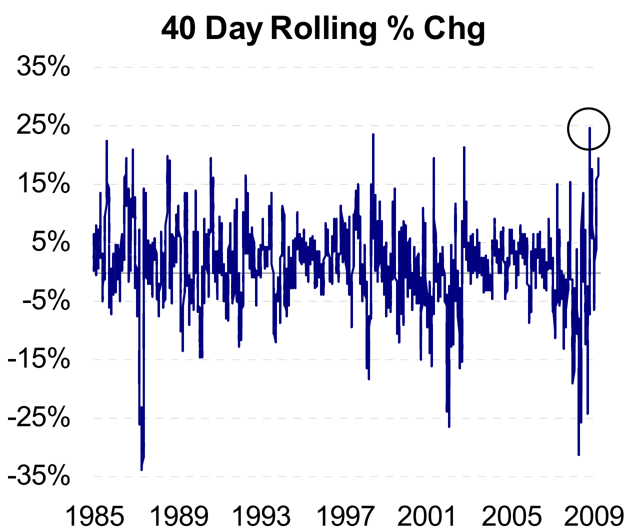
Oxeye
Capital Management Limited

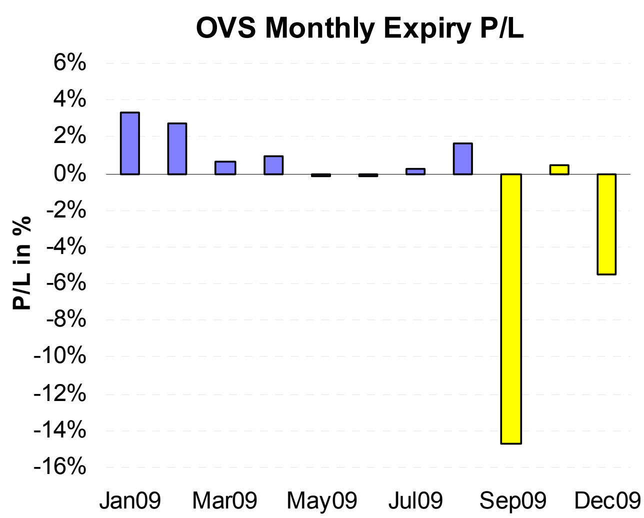
FTSE Option Value Strategy and Oxeye Growth Fund
July/August/September 2009 Performance and Outlook

Recent Performance

The performance to September show the OVS strategy losing 18.7% and the OGF losing 20.8% from the highs at the end of June to give YTD figures of –14.0% and –16.3%. But despite this recent loss the new style 'value' strategy has achieved superior absolute and relative returns since inception (February 2008). From January 2008 the returns are as follow: OVS +12.2%, OGF + 2.9% vs FTSE 100 –12.7%. Oxeye's Sharpe Ratio over the same period was +0.5 vs FTSE –0.5 and the return on cash averaged 2.9%.

The main reason for the loss is the unexpectedly large move by the index in a record period of time. On a 40 day rolling % basis this is the largest upside move the market has had since the FTSE 100 Index started in 1984 and consequently the portfolio's short calls struck at 4750 and 4800 for September expired in-the-money creating large losses.





By monthly expiries the **above chart (OVS Monthly Expiry P/L)** shows that the strategy had been profitable throughout 2009 when measured by expiry months (blue bars) up until the end of August. Monthly expiry p/l is shown as a % of the required initial margin and net of fees; May and June were profitable trading months but showed small negatives only after deduction of fees.

At the end of August the September short call position still had sufficient premium to recover the losses shown in our monthly performance flyer for July and August. Since the index at that time was at record levels on a rolling % basis we judged it a reasonable risk to leave the positions to expire, albeit with a stop loss set at 20% (FTSE level of 5075) should the market continue higher. The first few days of September looked promising as the index fell to our strike levels of 4750/4800 and a mean reversion appeared to be likely. Unfortunately the next 2 weeks saw FTSE rise inexorably to 5200, triggering our stops at 5075. And consequently the September expiry recorded large losses.

