

# 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,*

*I read the business publications and watch the stock market TV shows religiously. Statements from the FOMC indicate that inflation is not a problem. Many commentators on TV speak of a "Goldilocks" economy: steady growth and low inflation.*

*For January, the core rate of inflation was up 0.3 percent. Also, crude oil has rebounded over \$10 a barrel, grain prices are at decade highs and gold has moved up \$80 an ounce this year. This seems to be a more ominous sign for inflation. Is the picture really as good as portrayed? Or is inflation going to be a problem. What is your opinion?*

*-Gregg D, via email*

Dear Gregg,

I think about inflation and its effect on the markets all of the time. There are so many components to this subject and the biggest brains out there meet up to debate it with opposing views.

The recent rise in the core rate of inflation (minus food and energy) came from two main areas. The crack in real estate has moved potential buyers into the rental market, raising demand and rental costs. And healthcare costs continue to rise. These conditions could keep slight upward pressure on the inflation data.

There has been some uptick in commodity prices, as you have noted. However, it came after a sharp correction. The rallies in grains, oil and gold are less likely to be a reflection of worsening inflation than a fear of the situation with Iran.

My view: In 2000 and 2001, fearing the deflationary forces of the technology stock bust and 9/11, the Fed lowered short-term rates to 1 percent and raised the growth in the monetary base to 10 percent. This coincided with 0 percent rates in Japan and low rates worldwide. Easy money was the fuel for a real estate bubble across the continents. Furthermore, the world awash in liquidity pushed up levels of all stock markets.

In recent months, the situation has changed. First, growth in the monetary base has pulled back to 3 percent. Next, the sub-prime mortgage market has imploded as a result of a very weak real estate market, likely causing tougher lending standards and little chance for a rebound in home prices. These factors reflect a tightening monetary situation and possible credit crunch, which will keep downward pressure on inflation.

The biggest factor may be globalization. Manufacturing has essentially left the U.S., keeping strong pressure on prices of finished goods. It will take a much lower U.S. dollar to change this.

So, generally, my view is inflation will remain low. If the stock market falls significantly (that will happen sometime), coinciding with all of these other disinflationary forces, we could revisit the deflationary fears of six years ago. Then, in spite of low inflation and falling interest rates, Goldilocks will be eaten by the bears.

*Dear Slim,*

*In technical analysis, what is your opinion on the usefulness of the following two types of charts: On Balance Volume and Directional Movement?*

*-Nirmal M., PE., via email*

Dear Nimal,

On Balance Volume (OBV) was developed more than four decades ago by the well-known and entertaining technical analyst Joe Granville. It is a momentum indicator which measures the net difference of volume on securities on up days vs. down days. The theory is that the imbalance of buying and selling determines the direction of the stock. Makes sense.

Directional Movement Index (DMX) is a complicated trend-following indicator developed by Wells Wilder. Essentially, the Average Direction Index (ADX) is combined with the positive +DMI and the negative -DMI which yields an indicator that ranges between 0 and 100.

I have found OBV to be very valuable, because it gives a strong sense of when a trend remains in force. I have found DMX to be harder to use, as it often is trending opposite to where the security seems to be going.

Please refer to the daily chart of General Motors (GM) for December '06 through most of February '07. I have overlaid both the OBV and DMX indexes. OBV turned up sharply in January, reflecting the appearance of aggressive buyers. This brought a seven-point (23 percent) gain in just five weeks. The upturn in the DMX came about seven days later. Notice, also, in February, OBV turned down and the stock dropped sharply. In this case, DMX turned down a few days later.

Most often, OBV is far more sensitive than DMX and many other indicators. For cautious traders, these two indicators can be used together, one confirming the other. I tend to be more aggressive. I would trade on the breakout or breakdown of OBV and then add to the position when DMX confirms.

FIGURE 1: GM Daily Bar Chart



Dear Slim,

A public company is litigating an issue which will be decided within the next year. A favorable decision should bring a triple in the stock. An unfavorable decision might see the stock cut in half. A speculative approach would be just buying out-of-the money options. Please suggest a strategy which offers a more conservative use of options.

Thank you,  
-M.S., via email

Dear M.S.,

Since the timing of the decision on this company's litigation is in question, you are quite right to avoid playing the stock with out-of-the money options. Decay will kill you.

A more conservative approach: Use a "back spread" or "ratio spread", which can lower risk of option decay. Example: XYZ stock is trading at 79.50. The second month call options have six weeks to go to expiration. The XYZ 85 calls are trading for 1.30 and the XYZ 80 calls are 3.20. You buy two 80 calls (\$260) and you sell one 80 (\$3.20).

Scenarios: If the stock does nothing, holding under 80, or collapses on negative news, both options expire worthless and you actually make

the \$60 net credit (less commission). If the stock soars on good news, you do really well. Let's say it moves up 20 points quickly, to 100. The short 80 calls go to 20, losing 16.8 points (\$1680). The long 85 calls move to 15, gaining 13.80. (\$1380 x 2 = \$2760). So you make nearly \$1100 on a position that can actually profit in both directions.

The catch: If the stock drifts upward slowly, you will be in trouble. At 85, your worst case at expiration, your short calls lose \$180 and your long calls expire worthless, an additional loss of \$260, for a total loss of \$440 on just a one by two spread (ouch!). So my solution to your question is a good one, just not perfect.

Dear Slim,

I enjoy reading your column in SFO Magazine. I was especially interested in your response to Kevin G. in the February Issue. I sell naked puts and calls one to two months out, looking to profit from time erosion. I use fundamental research in my analysis. I sell calls on stocks with a negative outlook and sell puts on stocks with a positive outlook.

What technical studies would you suggest I use to refine my method and tell me when it is best to sell these naked options? I would appreciate any other input regarding this strategy.

- Ray L., Marseilles, Ill., via email.

Dear Ray,

Fundamental analysis is great for long-term investing. I can't see how it can help, however, in just the two-month window in which you sell naked options, as anything can happen. I'll bet you have gotten in trouble, which prompted your question.

There are a multitude of technical studies you can use to pick entry points to short naked puts and calls. The best spots are, of course, at turns in the security. Please refer to the previous question, which looks at OBV and DMX to indicate tops and bottoms. I would also use other oscillators like Stochastics, RSI, CCI etc.

I can't stress enough, however, that these are tools and you must use strict discipline when selling naked options. ■

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SEND ME YOUR  
QUESTIONS!  
AskSlim@sfomag.com or  
Ask Slim  
SFO magazine  
3812 Cedar Heights Drive  
Cedar Falls, IA 50613

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