Oxeye Capital Management Limited

Oxeye Asset Allocation Strategy

Explanation of Strategy, Risk and Current Market Environment

About Oxeye

Oxeye Capital Management Limited (Oxeye) is an independent Fund Management company regulated by the Financial Services Authority (FSA) and based in the UK.

Oxeye was established by Martin Petherick and John Parry and was authorised by the FSA in April 2002. Both have extensive experience within the Financial Services industry and have been managing client accounts on a discretionary basis as Futures and Options Representatives of ADM Investor Services International Limited (ADM) since 1997.

The firm has a team of 8 professional staff and the principals have made significant investments in the strategies managed by the firm.

Oxeye is owned 100% by the principals and has no ownership ties with any other financial institution.

Oxeye Philosophy

The Oxeye philosophy is to:

- Create disciplined methodologies, which on an unleveraged basis produce a consistent absolute return combined with a good risk profile.
- Use gearing to maximise performance.
- Employ tight risk control procedures to manage market exposure.

The practical application of the Oxeye philosophy has produced consistent, long term, absolute performance. Since 1997 the aggregate of All Managed Accounts has produced an annualised return of 59% with a standard deviation of 47%.

Chart 1

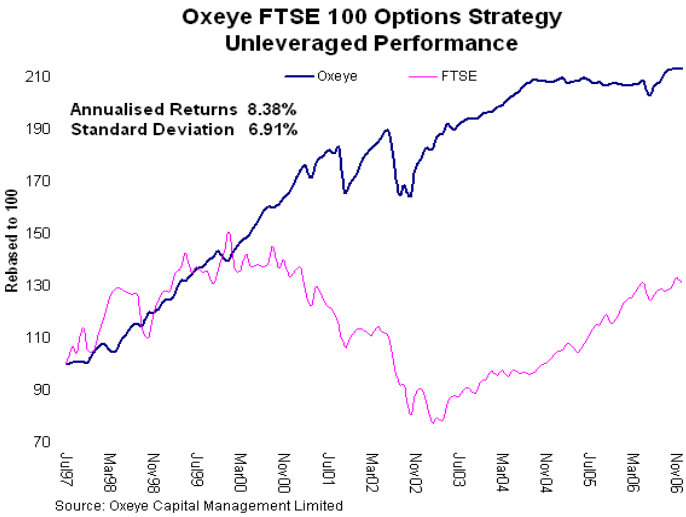
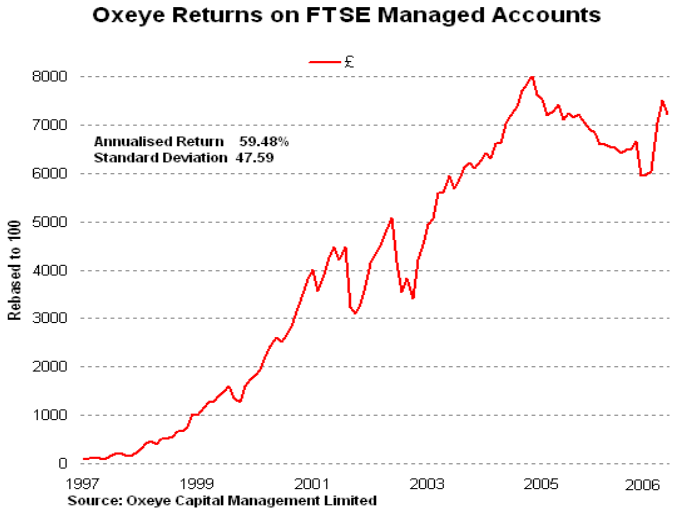


Chart 2



Explanation of Strategy

Oxeye strategies are designed to sell volatility using a combination of futures and options contracts on a variety of asset classes traded on Regulated Investment Exchanges worldwide. To date Oxeye clients are exposed to strategies trading Nymex Crude Oil, Eurex/Liffe FTSE 100 and the CME Euro Fx contracts. All are highly liquid with no OTC derivatives used. The Oxeye Asset Allocation Strategy combines all three strategies based on an asset allocation mix derived from each market's Implied Volatility (IV).

The strategy is based on 2 main concepts:

1) 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
2) If we can predict a range most of the time and sell wasting assets that straddle the range we should make money as long as the range holds.

We calculate statistically the normal range over the life of the options contract, sell call options at the top of the range and put options at the bottom of the range and for both receive a premium income. Since an option is a wasting asset, if the market stays within the range, the options dwindle away to zero and we keep the premium. **Charts 3 and 4** show the Break-even bands history over the relevant index - Crude Oil Chart 1, FTSE Chart 2.

