positions that have improved risk/reward characteristics than we would be able to get in a low-VIX environment.

While there are no guarantees of this going forward, we are happy to see the return of volatility to an otherwise very staid stock market.