WARRINGTON
ASSET MANAGEMENT

September 2008 Market Commentary

September has proven to be the most difficult month in Warrington's history, roughly equivalent to the Fund's previous worst drawdown in 2001. That year was the Fund's only negative year to date, but returns following this period were quite good, and the Fund returned to new highs within seven months of experiencing the trough. Still, the Manager wants to give you a detailed look at some of the factors that made this month such an outlier, and hopefully shed light on what the Manager is doing in this volatile environment.

During September the average daily range in the market, both up and down, was 3.67% per day. This number is not artificially inflated by a single volatile day, but of the 21 trading days in the month one third of them experienced daily ranges exceeding 4.3%, and no day had a range lower than 1.2%. To put that in perspective, since the credit crisis began in July 2007, the S&P 500 has averaged a 1.71% daily range. The market has not seen this kind of volatility in years, with July 2002 being the last month with an average daily range on par with September. For historical comparison, during the fall of Long Term Capital Management in September of 1998 the average range was 3.17% and September 2001 saw a daily range of 3.18%.

Another factor that impacted performance were the large overnight gaps in the market, which were also historic in nature. September saw the most overnight gap moves (both up and down) over 2% since October 1987. Of the 21 trading days in September, eleven opened with gaps of 1% or greater. Of these gaps, the one that had the greatest impact on the Fund's performance was the gap up on the morning of September 19th, which happened to be the "quadruple witching" options expiration. The S&P 500 futures options that the Fund trades expired based on the open of all 500 stocks on that Friday morning. The 6.66% gap up that morning (the largest on record other than in the days surrounding the 1987 crash), caused the Fund to lose about 6.5%. This was due primarily to the overnight decision by the SEC to eliminate short selling on 799 stocks, an overt attempt to manipulate markets that ultimately failed yet caused the huge overnight move. Without this loss, the month, while still bad, was much more in line with the Fund's worst months prior to now.

Going into September expiration the market had been trending lower, falling about 11.7% from the beginning of the month to September 18th. Then the proposal for a $700 billion financial bailout was announced that afternoon and a rally ensued. The Fund hedged its exposure to an upside move in the market, but in hindsight not enough to protect the Fund from the negative effects of a 6.66% opening gap higher. The following week, after the dust had settled a bit, the Fund entered into a small position of October ratio put spreads. The market then began another leg down, and the Manager acted aggressively to preemptively hedge its downside exposure, but the 8.8% decline (based on the cash index) on Monday, September 29th caused the deep out of the money put options to increase dramatically, even though they were still very far away from the market. Those mark-to-market losses (not yet realized losses) are part of what you see in the performance results for the month.

While this month has no doubt been bad for the Fund, it is now down approximately 11.8% for the year, with the S&P 500 down about 21%. Over the final five months of 2007, the Fund returned a compounded 20.64%. While there is obviously no guarantee of such history repeating itself, it does point out what this strategy can accomplish. The Manager is not striving for good relative returns when compared to the S&P or any other index (rather the Manager seeks good absolute returns), sometimes it does help to step back and gain some perspective. In that light, the press has reported about of some hedge funds run by the best and brightest in the industry being down over 50% on the year.

All that said, the Manager wants to stress that it is sticking to its strategy of seeking opportunity within its risk management tolerances and is not going to sacrifice this discipline to try to make back all of its losses in a quick fashion. This will most likely include periods of remaining in cash to avoid some of the most volatile action in market history.