
Ask Slim

By Steven Miller



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Dear Slim,

Love your column. You provide such good insight. My question is, how do market makers decide how much an at-the-money option (say a \$25 stock at a 25 strike price) should be priced at? I heard it was 10 percent of the stock's price plus a volatility factor, but apparently that's not correct. And why isn't the price the same for both calls and puts? What, if any, are the general guidelines to determining an option's basic value? And my main point of interest is how do they determine the spread between the bid and the ask, and why is it the spread can drastically change when the premium only changes ten or fifteen cents?

Can you recommend any books that discuss the role of the market makers, how they think and determine their pricing?

—Bruce, Lawndale, CA

Dear Bruce,

As Rosanne Rosanna Danna used to say, "Bruce, you ask alotta questions!" As I have discussed in this column in the past, the value the marketplace places on options comes through implied volatility. Notice, I did not say that the market makers have anything to do with pricing – they don't. The variables which make up this formula are interest rates, dividends, time left to expiration, current price and the historical volatility of the underlying security. The market makers who do trade off these valuations do so through computer printouts they get every morning that are created using this pricing model.

The part of your email that prompted me to include it in this column was about the price difference of at-the-money puts and calls of the same option class, strike price and expiration date. There are two main reasons for this discrepancy. The most obvious one is market sentiment. It is often the case, when the market is in free fall and stocks are hard to short, the supply of put options disappear. This adds an extra value into puts and makes them higher priced than the calls. This is somewhat unique to falling markets, as it is much more unusual for a rising market to move up in a panic.

The second reason for the price difference between like puts and calls is a bit more complex. Market makers can make money through a "stock loan" agreement. The market maker puts on a trade called a "reverse conversion" – short stock, long calls and short puts. The "delta" (change in price vs. stock) is zero, or no risk, other than the possibility of a dividend payment. The proceeds from the sale of short stock are used as collateral, and the holders of these funds pay interest to the clearing house, which pays a portion of this to the market maker. The nature of this arbitrage causes a higher valuation on the long side of this trade, the calls, than on puts. In the past, when interest rates were very high, this was very lucrative for market makers. Today, with interest rates incredibly low, stock loan pays very little. Thus, puts and calls are less affected and are valued at nearly equal prices.

The spread between the bid and ask on options is determined by the supply. At-the-money options with the closest expiration date, which are the favorite vehicle of most traders, have the most volume and the narrowest spreads. Options that are deep-in-the-

money or have expiration dates of many months out have the least interest and the widest spreads. Factors that may widen these spreads are an increase in market volatility or when the market gets very quiet. Generally, when the risk of trading goes up, the spreads go out.

Two books that cover the basics of option trading and valuation are *Option Market Making*, by Allen Jan Baird, and *Option Volatility & Pricing*, by Sheldon Natenberg.

Dear Slim,

I have never traded commodities before, but I plan to do so in the future. One thing that I do not understand is why brokerage houses charge commissions by contract instead of by trade. If I buy one futures contract of corn or ten futures contracts of corn, what is the difference? If I make the trade with a broker and the commission charge is say, \$35 for one contract, just what am I getting for the extra \$315? Is the broker doing any extra work by pushing a button with a ten on it instead of a one? The only answers I ever receive on this question are “that’s just the way we do it.” Perhaps you could give me a better explanation. Thanks in advance. —KGH, via-email

Dear KGH,

There are many components that make up the cost side of commissions. The clearing house for the exchange gets a per-contract fee for reconciling and guaranteeing the trade to both the buyer and the seller. The floor brokers, the persons that actually executes the trade if it’s done in the pit, gets a per-contract fee for their services. If executed online, Globex, a/c/e or whatever service gets an execution fee for each contract. The brokerage house maintains offices for brokers and handles the accounts of all its clients. This takes huge staffs and facilities with very significant costs. The brokers, themselves, have to get paid. And there are risks of errors all along the way. So, you see, there are many costs, and everyone involved has to make a profit, or there will be no incentive to provide these services. That’s why if you trade ten contracts, you pay ten times the commission of a single contract. If you are a larger trader, everyone offers a volume discount.

