WARRINGTON
ASSET MANAGEMENT

January 2008 Market Commentary

The end of month performance numbers for the S&P 500 in January do not tell the whole story of what proved to be a wild and historically significant month in markets. The S&P futures were down 6.61% for the month, but as large as that decline is, the index was down by 14.57% just days before the end of the month (and a total of 20.45% from the highs in October 2007). The magnitude and ferocity of this decline caused the index to record many extreme readings in technical indicators we follow. Our "Band Chart" of the highest probability S&P trading range was breached to the most extreme downside level seen since July of 2002. Only a few times in history (dating back to the inception of the S&P futures in 1982) has this indicator been more extended to the downside (the worst being October 1987, and also after the September 11th attacks). Also, for the first time in history, the S&P futures gapped open lower by 2% or more on two consecutive days (opening lower by 4.36% on January 22nd, and then lower by 2.77% on January 23rd). This unprecedented occurrence displays a level of fear and anxiety in the markets that we take very seriously. These indicators coupled with the intraday volatility are the hallmarks of an unstable market where massive swings are commonplace, and taking large positions is not advisable.

We entered January in cash, with all of our previous positions having expired at the end of December. At the beginning of the month we initiated two partial positions of ratio put spreads, one expiring at the normal January expiration and another expiring at the end of January. As we were holding these positions the market continued to trend lower. While this decline initially benefited our positions, we were primarily concerned about managing the overall risk in the portfolio should the pullback intensify. The S&P futures accelerated their decline and, as certain levels were breached in the index, we chose to hedge aggressively. We realized some losses by doing so, but in the process protected the portfolio from further market declines. On our positions expiring at the normal January expiration, we realized a loss around 2%, and roughly the same amount on our positions expiring at the end of January. After January expiration, we added a small position of February ratio put spreads. The volatility in the market continued, impacting position as well. At the end of the month, the February position marked-to-market at a loss of approximately 1.5%.

Throughout the market volatility, we continued to focus on our risk management discipline. At the same time, we have continued to hold positions in the market, keeping trades small and spreads extremely wide. As we have seen since July of 2007, the volatility of the S&P market can be a benefit as well as a detriment to our profitability, but on the whole, we feel that volatility in the market will allow us greater profit potential than in an otherwise stagnant market. Where the market declined over 20% from the highs in October 2007 to the lows in January, Warrington actually increased 5.5% from October through January, a testament to the strategy's ability to handle market volatility.