WEBB ASSET MANAGEMENT

September, 2010

Monthly Commentary

SYSTEMATIC, PROVEN & RELIABLE

Commentary

Getting Paid to Hedge

We would all want portfolio insurance for our equity investments if it was inexpensive. However, most of us do not use portfolio insurance as the cost of the insurance is too high. The most common types of portfolio insurance include: long-put options, short-futures contracts, market-neutral funds, and cash.

These forms of insurance either have significant absolute costs (long-put options) or significant opportunity costs (market-neutral funds, cash, etc.). In addition to the costs, there also have been significant trade execution problems and correlation break downs.

One of the best inverse correlations to equity markets is the VIX. The VIX is a measure of the implied volatility of options on the S&P 500. The VIX has an inverse correlation to the S&P 500 of -.82. The VIX rises when the S&P falls and the VIX falls when the S&P rises. Unfortunately, the VIX is not an investible asset. However, there is now an ETF called the VXX with a +.85 positive correlation to the VIX. Currently, the VXX is one of the better investible ways to capture the moves of the VIX.

A good portfolio insurance trade would be to be long stocks and be long the VXX. Given their inverse correlation, this strategy would lower the volatility of a portfolio. However, there is an opportunity cost in owning the VXX. The VXX is not an investment in a growing company. The VXX is just a measure of implied volatility. The VXX also does not pay a dividend.

We believe a better portfolio insurance trade is to write short-dated covered calls or naked puts on the VXX. Employing this strategy pays the fund significant monthly income from the option premiums while having a long-bias exposure to the VXX. Using an over-write strategy truncates significant positive returns vs. owing the VXX outright if there is a market collapse. However, writing options on the VXX produces consistent monthly option income which is inversely correlated with the fund's other positions.

In the WAM Enhanced Income Fund we employ covered-call and/or naked-put writing on stocks we are comfortable owning. This over-writing strategy pays the Enhanced Income Fund approximately 3% per month in option premiums.

To hedge part of the fund we also employ covered-call and/or naked-put writing on the VXX. Given the higher volatility of the VXX, this over-writing strategy pays the Fund approximately 5% per month in option premiums.

As long as the option premiums are high on the VXX we will continue to allocate a portion of the Enhanced Income Fund to this strategy.

– Derek Webb

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