Charts 5 and 6 show real monthly returns in the Oxeye Crude and FTSE strategies. It can be seen that the Crude strategy has been profitable except when the upper break even level came under pressure from the market (black line, **Chart 3**) in September-October 2005, January and April 2006 (see circles). The FTSE strategy had losing periods in 2001 and 2002 when the market was attacking the lower break even range and also between 2004 and 2006 when the upper range was breached. But over the whole period from 1997 the FTSE Strategy's record of winning to losing months was still 75% / 25%.

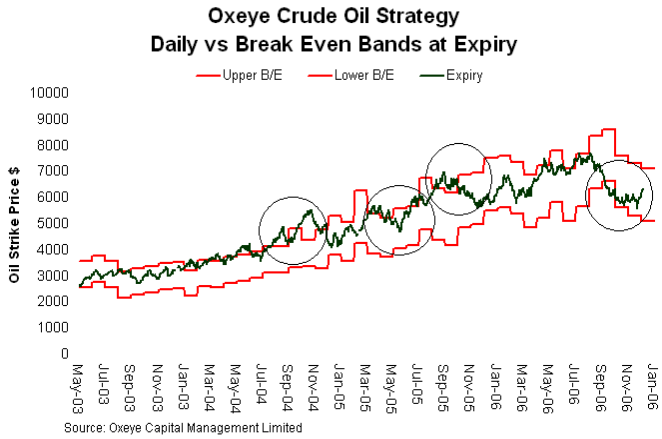
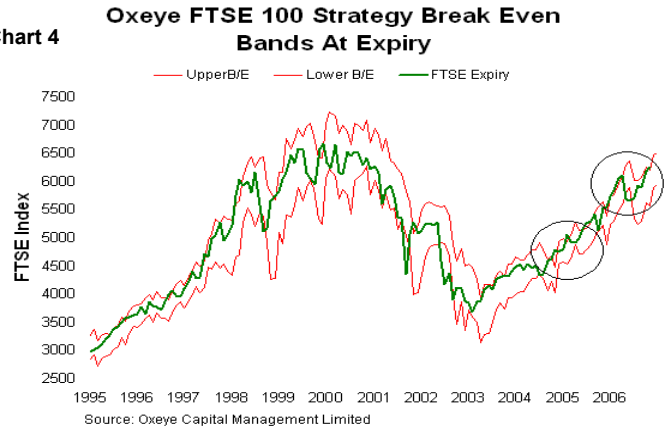


Chart 4



A third concept which contributes to the profitability concerns the nature of players in the option market and their willingness to lose money.

Because of the unlimited risk aspect of selling options, in low volatility environments the markets tend to be dominated by professionals and premiums become perfectly priced and drop to very low and hence barely profitable levels. In high volatility times the market takes on a higher risk premium as more players enter the market for different reasons. Bullish investors may buy options to take out a geared long play so that if their strategy does not work out they are less out of pocket than if they had committed to a full cash underlying long position. The same investors might also wish to hedge the downside and buy put options against their underlying long positions. This is tantamount to buying insurance against the loss of any asset and in most cases the owner is happy to pay the insurance as part of his annual overheads. Oxeye acts like the insurance underwriter taking on the risk and then reinsuring that risk. As long as the value of claims does not exceed the value of premiums written a profit will have been made.

So, to recap: the Oxeye approach is to

* straddle a predetermined range set by the market with a high statistical chance of profitability
* sell options to create an income stream
* profit from time erosion
* actively manage the risk

and as can be seen from the performance record, this approach has been consistently profitable.