Commission levels have been under constant pressure for years. Full-service brokers used to get from \$50 to well over \$100 for each round-turn contract traded. Today these fees are often as low as \$20 a contract for broker-assisted and full-service, a bargain for the store of knowledge these professionals have worked to accumulate and pass on to their clients. Online fees can range from below \$7 round turn to over \$15. Pressures remain to lower rates, and there is even talk, I’ll guess to your delight, of a flat-fee commission. Don’t look for that to catch on too soon though. There are just too many pieces to the commission pie.

Dear Slim,

After you mentioned the *Profit Magic of Stock Transaction Timing* by J.M. Hurst, I bought the book, which I found

extremely interesting. Do you know of any software that uses his model? I’m quite curious to look further into these cyclical patterns. —Jackie G., via email

Dear Jackie,

I am quite pleased to hear that you and several others of my readers have bought this very insightful book. Many market participants believe in the “random walk” theory of trading. Through my nearly 25 years of studying market cycles, I have learned very differently. Through all the chaos, there are clearly very recognizable reoccurring time and price patterns. This book offers the basic as well as the advanced methods in practicing cyclical analysis.

There are many charting programs that include a cycle analysis tool. Usually, what these systems give you is an idealized cycle projection, based on the previous cycles. In other words, the program figures that the present cycle will look very much like the past cycles. That assumption, though often correct, can get you in trouble if you haven’t learned to sense when the market is doing something other than what the software predicted.

Cycles are naturally occurring events. Think of the changing seasons; you can count on them coming at their scheduled time each year. Get the skis polished in November, ‘cause you’ll be on the slopes in December...maybe. How many times can we remember winter coming on the calendar and waiting many weeks for the snows to come? There are other meteorological factors involved. The same thing happens in market cycles. The software may be predicting a bottom on the daily chart of a particular market, but it can be quite painful when that low comes three weeks later. Other tools must be used to give us a sense of what is occurring in the market and when our best entry evolves. Cyclical analysis is not a science. It is an art form. I do not use cyclical analysis software.

Hurst developed a multi-media course that offers in-depth training on these concepts (www.traderspress.com for \$295). I have held workshops on cyclical analysis and would love to hear, from my “Ask Slim” readers, if there is interest in another workshop on this subject in the near future.

If you want to try a system that offers cycle analysis and specific trades, look at well-known Mesa Software. I have not personally tried this software, though, and cannot vouch for its value.

Dear Slim,

It was a special delight having the opportunity to meet you at the International Traders Expo in Chicago in July. Please clarify the difference between open interest and volume, e.g., which of these two best represents a market’s liquidity? Also, please give me a good explanation of the distinction between a “stop” order and a “market-if-touched” order.

—Norman M., Farmington MI

Dear Norman,

“Open interest” is the term used to describe the total of all contracts that are held by market participants as longs or shorts in a particular futures or option contract at the end of each trading day. “Volume” is the number of shares or contracts traded in a specific stock, future or option in a given period. Under normal conditions, both of these market measurements are good indicators of liquidity. A large jump in volume or open interest due to dividend payment is usually temporary and has little meaning. An increase in these numbers due to a specific news event, however, can be very significant and often signals a trend in force.

A “stop” order is a contingency order that becomes a market order to buy or sell a specific quantity of a stock, a future or an option when a specific price is met or surpassed. A

“market-if-touched” (MIT) order is an order that becomes a market order to buy or sell when a specific trigger price is reached. These two types of orders do sound pretty much alike. However they have very different uses.

A stop order is used, in most cases, to ensure that a loss is limited to a specific price or dollar amount. If you are long, you are selling when a security falls to a predetermined price. An MIT order is normally used to take a profit. If you are long, and you wish to sell the security when it reaches a predetermined price, the security is sold at-the-market if it just touches that price. So, you see, stop orders are used with the direction of the market, and MIT orders are used counter to the direction of the market.

