Ask Slim

By Steven Miller

SFO Stocks Futures & Options

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Dear Slim:
When someone chooses to exercise their option, how is it decided who gets called out (and who exactly makes the call)? In my mind, it should be the one who sold that particular option. Instead, the selection process appears to be tier-structured or skewed to select outsiders and individual investors before selecting institutions and brokerage firms who sell the majority of all options sold. Am I correct? And if I'm not, is this a form of insider trading and is it subject to some type of legal action?

—Bruce K., Lawndale, CA

Dear Bruce:
The method that exchanges use to handle exercises and assignment of options has been used since the birth of listed options on the Chicago Board Options Exchange in 1973. It is a lottery system and is extremely fair. When the holder of an option wishes to exercise an option, he notifies his broker or clearing house of his decision. The exercise is then assigned by a computer, which randomly picks a writer (seller) of that option. He is then notified through his clearing house or brokerage house that he has been assigned. If it's a call, that option writer must deliver the underlying contract (commodity) or stock. If it's a put, he must take delivery of that underlying contract or stock.

Options on indexes are handled differently. American-style index options can be exercised at any time and settle to the cash value of the index. So when these index options are assigned, the writer is essentially taken out of the short position at the day's settlement price. European-style options can only exercise on expiration day.

You are incorrect in your assumption that the process of assigning options that are called is somehow skewed to favor institutions or brokerage houses. Also, it is impossible to assign the individual seller of the particular option because option positions are constantly opened and closed. Therefore, the original writer of an option may be long out of the position before that option is called. Because brokerage houses and institutional sellers of options have the largest positions, they actually have a greater likelihood of getting "hit" on an assignment. There is no way a large trader or institution can influence who gets assigned. In this case, much unlike what we've seen in the corporate world, governance is quite pristine.

Dear Slim:
I like to short-term or day trade spread the stock indexes against each other. What quantities should I use of DJ vs. SP, DJ vs. NQ or SP vs. NQ? —Lew M., Chicago, IL

Dear Lew:
I also like to trade spreads on index futures. I have traded the S&P futures against the Dow very actively over the last five years. I find the spread to be quite consistent.

To determine the ratio of spreads between stock index futures, start by calculating the change of value of the individual contracts were they all to have the same percentage move. Then calculate the

number of contracts needed to create a neutral spread.
For example, a one-percent move in S&P futures, currently priced around 900, would be around 9 points. The value of each point is $250. So the value of a one-percent move in S&Ps is around $2250. The Dow Jones Industrial Average is currently priced around 8400. A one-percent move in that index would be around 84 points. The dollar value of each point in Dow Futures traded on the Chicago Board of Trade is $10. So a one-percent move in the Dow is valued at around $840. The ratio of these two indexes calculates to 2.7 to 1 or around eight Dow futures to three S&P futures. If you trade E-Mini S&Ps (one-fifth the value of the pit traded contract) against the $5 Dow futures online (half value), the ratio works out very close to 1 to 1.

To figure the ratio between the NASDAQ and S&Ps, do the same. The NASDAQ is currently trading at around 1250. A one-percent move is 12.5 points. Each point is valued at $100. Thus, a one-percent move in NQ futures is worth about $1250, or just about half the value of a like move in S&P futures. That makes the ratio two NQs to each S&P. E-Mini NASDAQ futures are one-fifth the value of the full contract (same as S&Ps). So the ratio for the minis is the same as the full contract.

There is a trap here, however. It is important to consider that the NASDAQ is far more volatile than either of the other indexes. While the S&P index fell 49 percent from its 2000 highs, the NASDAQ index fell 85 percent. Often, on big bounce days, the broad market may be up three percent, with the NASDAQ up much more. That makes the NASDAQ roughly one-and-one-half times as volatile as the broad market. Dow futures correlate much closer to S&P futures than the NASDAQ. It is very important to factor in these differences in volatility when spreading these index futures.