Chart 5

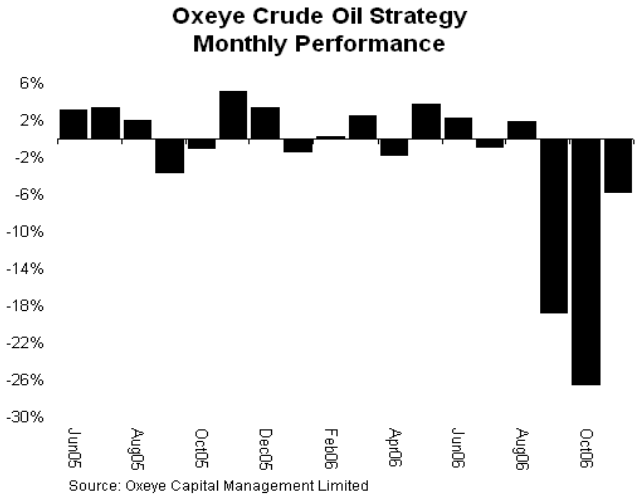
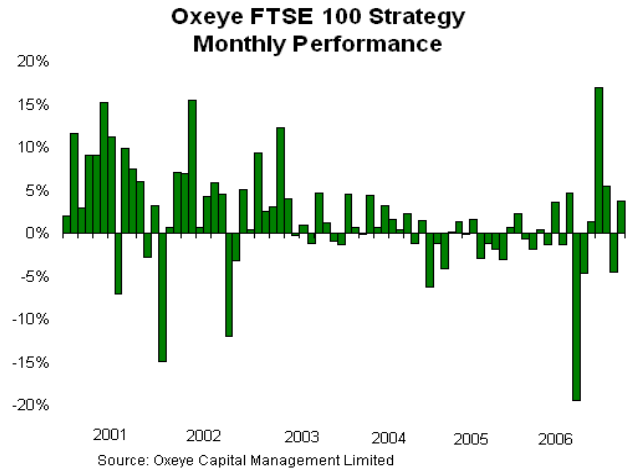


Chart 6



Allocation Strategy

Oxeye's style is to allocate to markets where the premiums offer the best risk/reward ratio and away from markets showing a poor risk reward. If all markets' Implied Volatilities are low relative to their history then a cash element maybe introduced. Allocations are remixed monthly based on a proprietary model created by Oxeye.

Chart 7 shows the volatility histories for each asset class. Oil has the highest absolute level, at around IV 28% but is also near the low end of its range. FTSE, which has been very low for the last two years, has risen to 15% (see circle), and has increased its asset allocation accordingly. The Euro remains at the minimum allocation of 10%. In **Chart 8** we show the current allocations. (Crude 25%; FTSE 65%; Euro 10%; Cash 0%)

Explanation of Risk

We have stated earlier that when the range holds for the life of the options the strategy makes a profit. During the life of the options the risk is perceived to be only on one side ie. the market is unlikely to break both sides of the range at the same time within the life of the open option positions.

Sharp moves outside the range in either direction pose a limitless risk for any uncovered options. So in order to limit the risk the strategy buys far out-of-the-money calls and puts thereby covering the short positions. This form of insurance, when combined with the income potential from the short options positions, can be simply illustrated in a typical Profit and Loss at Expiration chart. **Chart 9**.

The Oxeye approach can be most profitable in a highly volatile market because the fear premium in option prices allows a wide range to be written, which statistically is rarely breached on one side, let alone on both sides within the life of the options (normally 3 months). **Chart 10** shows the monthly break even range in Crude Oil points (currently 25 points, yellow bar left scale), which represents 42% (blue line right scale) when compared with the current price of Oil at $74. In other words the range allows a move higher or lower of around 20% before the range is breached. When the market fluctuates the range naturally re-establishes itself as old options expire and new positions are written, creating new break-even bands going forward. As long as the premiums are sufficient to scroll up the side under pressure and still make a profit on the original strangle written then the risk can be adequately managed without adopting any special directional insurance.

