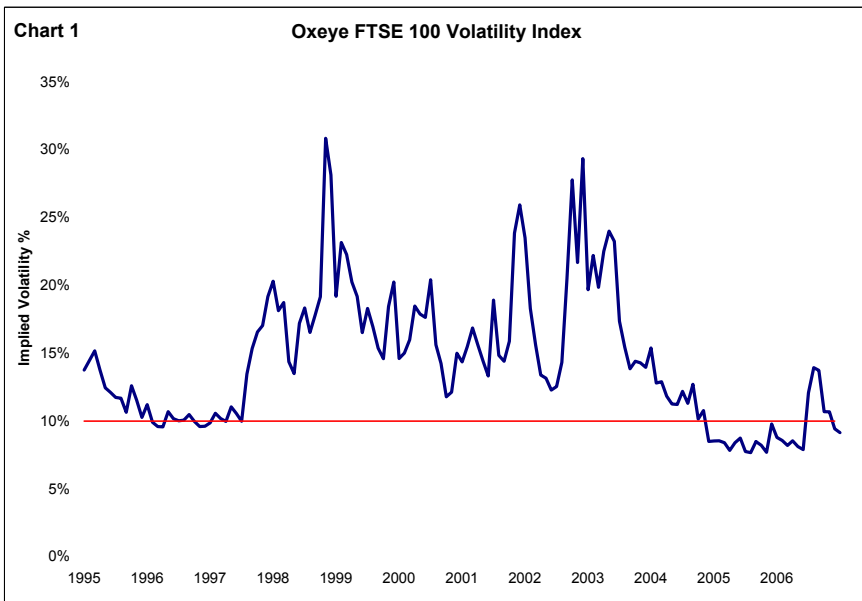


OXEYE TRADED OPTIONS STRATEGY : HEDGING A FALL IN UK EQUITIES.

In this note we look at 3 different ways to hedge a fall in the FTSE 100 Index by use of Exchange Traded European style options. We will make the calculations based on a portfolio worth £100mn and the duration of the hedge will be until December 2007. All prices used in the calculations are closing basis December 15th 2006 and are likely to vary. The FTSE 100 index level is currently 6250.

In Chart 1 we show the Oxeye FTSE 100 Volatility Index. This is Oxeye's proprietary indicator tracking the implied volatility of option prices on the FTSE 100 Index. The chart shows the cycle of volatility from 'low' in 1995 to 1997 through 'high' 1997 to 2004 and then 'low' again 2004 to 2006. Anything below 10% (denoted by the red line) we would consider to be 'low' volatility.

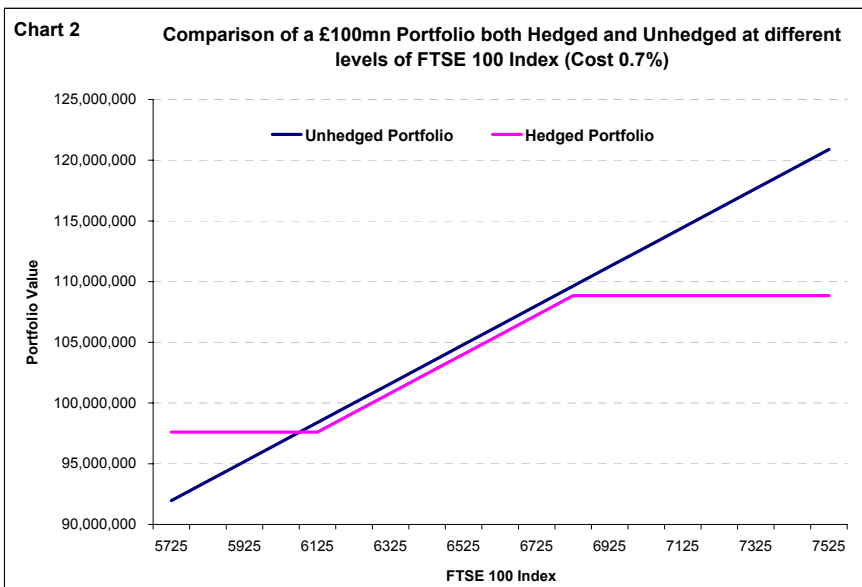


Source: Oxeye Capital Management Limited

A 'high' volatility environment would be ideal for option writers, because premium levels are high and time value erosion (theta) is potentially at its most lucrative. A low volatility period would be better suited to option buyers, because low premium levels would benefit from an increase in implied volatility (vega) as a result of a sudden and large move in the underlying index.

The latest reading suggests that **now is a good time to be buyers of options** as the index is below 10%. As such we have calculated some downside protective option strategies suitable for long only portfolios.

In Chart 2 we show the value of the portfolio on a hedged and unhedged basis at different levels of the FTSE index.

