



Oxeye Option Value Strategy Stop Loss Explanation & Performance of Back-test October 2009

BACKGROUND

Since inception in August 2000 Oxeye managed accounts employing the Oxeye Option Value Strategy (OVS) have produced an average annualised return of 18.3% (see Appendix 1 - Flyer OVS). However from 2004 the performance has been below the target return for this strategy of 15-20%. 2004 and 2005 suffered from low implied volatility which made it difficult to write sufficient premium to achieve the target return. But since 2006 implied volatility has been at a sufficient level to achieve the target.

In 2006, and in each subsequent year, one large drawdown over a short space of time, markedly reduced the performance below the target rate of return. In the table below we have summarised these drawdowns and shown how limiting the loss to 5% would have altered the performance for the year.

Date	Drawdown Period	Drawdown %	Gain on CY %	Gain on CY if DD restricted to 5% loss
2006	May/June	-23.22%	5.73%	30.81%
2007	July/August	-13.03%	10.05%	20.22%
2008	September / October	-10.90%	5.41%	12.39%
2009	July / September	-18.73%	-13.71% (YTD)	0.86%

A simple look at the numbers suggested that if we had managed to limit the loss to 5% each time then in each of the last three years 2006 to 2008 the target return would have been achieved. 2009 is still open, although it looks as though due to the extended nature of the drawdown – 3 months – it will be unlikely to make the target + 15%.

We decided to test various measures of stop loss policy to see if the results would improve if we restricted the drawdown to a certain minimum without reducing the profitability.

The aim of this note is to explain how we performed the back-test and to compare the results with our actual performance.

BACK-TEST

We performed two types of test.

Mathematical

- Systematic testing to find the 'stop loss' policy which provided the best risk / reward ratio. This indicated that using a monthly stop at 5% of capital would maximise profitability.

Manual

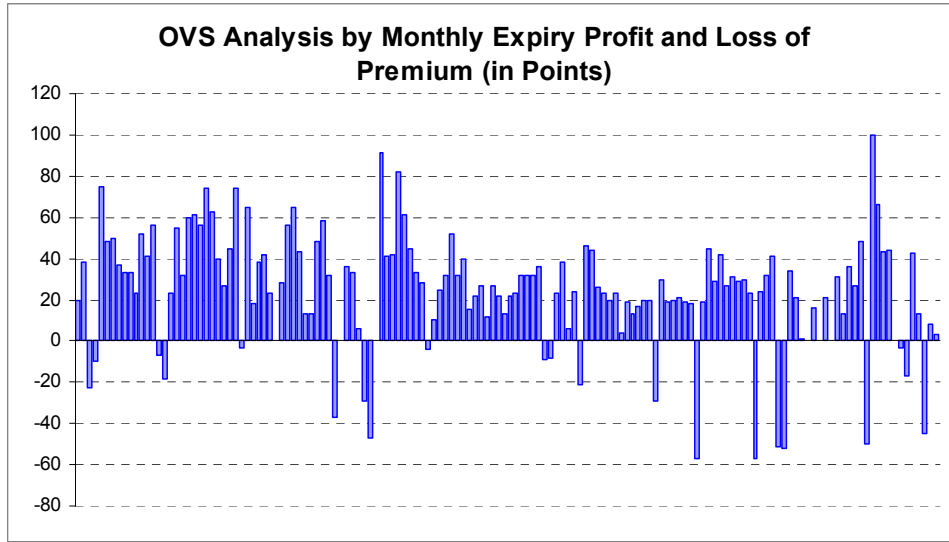
Based on the findings in the mathematical test:

- Day by day recreation of positions, using daily option price database back to 1997
- Scrutiny of daily index moves to ensure all stops recorded accurately.
- Record maintained of monthly portfolios
- Slippage incorporated on all prices
- Comprehensive set of trading parameters