Chart 7

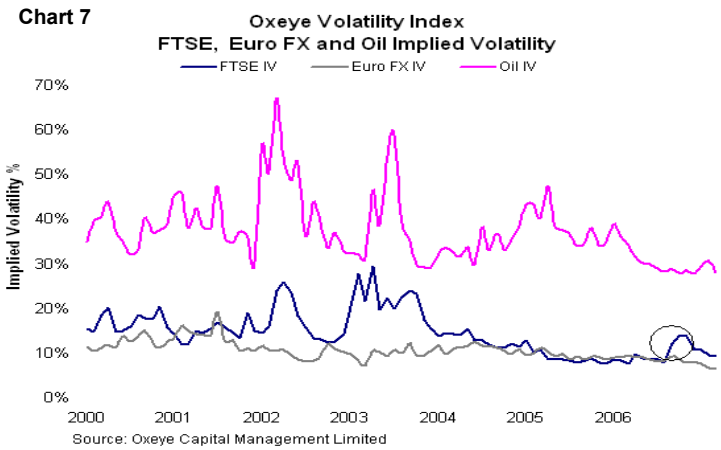


Chart 8

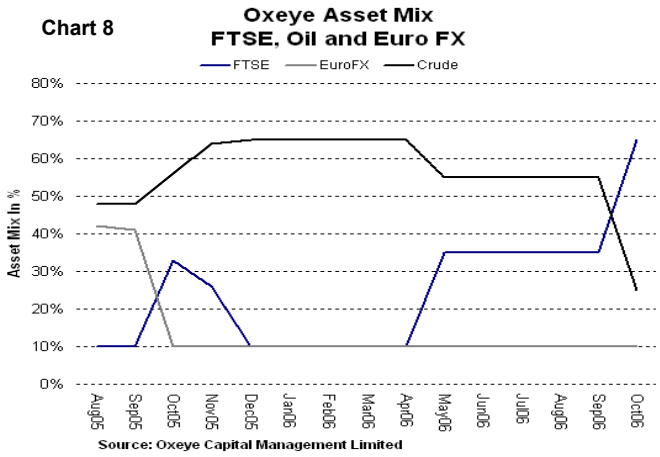


Chart 9

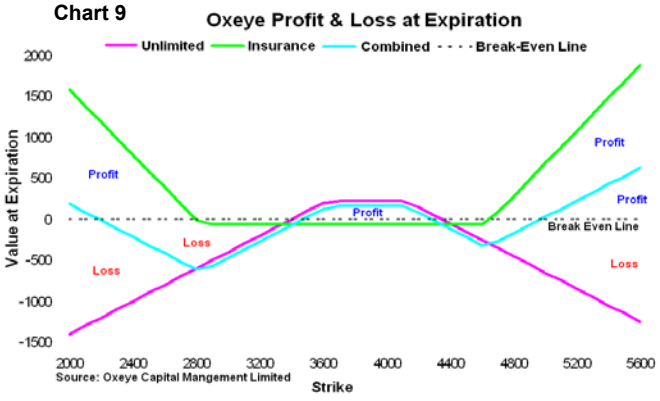
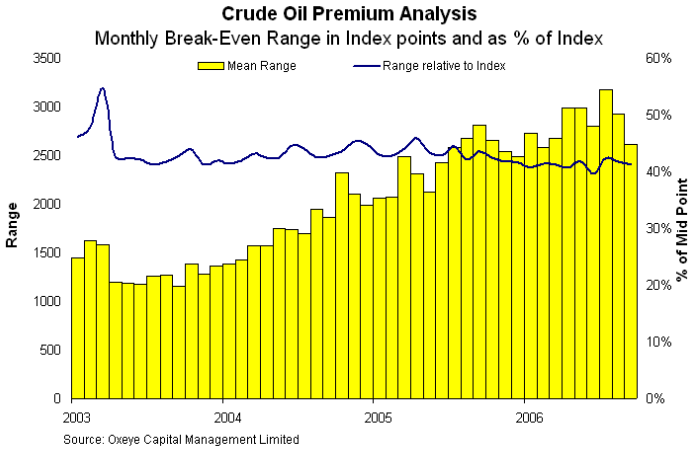


Chart 10

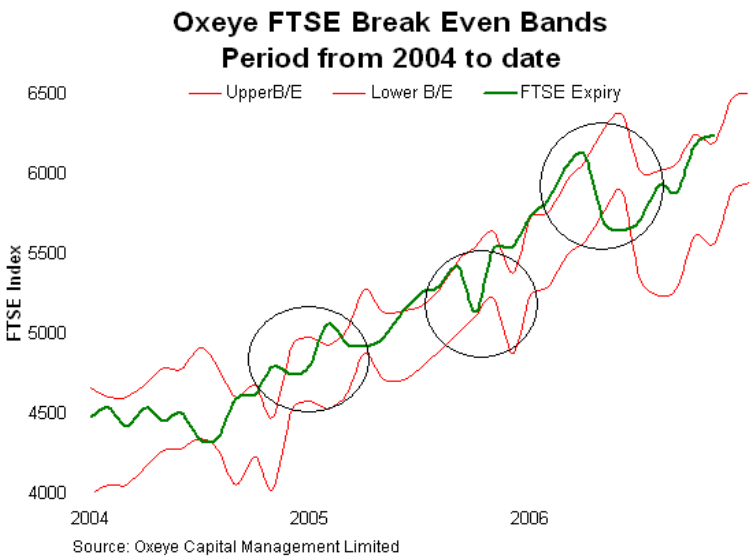


In a low volatility environment the premise (that the market is unlikely to break both sides of the range at the same time within the life of the open option positions) is likely to be wrong, because the range is so narrow. **Chart 11** shows that in the last 18 months there were 4 incidents of both sides being touched inside a 3 month period. The fourth circle shows a break-out, lasting several months, on the upside of the range followed by a break below.

