

Optioning Fear

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<b>Vital Statistics</b>	
<b>Assets under mgt</b>	\$24 million
<b>Minimum investment</b>	
Oxeye Growth Fund	\$50,000
Managed Account	\$3 million
<b>Registration</b>	FSA
<b>Fee structure</b>	
Management fee	2%
Incentive fee	20%
Avg commission	2% per annum of assets
<b>Ratios</b>	
Avg margin-to-equity	25%
Ann comm -to-equity	£20k per £1m
Roundturns/\$M/year	2,000
<b>Auditor</b>	
Managed Accounts	BDO Stoy Hayward (figs unaudited)
Fund	PricewaterhouseCoopers

**Success has its drawbacks. Starting out in 1997, Oxeye Capital's options trading strategy was wildly successful, posting close to 100% that year.**

One is constrained to ask how much credit for such strong performance belongs to the program and how much goes to the good fortune of starting out in the perfect environment.

If it was luck, it continued to hold for the next three years. The program posted a massive 237% return in 1999, followed by 90% in 2000 and 169% in 2001.

"The environment we were in was extraordinarily good," says firm principal **Martin Petherick**. "For that to happen again, you would need a market that's fearful so that volatility stays high but it still trades within a range."

Those dramatic returns did come at a cost, however. The program shoulders a standard deviation of 60%, seven times that of the median of the CISDM diversified subindex. But Petherick notes that is a function of netting a compound annualized return of more than 100%.

"Nobody minds a drawdown if they feel the pieces are in place for them to recover quite quickly," he says. "Our return to decline ratio is very good and very fast."

Over the years, the firm's risk management has improved, which should limit declines albeit at a cost to returns. "But we would be happy with returns that are lower but not as volatile," says Petherick.

The firm, previously known as **Martin Petherick**

Futures and Options Strategies, changed its name to **Oxeye** this year after Petherick and his partner John Parry became an independent capital management company licensed by the Financial Services Authority.

**Oxeye** has a pure options writing strategy and a futures and options (volatility arbitrage) strategy as well as the **Oxeye** Growth Fund, which was launched in July. Both strategies are based on the FTSE 100 index, while the fund may also trade other European stock and government bond markets.

The largely mathematical options strategy is based on two concepts, says Petherick. One is that markets make most of their moves on a very small percentage of trading days, and spend the rest of the time in a definable trading range.

The other concept defines options as wasting assets. "If we can predict a range most of the time and sell wasting assets that straddle the range, we should make money most of the time," says Petherick.

Within the first year of trading with client capital, the program began writing strangles — out of the money put and call options — on the FTSE 100 index. "If the market trades in a 10% range, you sell a call option at the top end of the range and sell a put option at the bottom end of the range and for both you receive a premium income," says Petherick.

"If an option is a wasting asset, you hope that the market stays within your range and those options dwindle away to zero and you get to keep the premium."

Sharp moves outside the range in either direction pose a limitless risk for the strategy. "If the market breaks out of the range, whichever side it breaks out at, you are short the equivalent of what could turn into a future," says Petherick.

Awareness of the unlimited nature of the risk prompted the firm's first risk management protocols — clients choose the amount of leverage they want, ranging from none to a maximum of 10 to 12 times.

"We calculated the level at which risk-averse clients would receive a margin call in a fast market collapse *À la* 1987," says Petherick. "We insured just inside that level by buying out-of-the-money options at lower levels in the same or greater number than we were short.

The advisor would be short a call option, short a put option and long a far out-of-the-money put option. That combination would give an unlimited potential loss on the upside, a profit between the range, and a limited loss on the downside.

In addition to the risk posed by sudden moves in the index, options have inherent risks. Although classified by Petherick as wasting assets, options may actually increase in value in high volatility environments before they disappear to zero.

"An option can go up in value, depending on implied volatility and whether it is in the money or not," he says. "The risk is that the market goes the wrong way after you've sold the options and they end up with an intrinsic value of more than the price they were sold at."

<b>Oxeye Capital Management</b>			
<b>PERFORMANCE HISTORY</b>			
July 1997–October 2002			
	<b>Oxeye Capital Management</b>	<b>Median of CISDM Stock Subindex</b>	<b>S&amp;P</b>
<b>Return (%)</b>			
Annual comp rate	101.70	5.09	1.41
1997	98.38	(0.52)	10.59
1998	237.97	23.86	28.57
1999	90.32	22.44	21.03
2000	169.43	7.92	(9.09)
2001	7.25	(2.51)	(11.88)
2002	14.41	3.81	(21.84)
November estimate	7.50		
<b>Risk (%)</b>			
Annual std dev	60.11	8.84	18.75
Semideviation	23.36	5.39	13.31
Maximum decline	(33.00)	(11.59)	(44.73)
<b>Return/Risk</b>			
Sharpe Ratio	1.61	0.14	(1.00)
<b>Comparison with CISDM Stock Subindex</b>			
R-Squared	0.02		
Alpha	7.71		
Beta	(0.81)		

In the meantime, if there's an enormous move in volatility, options can take on still more value related to fear. A runup in option values leads to declines in the program, says Petherick. This reality pushed Petherick to develop the futures and options strategy, an evolution of the pure option strategy.

In an environment like the current one, **Oxeye** prefers to be long rather than short options in order to guard against big downside moves with the market breaking upward. This involves using futures to ride a directional move, being net long volatility.

"Most of the time, we believe the market trades in a range and we will be short options, which suggests we are short volatility — selling options," says Petherick. "There will be times when the market moves out of the range, in which case we want to be long volatility, putting us net long or net short the market — buying options.

"The key to success is being able to quantify and predict when we are moving from one environment to another."

Decisions begin with fundamental economic analysis followed by statistical analysis, probability research and standard deviation calculations to work out the likely trading range for a contract from start to expiration. "That will also give us the ability to value the options with a view to straddling that range," says Petherick.

"In most cases, volatility and therefore option prices are built up by a fast drop in the market, which creates a climate of fear and in the process an enormous demand for put options by people trying to protect long-only portfolios. Those prepared to sell put options can almost name their price."

He says that when **Oxeye** gets into a decline because it was short volatility when volatility went up over a number of months, "this sets up the environment where we do best, which is why our declines tend to be made back within a short period."

**By Philip Scipio**