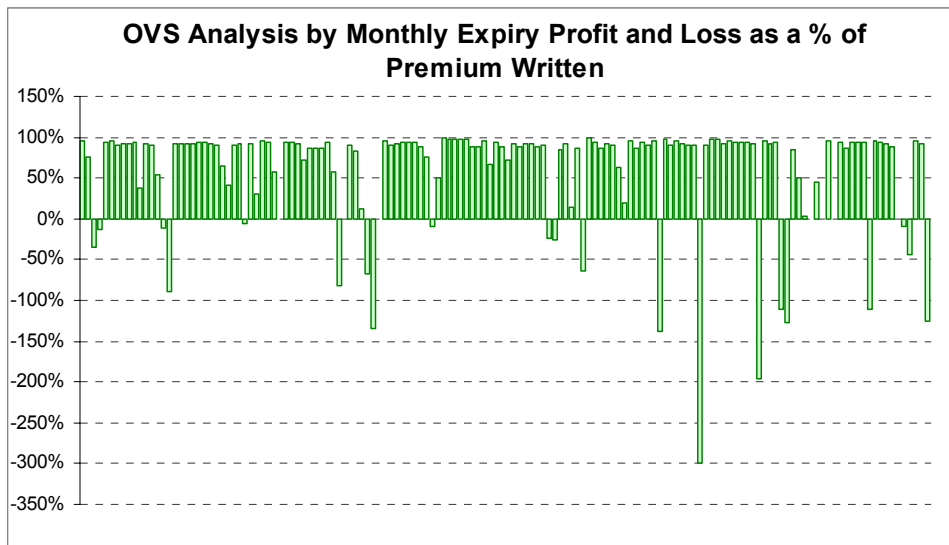


RESULTS OF BACK-TEST

- Performance . The test produced an annualised return of 25% between July 1997 and October 2009. Specifically 2006 21%, 2007 10%, 2008 22% and 2009 7% (to date).
- Analysis by monthly profit and loss bar chart. This shows the high degree of profitable (80%) to losing (20%) months.

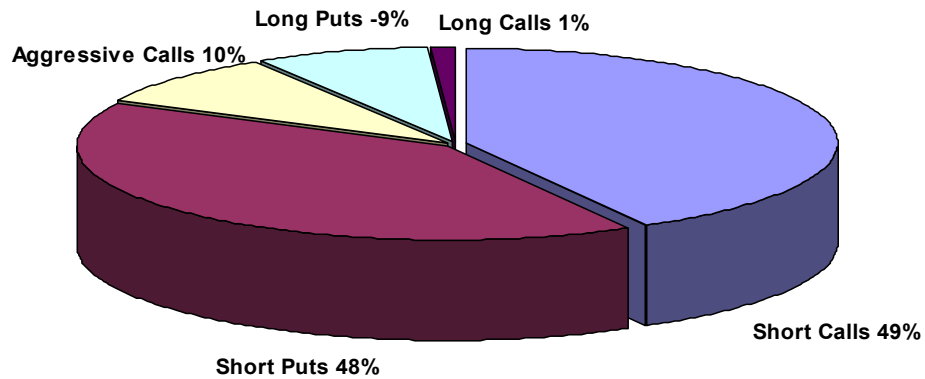


- Analysis by monthly expiry profit and loss as a percentage of premium written. This shows that on the majority of occasions most of the premium written expired worthless and therefore profitably.





- The pie chart shows how the profits were sourced and the cost of insurance (long puts). For instance 49% of profits came from shorting call options, 48% from shorting puts. Buying put options lost 9%, but this was amply covered by writing aggressive calls to pay for the puts. Long calls were used only in low volatility periods such as 2005.



CONCLUSION

Premiums and implied volatility are still sufficient to enable 15% to 20% returns to be achieved so long as the occasional but inevitable drawdown periods are limited to no greater than 5% per month. We should therefore adopt the 5% stop loss policy as explained in this note.