We therefore need to be aware of two specific operating environments: high volatility and low volatility. **Chart 12** will illustrate this:

Between 1995 and 1997 FTSE 100 traded at a low level of volatility (IV), around 10% (see RHS). Between mid 1997 and 2004 IV rose and stayed consistently high. From 2004 onwards IV fell back to the low levels seen in the 95 to 97 years. This illustrates a clear distinction between a low and a high environment. This showed up in the Oxeye performance statistics as follows:

Chart 11



Between 1997 and 2004 the strategy produced annualised returns which featured in the top 10% of all global CTA and Managed Futures strategies (between 50 and 100% depending on the leverage employed). In the low IV periods much smaller returns, and in 2005's case a losing period, were suffered. All of which suggests that a different approach is required for the 2 environments.

How does the strategy change for a low IV environment? Firstly, the main engine of income earning will continue to be from writing options, but more buy backs of threatened positions and the use of long volatility plays will be prevalent. **Chart 12** shows just how low IV had become. The yellow bars show the history in FTSE index points of the Oxeye break even range. The mean break even range written by the strategy is back up to 800 points which is approximately 14% (7% up and 7% down from the middle of the range) of the FTSE 100 Index. In other words a move greater than 7% in either direction will require the application of our active risk control procedures.

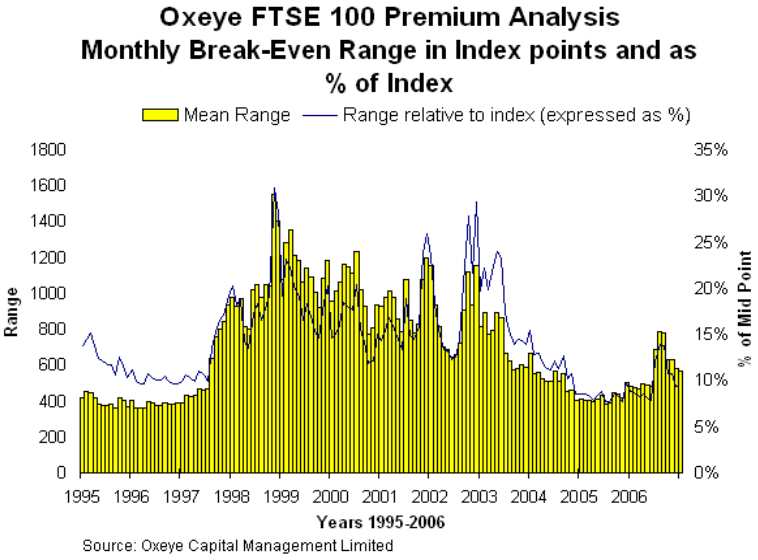
As such, in a strongly trending market, the net gearing (delta) will need to be reduced. There are several ways to do this:-

Buying back short call positions with a delta in excess of a target %
Buying long duration calls / call spreads
Scrolling up short put positions
Buying / Selling Futures

In essence tighter control of the delta is required, which in turn maintains the net gearing at levels which do not allow for large losses except in sudden and large short term moves.

But at current levels IV has risen to 15%, which potentially puts it back in the high vol environment and this should prove to be an encouraging development.

Chart 12



One further element of risk is vega, or the sensitivity of the portfolio to moves in implied volatility. Although options are wasting assets, during their life they can rise in value in high volatility environments, even if they are out of the money. This extra risk premium can lead to losing periods for the strategy, but will usually work to the strategy's advantage because a higher premium income can be written going forward. This shows in the May and June 06 performance figures.

Profitability and risk can be combined into one simple P&L at Expiry chart. As an example, **Chart 13** shows the Profit and Loss of a position ON EXPIRY at varying levels on the price of Crude Oil. It can clearly be seen that the excess of long out-of-the-money call options allows for an unlimited profit should Crude futures rise above $76 and a limited loss if the oil price dips below $50. However, because the strategy is dynamic in nature this profile changes on a daily basis and the tails (each end of the curve) reflect a worst case scenario. **Chart 14** shows the current profit and loss zones reflected on the historical price of oil.

