

**Oxeye FTSE 100 Options Strategy – May 2006**  
**FTSE Drawdown : Dramatic Implied Volatility Increase and Asset**  
**Allocation Shift Combine To Present An Opportunity**

This month Oxeye strategies recorded profits across all classes barring FTSE, which had its largest ever drawdown amounting to 19%. Since FTSE was only at 10% of our allocation mix our portfolios have not been greatly affected. However the resulting build up in premiums has increased the allocation to FTSE at the expense of both Crude Oil and the Cash component which we have carried for the last two months. From now on the Oxeye Asset Allocation indicates that FTSE should be increased to 35% (from 10%) Oil should fall to 55% (from 65%), the Euro should remain at 10% and Cash should be reduced to zero.

There were two reasons for the huge FTSE drawdown:

- a) Implied volatility (IV) had its biggest monthly % increase since we started the strategy (nine years ago), doubling from 10 to 20% thereby raising short option prices dramatically and creating unrealised losses;
- b) The preceding 2 year period of low IV had reduced the initial margin by some 30%. Consequently the loss in % terms was nearly one third bigger than it would have been in prior drawdown periods such as September 2001 (-15%) and Jun/July 2002 (-17%), despite the monetary amount of the loss being slightly smaller.

When we quantify the loss, 80% came from the increase in volatility. Because this is unrealised we would hope to recoup most of this through to August expiry. The remaining 20% of the loss has been realised by buying back short in-the-money put positions to lower the downside risk. This is a realised loss and can only be recouped by writing new positions, part of our normal strategy operations.

Whilst our strategy does best during periods of high volatility it tends to suffer from sharply higher adjustments in volatility when these occur. The strategy then realigns itself with the new range resulting from the fall in the index by writing premium at higher levels. If volatility then falls and/or the range remains intact the strategy profits.

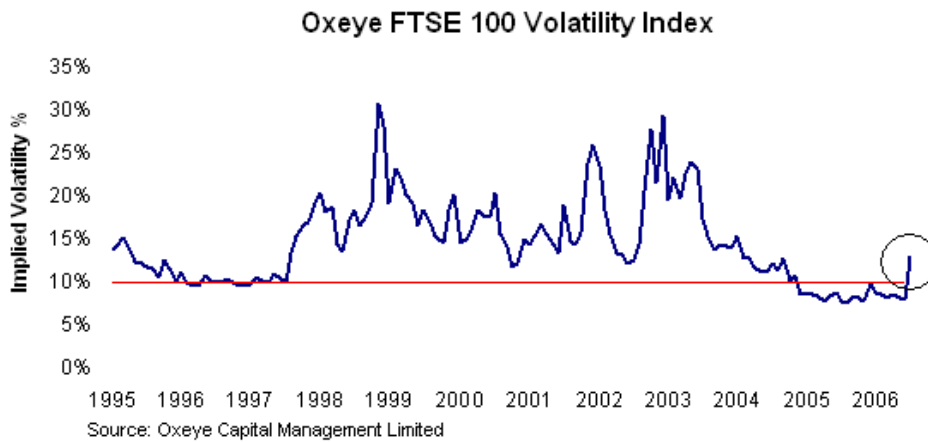
And this is the situation currently. We have suffered the readjustment in IV and now can write new and better priced option premium going forward. Our break even range for August expiry has widened to 15% as a % of the FTSE index (for most of the last 2 years it was 10%) and we are writing a monthly premium income of over 12% of assets as opposed to only 5% as recently as March expiry.

Our total premium as a % of assets/margin requirement is currently 38%, before insurance and buy backs. This is through to August expiry, or approximately 10 weeks away and is the highest level we have seen for three years.

If FTSE Implied Volatility continues to rise then the asset mix will further increase the FTSE component over the coming months.

Finally, we believe this to be a good opportunity for our FTSE Strategy. The chart shows how IV has risen above the long term low at 10%, presenting an environment that we have not seen for 2 years. The annualised return for this Strategy over the whole period since inception in

July 2000 is 20%. But for the period from inception to mid 2004 the annualised return was 41%. If IV stays at these levels, there is a good chance that we can return to a period of producing consistently strong absolute numbers.



M.Petherick  
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