Worst Case Scenario: Overnight Gap Lower

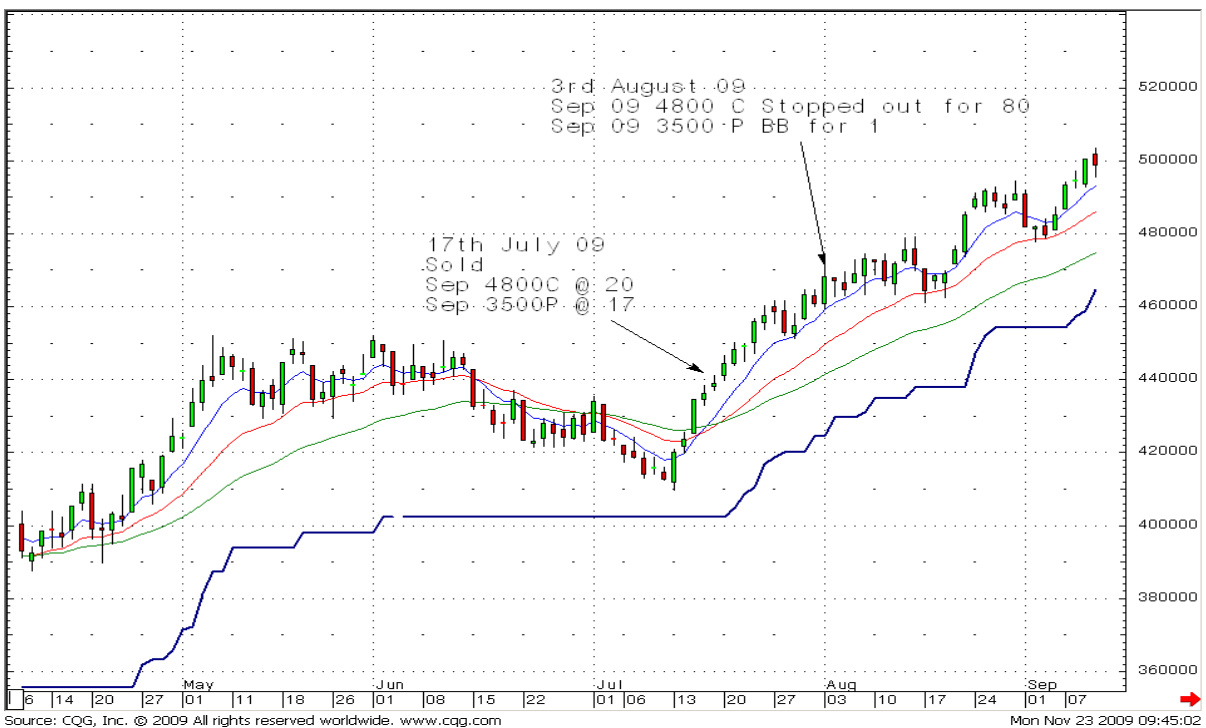
One situation where the 5% stop loss rule could be breached is when a large overnight gap occurs the day after option prices have neared the stop loss level. In the following example we show 2 charts. The first marks the point at which we wrote positions for November 2008 expiry. The second chart show how the market traded over the next few weeks: sharply lower. On 6th October the November 4100 puts were stopped out for 88. If on that day the stop level had not quite been reached and if, on the following day, the market had gapped lower the effect on the portfolio would have been as follows: (bearing in mind we were long of October 4000 Puts as protection against short puts)

- 100 Pt Drop Portfolio Valuation Drops by 1% (Index @ 4700)
- 300 Pt Drop Portfolio Valuation Drops by 4% (Index @ 4500)
- 500 Pt Drop Portfolio Valuation Drops by 7% (Index @ 4300)
- 1000 Pt Drop Portfolio Valuation Drops by 10% (Index @ 3800)
- 2000 Pt Drop Portfolio Valuation Drops by 10.5% (Index @ 2800)