Chart 13

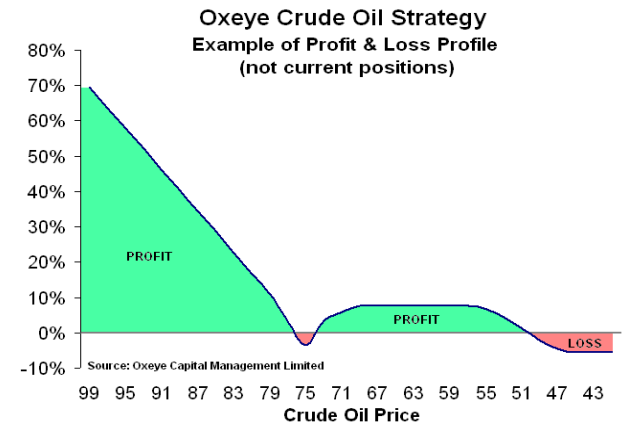
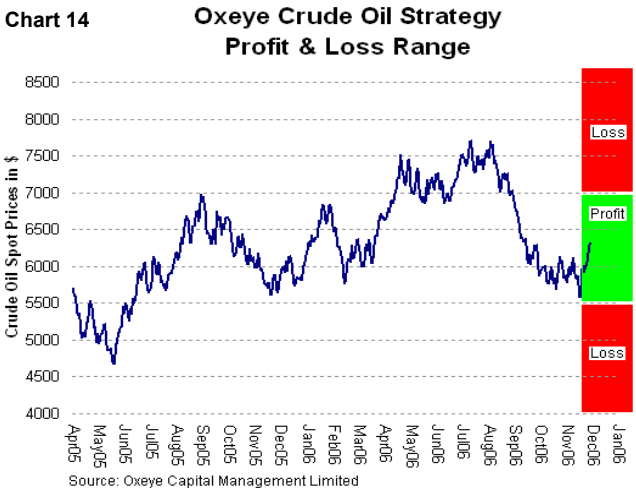
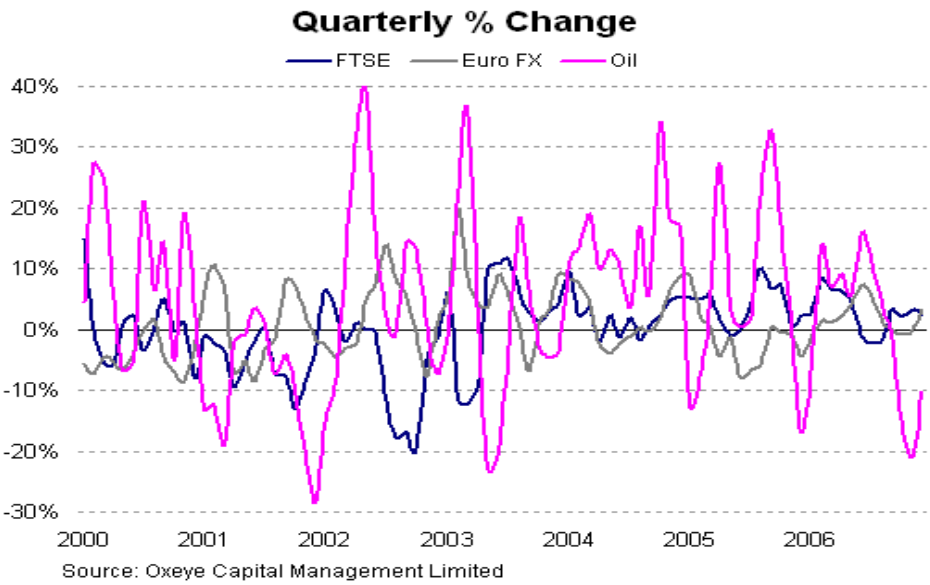


Chart 14



In **Charts 15** we have shown the history of the % quarterly change on a rolling monthly basis for each of the three asset classes. The asset allocations will be remixed based on the analysis of the latest readings. This particularly shows how much larger are the moves in Oil relative to the other two asset classes. It also shows that the biggest percentage moves are on the upside for Oil.