The December 09 unrealised loss in the above chart is due to the long 'put' positions bought for insurance purposes as we entered a downtrend at the start of July. Instead the market's 26% rally caused the puts to fall in value, hence the unrealised loss. If the index falls between now and December then these positions will regain value.

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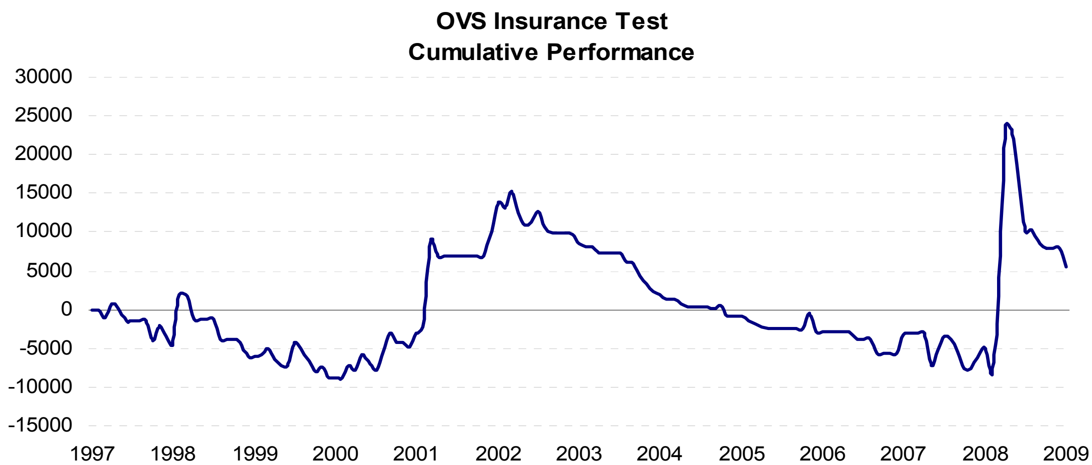
The strategy values options relative to Oxeye's statistical estimate of the FTSE index's predicted range. Those deemed overvalued are sold and those undervalued bought. Occasionally these ranges come under threat and in order to hedge short 'put' positions and to protect against rising implied volatility the strategy buys put options with longer term durations. Generally the threat of a large losing month for the strategy comes from a very fast index price fall and so the strategy actively hedges against such a move. Sometimes this 'hedge' turns out to have been unnecessary resulting in losses. Furthermore, if the market rises extensively, the strategy can suffer a large drawdown if any short 'call' positions go 'into-the-money'. Both events occurred in the July to September period with FTSE 100 rising from a low of 4090 to a high of 5183 in a short space of time.



It is worth noting that although the July 2009 loss was partly attributed to the long December 09 puts which proved to be a loser on this occasion, over the long term this form of 'insurance' has shown to be profitable (see **chart above**). Specifically, over the bear market of 2000 to 2003 the insurance was highly profitable and more than offset any losses from short 'put' option positions and, in the 2008 bear market the same was true. During the bull market years of 1997 – 2000 and 2004 – 2007 the insurance lost money but lost considerably less than the short option positions were making. In the past the call range has always been sufficient to contain the index move and so we have not deemed it necessary to insure against upside moves. That will now change and a tighter stop-loss policy will be adopted.

Outlook

October short call positions have been closed because we believe the upper side of the portfolio's range to be inappropriate given the scale of the recent move. A loss of ½% has been taken on these positions. October short puts struck at 3900 are covered by a long position of 4400 puts, so a fast collapse into October expiry will see gains on these positions. November and December short positions are yet to be written. With implied volatility at these levels we would expect to take in some 2 to 4% a month. And if the market falls IV will rise, and the long December puts will recover in value. In the past we have never experienced such extreme pressure on short call positions and in future we will set a tighter stop equivalent to a set multiple of the value of premium written. On having undertaken thorough analysis we do not believe this policy will greatly reduce the profitability of call writing. Whilst it will take time to recover recent losses we are confident the strategy is sufficiently robust and implied volatility sufficiently attractive to allow profitability to be restored.

M.Petherick
October 2009