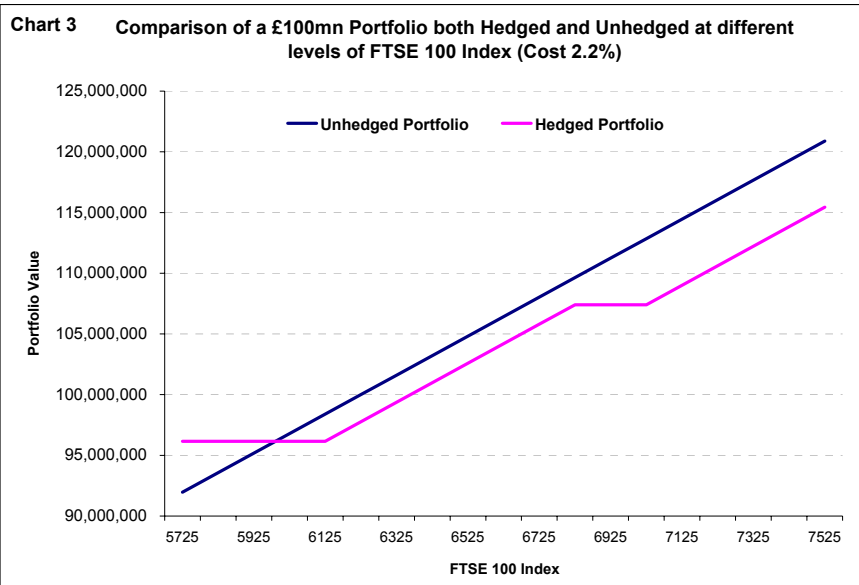


Source: Oxeye Capital Management Limited

At a level of 5725 the unhedged portfolio would fall to below £92 mn a loss of 8% with unlimited downside potential. The hedged index could fall only 2% to £98mn. The cost of this hedge would be approximately 0.7% (£700k) and would limit upside gains to a maximum of +9% or a portfolio value of £109mn.

This means that if the FTSE stays between 6125 and 6825 the hedged portfolio value will underperform the unhedged by only the cost of the insurance.

Above 6825 the hedged portfolio will be limited to a gain of 9% and will underperform the unhedged portfolio if the index continues to strengthen.

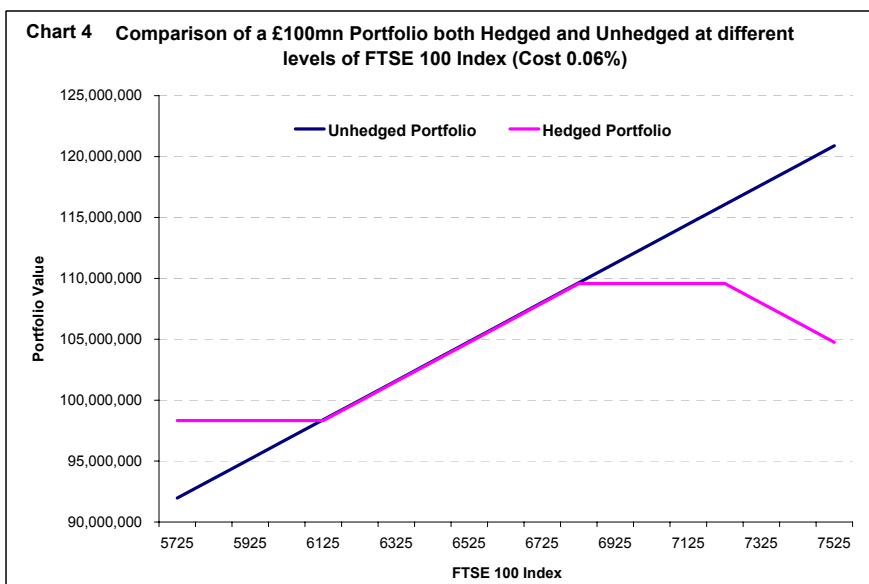


Source: Oxeye Capital Management Limited

In Chart 3 we show a more complicated options strategy which aims to allow unlimited upside performance for the hedged portfolio although to a lesser extent than the unhedged portfolio. The downside is capped at 4% (£96mn) and the cost of the insurance is 2.2%.

At FTSE 7025 and above the hedged portfolio would underperform the unhedged portfolio by approximately 5%. ie at 7025 the portfolios would be valued at £107mn and £112mn.

With any further rise in the index above 7025, both portfolios would appreciate in line.



Source: Oxeye Capital Management Limited

A third alternative is shown in Chart 4. Here the cost of the insurance is limited to 0.06%. The downside is limited to 1.5% (£98.5mn) and the upside limited to 9.5% (£109.5mn) for the hedged portfolio.

If the FTSE rises more than 15% (from 6250 to 7225) then above 7225 the hedged portfolio would start to decrease from £109.5 mn. This is because additional short call option positions would be required in order to reduce the overall cost of insurance.

Adopting an options overlay allows the portfolio to be structured according to the Fund Manager's:

- a) target for the index either on the upside or the downside.
- b) level of performance the Fund Manager is prepared to pay/forego for the downside insurance.

In conclusion the aim should be to ensure that the downside is hedged in the event of a big fall in equities, without reducing upside performance up to a certain level above current prices.

M Petherick
December 2006

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