WARRINGTON
ASSET MANAGEMENT

February 2013 Market Commentary

In late February, the first signs that the Federal Reserve might take away the proverbial "Punch Bowl" started to appear. In the release of the minutes from the late January FOMC (Federal Open Market Committee) meeting, "many" Fed governors openly questioned the costs and benefits of the Quantitative Easing programs. The primary benefit is quite clear: drastically lower interest rates than what the market would price otherwise. The costs are also rather clear: massive asset price increases across the board (stocks, bonds, real estate, etc.) from when the Fed's Quantitative Easing programs began in 2009. After such extensive purchases of treasuries, MBS, etc., the law of diminishing returns has caused each successive round of purchases by the Fed to have a decreasing affect upon asset prices.

This disclosure by the Fed sent shockwaves through markets. The S&P 500 had just hit new highs for the year when the Fed minutes were released, and markets traded down 3% over the next few days (markets were also impacted by surprising results from Italy's election, meaning that Europe once again may become a focal point of news headlines). This decline worked in Warrington's favor as the fund was holding ratio put spreads in anticipation of such a decline. But just as quickly as the decline occurred, the majority of it was erased as the S&P popped 2.7% in three trading days. This rally decreased the value of the ratio put spreads held by the fund, deteriorating the potential profit for those end-of-month positions.