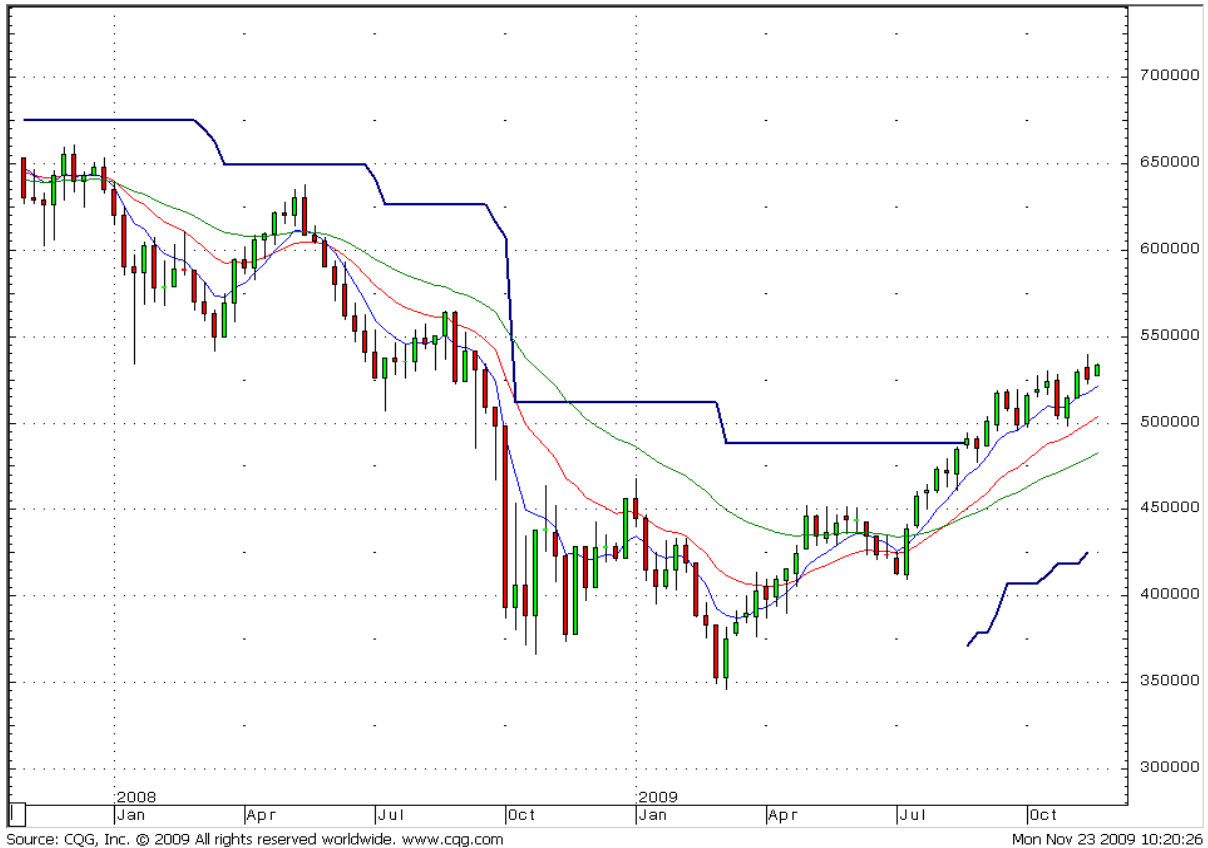


In the next example we show the effect of being stopped out in a rising market. The Sep 4800 calls, written for 20 are stopped-out at the 5% level. If the index had gapped substantially higher before the stop loss was triggered then the loss would have been greater. (For every 100 pts higher the portfolio would lose a further 5%) But in our opinion it is unlikely that a substantial (more than 5% approximately 250 points) overnight gap higher will arise.





Weekly Chart From 2008 to Present Day



Martin Petherick
November 2009

Close Gate House, 47 High Street, Salisbury, Wiltshire, SP1 2PB United Kingdom
Tel: 1722 336388 Fax: 1722 339537 Email: info@oxeye.co.uk www.oxeye.co.uk

This Publication is issued by Oxeye Capital Management Limited ('Oxeye') which is authorized and regulated by The Financial Services Authority. References to 'we', 'us' and 'our' in this Publication shall mean Oxeye unless otherwise stated. This Publication was prepared and distributed by us for information purposes only, and may contain information, advice, recommendations and/or opinions, which may be used as the basis for trading undertaken by us and our officers, employees, associated and/or affiliated companies. This Publication should not be construed as solicitation, nor as offering advice for the purposes of the purchase or sale of any derivative, security or investment. The information and opinions contained within this Publication were considered by us to be valid when published. This Publication may also contain information that has been provided to us by third parties. The source of such information may be disclosed within this Publication where relevant. Whilst we consider we have taken all reasonable steps to ensure the information is correct, we do not under any circumstances whatsoever, warrant the accuracy or completeness of such information. Any person placing reliance upon this Publication to undertake trading, does so entirely at their own risk, and accordingly, we do not accept any liability as a result, whether direct or indirectly incurred. Derivatives and securities markets may be subject to rapid and unexpected price movements, and past performance is not necessarily a guide to future performance. Currency movements may also have an unfavourable, as well as favourable effect on the value of the underlying investment and/or assets. Investments and/or strategies discussed herein, may not be suitable for all investors. Accordingly, if any person reading this Publication has doubts about their particular suitability, they should consult an independent investment adviser.