

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,

There is a lot of advice on setting stop losses on stock positions. My broker says to use a price on a stock of 8 percent below my cost. Some people say to use support and resistance levels on the charts for stop points. But how do you set your stops on option positions?

•• Richard S.

Dear Richard,

There are really two issues to consider. When do you stop out a losing option position and how do you do it?

The 8 percent number your broker uses as a stop-loss is fine for stocks. For option strategies, however, a move that big in the stock could mean a total loss—quite unacceptable, in my mind.

I have a couple of rules that I use. First, I never want to lose more than 50 percent to 55 percent of my cost. So that's one of my stop-out points for option positions. That's much more controllable with in-the-money option positions, long puts or calls, than with out-of-the moneys. That's simply because you're buying less premium, hence, you suffer less option decay. So I rarely make those long-shot, deep out-of-the-money plays, which are extremely difficult to stop out.

Next, I don't sell naked out-of-the-money options. There is just too much "event risk," especially in equity options, in this time of extraordinary mergers and acquisitions activity. Odds are that one bad trade I can't stop out at an acceptable level will wipe out five or 10 good trades. If I want to play option decay, I do it with vertical spreads or butterflies. Still, in these more conservative types of strategies, I want to control losses. So I stick as close as I can to the 50 percent rule, even for spreads.

Stopping out option trades with chart patterns is actually quite difficult. Usually, if the chart shows a bullish breakout or bearish breakdown, signaling it's time to get out of a losing option trade, it's already gone way past the 50 percent rule. Absolutely, close out a trade if the charts say the position is wrong, loser or not!

The next issue is how you stop out a losing option trade. The big problem is "slippage," which is the difference between the expected and actual cost of getting out of the trade. When a stop order gets hit in a heavily traded electronic future, odds are that you will get filled a tick or two away from the current price; quite a negligible cost. In options, however, if the underlying security is moving quickly, your execution price could be disappointingly poor. Thus, I suggest never using stop orders in options. Set alerts in the option or underlying security and then put in limit orders to exit the trade, moving the limit when appropriate.

Of course, one of the best ways to limit your losses on a trade is to be more selective about when you get in. So when you're feeling angst about that trade you think you just missed, take a breath and wait for the next wiggle in the market to put you in at a favorable level. You might miss a momentum trade by using this cautious approach for entries. So be it. It's worth it in the long run.

Dear Slim,

Recently, my broker added portfolio margin as an upgrade from Reg. T. Since I usually sell put and/or call options on the S&P E-minis, I was interested. My understanding was that portfolio margin would extend to index options, specifically CBOE S&P 500 Index options. If S&P 500 Index option margin requirements were similar to S&P 500 E-mini future margin requirements, then I would trade them. So, I upgraded my account.

My broker has a nice feature that allows the trader to check margin requirements on all trades prior to execution. Boy was I disappointed. Margin requirements were about five times higher for the index options than the futures options. I expected the requirements to be about two times higher. Did I misunderstand something? By definition of portfolio margin, should the margin requirements be the same?

•• Jeff W.

Dear Jeff,

For as long as I can remember, margins, on the securities side, have been calculated according to Reg. T rules. Over the past couple of years, the Securities and Exchange Commission (SEC) entered into a pilot program, testing a more equitable format.

Under portfolio margining, positions in the same class or product group are offset and evaluated based on net risk. Margins are calculated by stress test, based on the probability of moves in a specific market. This usually will create a smaller margin requirement than under Reg. T., which

would margin everything separately. It also means that a trader can now get more leverage. This is much like "SPAN" margining used in futures. So there are stringent requirements for a trader to be eligible for portfolio margining.

The formula used in calculating portfolio margining varies on a firm-by-firm basis. Jeff, I'm guessing your broker is not yet applying it to index options. With some firms, the margin reduction may be as large as 60 percent. I suggest you ask them, and if you're not satisfied, look around.

Dear Slim,

Where can I get software for my computer that will analyze and graph strategies on futures options? I would also like to be able to determine the futures SPAN required for the trade.

•• H.V. S.

Dear H.V.,

Most futures option-execution firms will have some analytics in their platforms for option strategies. One good example is Xpresstrade.com, which is the futures subsidiary of optionsXpress.com, one of the largest and most successful equity-option brokers around.

If you want highly sophisticated software for option analytics in equity, currency, index and futures options, go to Peter Hoadley's site, www.hoadley.net. The software features multiple pricing models, charts, diagrams, Greeks and tons of other types of analysis.

Regarding the calculations of standard portfolio analysis and risk (SPAN), which is a portfolio margining method developed by the CME in 1988, you have a few choices. An occasional user can create a strategy, real or hypothetical, and ask his or her broker to do the margin calculations for the trader. Also, as mentioned in a question above, there are execution platforms that tell you your margin requirements

before you execute a trade. Or you can go to www.cme.com and buy the PC-SPAN software.

Dear Slim:

An article in the April SFO issue on ETFs stated, "With most common stocks, shareholders can only sell short on an up tick. But ETFs can be sold short on a down tick. This gives traders and investors more precise entries and improved pricing opportunities for selling short." Please help me to understand this.

•• Chris F.

Dear Chris,

Your referring to Toni Turner's comprehensive article entitled "Splash Around with Exchange Traded Funds."

The simple explanation is that if you want to be short a particular group, market segment or the stock market in entirety, you can get there in a couple of seconds by shorting the appropriate ETF. With ETFs on the major indexes, you can do it in enormous size without moving the market more than a few ticks. If you were a big institution, trying to short individual stocks, you might have a lot more trouble. You would need an up tick to short the stock, and if you show a large order, the bids will go away and the price will drop. That's one reason why shorting an ETF is a better choice.

Here's another reason being able to short an ETF on a down tick is an advantage for sophisticated traders. One strategy that is used by program traders is trading a basket of stocks against an ETF when the computer calculates that there is a pricing advantage. That might mean buying 100 or more stocks and shorting the ETF at lightning speed; all to make a few pennies. There is no room for error. Trading the ETF, you can count on getting off the short side of the trade without much slippage. This is an example of the "improved pricing opportunities" to which Turner has referred. ■

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SEND ME YOUR
QUESTIONS!
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