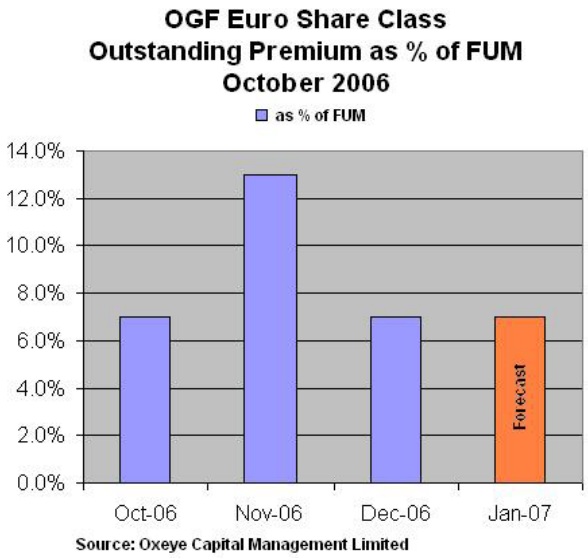
Chart 15



Recent performance

Over the last 14 months, since inception of the Oxeye Growth Fund Euro Share Class, the Crude price has continued to be volatile within a wide range, see **Chart 3**. This has coincided with falling Implied Volatility (option price levels), meaning that progressively less income has been taken in by the Fund each month since the extreme volatility in August 2005 at the time of Hurricane Katrina. This volatility has required more intense insurance activities and the performance, although positive, was not as high as in the earlier part of 2005. At the same time the other asset classes, FTSE and the EuroFX, were suffering from low volatility and contributed little to the overall return by reason of their low asset allocation - 10% each. In April, IV for oil recovered slightly and the Fund had several good expiries which brought the cumulative Oil profits into positive territory for the first time since inception. However a huge increase in FTSE IV in May dragged the overall fund performance down, even with the low allocation, so that the results were not as good as they might have been. At the end of May we increased FTSE exposure and this asset class continued to drag slightly into June.

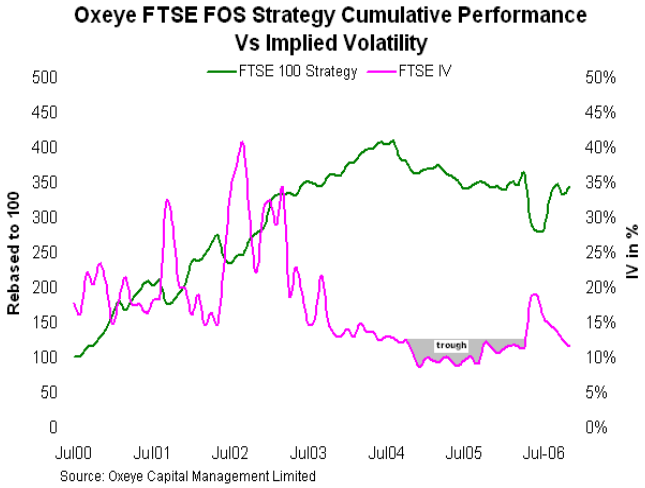
Chart 16



Outlook

Coming off a somewhat flat period, we have again entered a climate offering strong performance. FTSE and Crude IVs are at attractive levels. The Net Market Value of Options (outstanding premium see **Chart 16**) written through to September amounts to nearly 16% of Fund assets. That is a measure of the gross potential return through to September. However this figure is before insurance costs and fees. If the market benignly range-trades for the next few months then the % we realise could be high. This is the highest figure we have seen for two years. Finally, FTSE has recently broken above its IV trough of the last two years (see **Chart 17**), and it is worth noting, that when strong IV increases have occurred in the past, the ensuing performance by this asset class has been strong. (See **Table 1**)

Chart 17



Oxeye FTSE Performance After Drawdown

Date	IV % Move	9 Month (low to high) Post Perform.
Sep-01	+98%	+54.57%
Jul-02	+129%	+43.41%
May-06	+77%	

Table 1

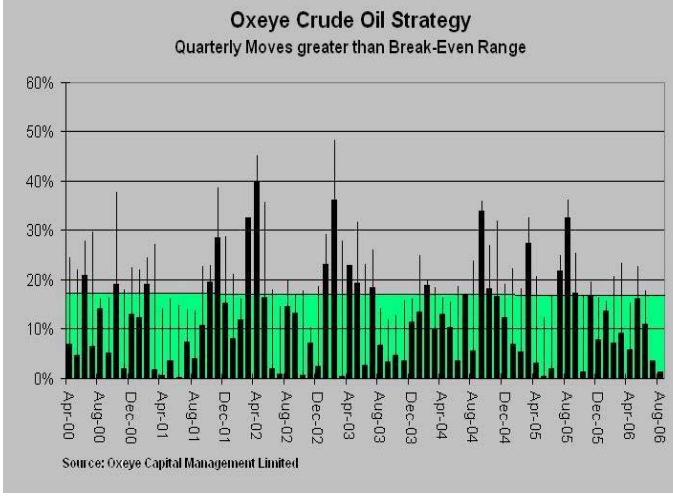
Example of How Oxeye Strategies Make Money.

