WARRINGTON
ASSET MANAGEMENT

May 2010 Market Commentary

During May, the S&P 500 traded with such violent volatility that comparisons to fall 2008 could be made. The VIX spiked 118% at its highest point in the month, and the Dow Jones index experienced its single largest intraday point decline in history (greater than September 11th, 2001; greater than any day in the tech bubble crash; and greater than any day in the financial crisis turmoil). This unprecedented activity caused Warrington to have a very difficult month, with the majority of the loss coming from the days around the May 6th "Flash Crash."

On May 6th the market and Warrington both lost around four percentage points, but when the market opened on Friday the weakness continued. As key technical levels were breached, the fund manager chose to protect the portfolio by covering all exposed short puts, thus incurring an additional loss for the month, but completely protecting the fund from continued market declines. It is this type of risk management that insulated the fund from the severe market losses of the first weeks of October 2008, and a move that has proven most effective in the past.

When the ECB unexpectedly announced a $1 trillion debt swap plan that weekend (an event that was certainly not a foregone conclusion on Friday afternoon), the S&P shot higher on Monday and continued climbing for the next few days. In this instance, the fund manager's risk management protection ultimately was not needed and the loss on the position was realized. Despite this result, the fund manager believes this was the most prudent course of action, as markets were in a precarious state, clearing systems were experiencing significant malfunctions and the true reasons for the "flash crash" remain a mystery even today.

As the market climbed higher, certain technical levels of the strategy were met that indicated that the market had regained some degree of normalcy and that new, albeit smaller, positions could be attempted. The manager decided to re-enter small ratio put spread positions, which would have profited from a decline to the prior lows. Over the following week, the stock market did resume its decline, but it eventually breached the low made on May 6th and the VIX spiked to even higher highs. Again, the manager chose to protect the portfolio when trading activity became unstable and incurred an additional small loss in doing so.

The losses incurred this month are not ones that the manager takes lightly. All principals at Warrington hold a disproportionately large percentage of their net worth in the fund, and the fund manager is one of the single largest owners of units in the fund. As such, please know that efforts to regain losses are ongoing and will continue in earnest. It has often been the case historically that, after extreme market moves, volatility remains high for a period after the initial turmoil. Warrington has the potential to capitalize on this due to wider ratio put spreads than would be expected in a less volatile environment. This translates into greater profit potential for the same sized position. While past performance is no guarantee of future results, this has often been the case in Warrington's history dating back to 1997.