Important factors to consider when trading these intermarket spreads are that there are significant risks in execution and market fluctuation. And, because these spread are made up of two different indexes, you have to "take a leg" on one side of the market before you get the whole spread on. Two good tips: 1) you want to make sure you're long and short on the right side of the spread based on the short-term relative strength of the two indexes; 2) take legs initiating or exiting the spread on the side of the present market momentum.

Dear Slim:
How do you deal with offsetting buy/sell signals during the trading day (i.e., technical buy signal vs. bearish news from the Fed)? —Alex S., via e-mail

Dear Alex:
My assumption is that the market is always right. If the market has an established trend, outside news will not affect that major trend unless the market was ready to reverse anyway. So if a signal is reversed, I believe it.

In response to your reference to the Fed, since 2000 the Federal Open Market Committee (FOMC) has lowered interest rates 11 times. Many of those occurrences caused the market to bolt on the upside. In fact, on one occasion the FOMC surprised the markets with a rate cut, and the market exploded upwards nearly five hundred points in a few minutes. However, the primary trend, which is identified in the daily and weekly patterns, remained down. And as we know, the market has had its worst bear market since the depression.

Short-term traders rarely look at the primary trend of the market. In fact, they mostly look at charts of time periods 15 minutes or less. For these traders, it's even more important to believe the most recent signal, no matter the cause. Most short-term traders will be out of positions by the end of the day, anyway.

Dear Slim:
What is your preference: long-term position trading, catching two-to-five day swings, or day trading? Why? What do you suggest for a beginning trader? A two-year trader?
—Bill C., via e-mail

Dear Bill:
My trading career started as a Market Maker in the pits of the Chicago Board Options Exchange. I, along with the vast majority of floor traders, am a day trader. Floor traders normally go home each day flat or have hedged or spread positions with a measured risk. I have spent 28 years trading this style, and it is my own personal preference.

When deciding the best trading style for you, there are several aspects to consider. What role does trading play in your life? If you are a part-time trader, trading is not your sole source of income. The markets, for part-time traders or investors, may be a hobby or a curiosity. It is likely you don't keep track of markets on an hourly basis, maybe not even daily. Your holding period is probably days or even weeks.

Trading styles for full-time traders will be determined on an individual basis. People that are more risk averse or those who have relatively low levels of trading capital or who simply prefer instant gratification will be more comfortable as day traders. People that can handle risk and are well capitalized may look at longer trends. These traders will hold trades longer and have larger trade objectives.

Beginning traders may fit into any trading style, of course — long term or short. No matter which, however, it's very important for new traders to outline their own trading rules and maintain that discipline, while discovering what trading style they have the greatest comfort with. That will help keep costs low during what can be a very long learning period.

Dear Slim:
Why does a market often move in the opposite direction of seemingly important economic (i.e., unemployment, GDP,

weekly API, etc.) or USDA reports (cattle or feed, monthly grain stocks, quarterly hogs and pigs, etc.)?

—Carol B., Wilmington, DE

Dear Carol:

Much of the data that make up economic numbers and agricultural reports are available well in advance of their release. Research companies and brokerage houses compile the data and offer their estimates in advance. Based on these estimates, markets often anticipate these reports. In anticipation of the number's actual release, many traders or investors have had the opportunity to position themselves, causing the market to move. Often, traders find that so many market participants have expected the news that no one is left to take them out of their positions. Consequently, the market goes in the opposite direction of the news as traders scramble to get out.

In recent days, it has been interesting watching how stocks react to earnings reports. The much slower economy has put huge pressure on corporate earnings. Recent events have forced corporations to be much more transparent and conservative with earnings. And stock analysts must be much more careful of overly bullish forecasts. The result has been the constant lowering of earnings expectations and a great increase in the number of sell ratings. Anticipating this reduced performance, investors pushed stocks down sharply. The result is that when a company makes or beats forecasts, the stocks are jumping upward as participants scramble to reverse their overly pessimistic stance. IBM recently exploded over 30 percent in a week when they "beat the street." Sounds like the opposite of what made the top in 2000.

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