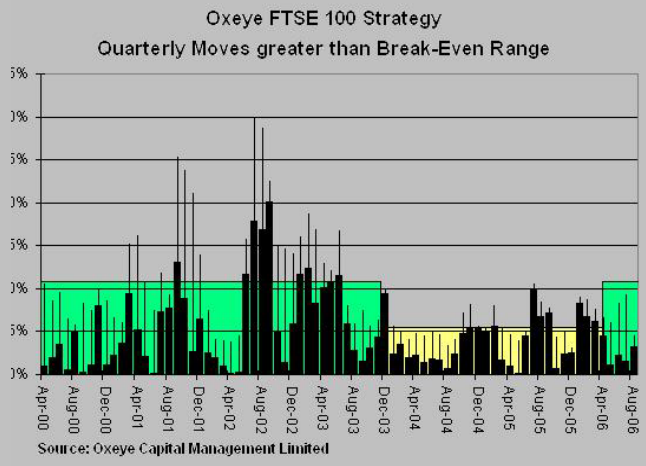
Option prices erode over the life of the contract. The average option duration that Oxeye operates is 3 months. The options are struck at market levels which have a high statistical chance of not being breached (more than 15% of the time or 1.75 Standard Deviation SD).

For example, by selling an option for 100 and buying it back for 0 (ie it expires worthless) the seller makes 100 points. Over 12 months that will equate to a profit of 1200 points. If losing months occur 15% of the time and the loss is as great as the profit in an up month then 100 points will be made in 10 months and losses of 100 points in 2 months to give a total of 1000-200 = 800 points. At £10 a point this strategy will have made £8000.

Clients may choose their initial margin, although for the Fund this will be predetermined. If the initial margin was £10,000 a gain has been made of 80%, before fees. If the initial margin was £50,000 a gain has been made of 16%, before fees.

Charts 5 and 6 show the history of quarterly moves in the underlying index over and above options strikes at 1.75 SD levels above or below the market. The FTSE chart shows 2 different SD zones to reflect the high volatility environment prior to 2004 and the lower volatility period since 2004. The chart shows that quarterly % changes in the underlying markets on a closing basis rarely break the range. (18 out of 67 = 25% for Oil and 9 out of 67 = 13% for FTSE.)





Example of the Life Cycle of a 3 Month Strangle

Calculate statistically the normal range over the life of the contract. 1.75 SD shows a range of +/- 10%.

Call strike at 10% above latest market / index price (LMP) 6000 + 10% = 6600

Put strike sold at 10% below LMP 6000-10% = 5400.

Call premium with 3 months to expire = 25 points

Put premium same duration = 25 points

Total premium = 50 for the strangle.

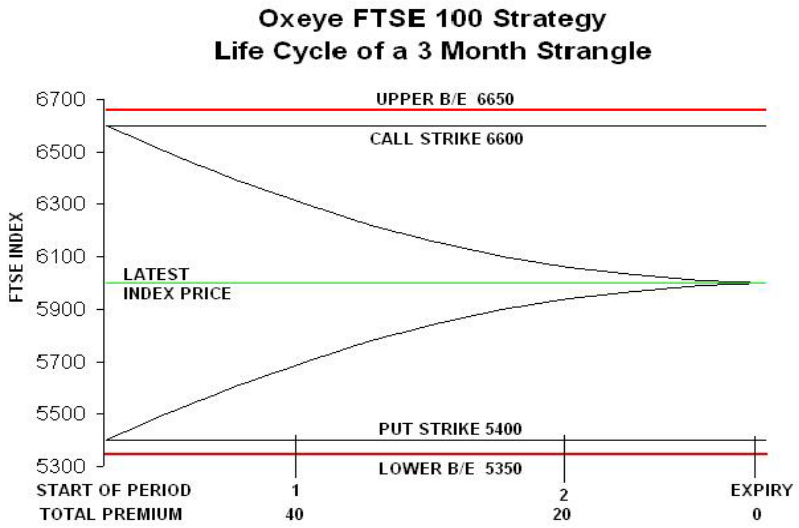
Break even = call strike plus total premium = 6600+50 = 6650 and put strike - total premium = 5400-50 = 5350.

BE Range = 5350 to 6650 = 24% wide range.

As long as the market stays within the range options have no intrinsic value and erode steadily to expiry when they expire worthless. After 1 month the premium of 50 falls to 40; after 2 months to 20 and after 3 months to zero.

But if the market breaks the range then options go INTO THE MONEY and take on an intrinsic value.

Intrinsic value is calculated as follows: Call option = Market price less strike; Put option = Strike less market price.



Martin Petherick
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December 2006

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