WARRINGTON
ASSET MANAGEMENT

February 2018 Market Commentary

The short volatility trade, where investors position themselves to capitalize on the artificial calm engendered by Central Bank influence, has been both popular and profitable in recent years. It has been our belief that many in this trade enjoyed the gains yet seemed oblivious to the potential losses, as well as the velocity with which losses could accrue. In February our concerns were realized, as the S&P experienced its first drawdown of over 10% since January 2016. We believe this recent decline was caused by traders unwinding short volatility positions, selling the S&P 500 index and buying VIX futures in record amounts, leading to a powerful negative feedback loop. This confluence of events caused the S&P to decline 12% from the highs in late January.

The return of volatility was a welcome development for the Strategic program, leading to a positive return of 1.45% for the month. We started February with a light position of short-dated put spreads, but the market decline on Friday, February 2nd triggered our strict risk management and we covered all downside put spread positions for nominal gains. After the record volatility spike on Monday February 5th, opportunities arose for new positions with very favorable risk/ reward characteristics. We judiciously traded put spreads over the rest of the month, leading to gains on all positions and our best monthly return in a year.

The Tactical program's downside risk parameters also were breached, and all downside positions were closed prior to the market decline and VIX spike. The expanded range in markets then allowed for new positions to be established much further out of the money than in prior months, adding a margin of safety but with the same profit potential we typically seek out. These increased opportunities, paired with conservative risk-based position sizing, led to a positive 0.73% return.

As we move forward, the main question is whether February will be a turning point for markets, allowing for volatility to return to historically normalized levels, or will this decline be rapidly retraced to new highs in the stock market, similar to nearly all pullbacks in the S&P in recent years. One important difference now is the introduction of a new head of the U.S. Federal Reserve, Jerome Powell, and whether he will attempt to calm markets at the first sign of volatility as his predecessors have done. Early indications point to his style being more laissez-faire than past Fed Chairs, but it is early in his tenure and the exact nature of his goals for the Fed are yet to be fully understood. Nonetheless, these recent moves are more in-line with historical market norms than the artificially buoyant environment of recent years and are further evidence that Warrington can excel in any market environment.

As always, we thank you for your continued support of Warrington Asset Management.