

ASK SLIM

I'll share a quick history of my trading career and let you decide. I've been a trader for 31 years. My trading career began in 1974, at 24 years of age, on the Chicago Board Options Exchange (CBOE). Over the 17 years I was a member of the CBOE, I traded in nearly every pit on that floor. Much of that time was spent in the chaotic OEX pit. Over the years I was a member of the Chicago Mercantile Exchange (CME) and the Chicago Board of Trade (CBOT). I have traded "off the floor" since 1984.

In this column, I will answer your questions on the technical and psychological aspects of trading and trading methodologies. Oh, and the next question would be, why the name "Slim?" My badge on the CBOE was "SLM" (Steven L. Miller). Other traders gave me that nickname on my first day of trading, back in 1974. So, ask Slim!



Dear Slim,

My question is about the best strike price to choose when trading options. I seem to be drawn to the cheaper out-of-the-money options. That's due to less decay if the stock moves the wrong way (lower delta). I have a small account. So anything over \$2.00 is too expensive. Please give me any help or advice.

Thanks,

—Burt, via email

Dear Burt,

First, I'll challenge your assumption that out-of-the money options are less expensive because they may be under \$2.00. Here is the proof. A \$2.00 out-of-the money option, with 20 days to expiration, decays \$0.10 a day. Without a significantly favorable move, it will yield a 100-percent loss if not closed before expiration. A \$5.00 in-the-money option, with \$1.00 premium and \$4.00 intrinsic value, with the same time left to expiration, loses \$0.05 a day in decay. A sideways move will yield only a 20-percent loss and the underlying security needs to move just over one point to yield a profit at the expiration date. Thus, the higher priced option is less expensive in the long run.

If you are comfortable only trading very low priced and far out-of-the-money options, expect to have a lower percentage of winning trades. Also, consider that a good discipline rule is no option trade should lose more than five to ten percent of your account value. This will help to keep fear out of your decision-making, which is a trader's Achilles heel. So, to trade a single \$2.00 option (\$200), you should have at least a \$2,000 account. And that should be risk capital.

Dear Slim,

I am interested in information about market makers' actions or influence on stocks. I am trading small stocks, and price changes are sometimes unreasonable to me. Do market makers hold or control significant amounts of shares for the purpose of filling large-sized orders?

—Leonard V., via email

Dear Leonard,

The function of a market maker is to promote a "fair and orderly market" by posting a two-sided market (bid/ask). They profit by "getting the edge," trading on the bid or ask price and then quickly closing the trade out for a few cents profit. Three cents on a thousand shares is worth \$30. Sure, a market maker might hold a position for a short while, taking advantage of stock momentum. To ensure overall profitability, however, with the average winning trade so small, they cannot risk large losing trades. Therefore, it is very unlikely they will hold sizable positions.

In stocks with small floats, there is usually less interest by institutions than in higher-cap stocks. Furthermore, short-term traders usually stay clear of thinly traded stocks, because they want an easy exit if they are wrong. Therefore, with less participation, there is inherently more risk in trading these stocks, and market makers are motivated to post the widest markets possible. This is the reason you perceive that "price changes are sometimes unreasonable," and is probably what attracts you to trade these less-liquid, small stocks.

Dear Slim,

I read your 2006 stock market predictions in the January issue of SFO magazine with interest. On the surface, your forecast seems quite plausible (Slim's forecast for 2006 for the Dow Jones Industrial Average: spring high 11,375 – winter low 8,303). However, I had difficulty reconciling it with the strong performance of the Dow Jones Transportation Average over the past several months, which now stands well above its 2000 peak. Based on Dow Theory, I would expect the Dow Jones Industrial Average (DJIA) to be setting all-time highs in the very near future. Do you feel that the Dow Theory is no longer valid? If you feel this theory is still relevant, how do you explain the clear divergence between the two indexes, especially in a time of high energy prices?

—R.W., via snail mail

Dear R.W.,

You are interpreting Dow Theory to mean that because the Dow Jones Transportation Average (DJTA) has made an all-time high, it means the industrials will do the same, trading over the Janu-

ary 2000 high at 11,750. My interpretation is different than yours. Both indexes made bull market highs in March of '05 and then had corrections into April, with the DJIA losing 9.8 percent and the DJTA dropping nearly 14 percent. The follow rally saw the transports make a new high in October '05. Then the lagging industrials followed with a new high in February '06, when the index finally moved through 11,000. This is a Dow Theory confirmation, meaning the "primary trend" is still bullish. It does not, however, necessarily mean the industrials will go to an all-time high.

There are several reasons why the Transportation Index has been very strong. While the airline industry is in huge trouble, higher energy costs have actually helped the DJTA. First, the failing airlines, like Delta (DAL) and Northwest (NWAC), were delisted from the DJTA, leaving better-performing airlines in the index. Southwest Airlines (LUV), it is said, has hedged their fuel needs for many years out. The rail components of the index have done extraordinarily well, benefiting from the higher demand for coal shipments and strong pricing power. Also, the airfreight companies, UPS and FedEx, have soared, cashing in on the huge growth of online commerce.

Higher energy prices have coincided with a generally booming commodity market, which has boosted the energy sector, along with commodity stocks and makers of heavy machinery. Costly oil has sent a large number of dollars into foreign hands; those dollars have been reinvested in our Treasury markets, keeping long-term interest rates low. That has lifted the financial sector, with stocks like Goldman Sachs (GS) and

Lehman (LEH) consistently making all-time highs. The stock sectors I just mentioned, in total, represent more than 35 percent of the S&P 500. So high energy costs, paradoxically, have helped the stock market.

My thoughts are that this condition will end in coming months, either with an inflationary spike in interest rates or a sharp retrenchment in energy and commodity prices. Either one of these will unravel the aforementioned bullish factors and pressure the stock market. Anyway, this bull market is now 42 months old and is set up for a bear market that should last six to nine months. I will stick with my previously mentioned forecasts.

Dear Slim,

I read your column every month. Can you suggest a website I can go to get the history of how long a stock has been paying a dividend?

—Richard M., via email

Dear Richard,

There are many sites that allow you to search for dividend information as part of their "stock screeners." Businessweek.com and moneycentral.msn.com are good examples. I have not found a website in which you can search for dividend histories on individual stocks. This information is available from the investor relations departments of most companies. You can also find free, current information on dividends at Yahoo! Finance. ■

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SEND ME YOUR
QUESTIONS!
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SFO Stocks Futures & Options

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