

# 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'm thinking about spreading two retailers: buying Wal-Mart and selling the new Sears-Kmart stock. Would it make sense to use comparable dollar amounts in each position or an equal number of shares? What do you think about this trade strategy?*

*–Dave M., via e-mail*

Dear Dave,

The strategy you suggest is called a "pairs trade" – buying one stock and shorting another, usually in the same sector. The assumption is the stock you buy will outperform the stock you short, while maintaining neutrality to movements of the stock market as a whole. To accomplish this, the trades should be in balance. This normally would mean buying and shorting in equal dollar amounts – though minor adjustments can be made relative to the "beta" (volatility relative to the stock market) of the individual stocks.

I like the pairs trading strategy. However, it can be deceptively risky. You must have a stop-loss point based on a specific dollar loss or the trade may go against you for a very long time. A great site for pairs trading is [www.pairtrader.com](http://www.pairtrader.com). Put the two stocks in the appropriate fields, and it gives their beta, correlation to each other and the S&P 500, etc.

*Dear Slim,*

*Last year a reader asked about making a career switch to trading after having been employed in different industries for a couple of decades. You suggested that the reason behind his motivation to change careers could be something deeper than simply wanting to have freedom from the rat race. Spend more time discussing what exactly you had in mind when you mentioned that, and also what the failure rate is for those who attempt discretionary and proprietary trading.*

*–Craig, via e-mail*

Dear Craig,

This person had made several career changes over the past 20 years, was presently the owner of a successful business and was considering a career in trading. This suggested to me that he had something deep within himself that he was trying to satisfy through his work.

One of the greatest reasons for failure in trading is that the person assigns a role to trading that is inappropriate. If he trades because making a winning trade "feels good" or helps cover something uncomfortable in his life, it will be very hard to get out of a losing trade when it feels really bad. My suggestion was that he deal with the underlying issue before venturing into a trading career – then move forward with the process of learning to trade – uncontaminated – with clear focus on methodology and trading style.

Failure rates for people venturing into trading are very high. It is hard to give you an exact percentage. I believe, however, that with emotional fitness and a diligent approach to developing trading knowledge and skills, the probabilities of success greatly improve.

*Dear Slim,*

*Why do commodity futures exchanges view cash deposited as margin differently from Treasury bills deposited for the same purpose? As an extreme illustration: cash deposited as margin that equals 100 percent of a futures contract's worth averts any margin calls. Substitute Treasury bills for cash margin, and should the market move against one's position, a margin call is inevitable.*

*–Norman M., via e-mail*

Dear Norman,

If you have enough cash in your account to cover margin requirements on futures positions, a margin call will not be issued. However, if you have a T-bill in your account, it seems to you that it's just like cash, but it is a separate security. Thus, if a futures position requires margin, a call will be issued. Then, based on the amount of the margin call and

your relationship with the brokerage firm, the T-bill or like security may have to be broken (sold) to meet the margin call.

Dear Slim,

Your "Weekly Trader's Report" is one of a few reports worth reading. It seems you use basic long puts or calls in your newsletter. I prefer verticals and am trying to learn more about managing them. I will typically buy an in-the-money bull call spread if I am bullish, and on a rally sell the next higher at-the-money call or a put spread to complete the position as a butterfly or condor. I have had pretty good success with these as I can bail quickly if it goes against me.

My question is about "morphing" the position into something else if it goes against me rather than closing it out. Do you and other pros do this regularly? For instance, if I have a bull call on and it goes south, and I think the move will continue, should I flip it to something that can benefit from a continued downward move, such as a ratio or synthetic put (long call-short stock)?

—Chris K., via e-mail

Dear Chris,

Because readers of my "Weekly Trader's Report" are at all levels of trading experience, my "Option Trade of the Week" is always given in the simplest form, buying calls or puts. This does not preclude experienced traders from taking the stock analysis and determining a more suitable, advanced option strategy.

Your approach to option trading is to trade vertical spreads and then to convert them to more neutral option strategies once they have worked for you. Should you do the same if the trade starts to go against you?

First, any time you enter into a trade, it has to fit with your analysis and have economic justification. Avoid the temptation to convert a winning option strategy into something else just because it has a profit.

Next, when a trade is losing money, it's tempting for many traders to try to find a way to get the money back. However, the message in the losing trade may be that something has changed in the underlying security, which removes the justification for the trade. If so, why stay in the trade at all? "Morphing" a trade that isn't working into something else that is more complicated might just be compounding the problem. Reversing the trade often is an emotional decision and has the risk of a "whip saw." In either case, the cost, beyond money, is that it's harder to focus on the market and moving on to the next trade when you're mired in what to do with the present disaster.

My approach is to enter a trade with a partial position and then accelerate into a full position when the market confirms the trade is correct. If things change and the trade is a loser, I'm out!

To sign up for Slim's "Weekly Trader's Report," go to [www.askSlim.com](http://www.askSlim.com). It's free! **SFO**

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QUESTIONS!  
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