

# 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,

Would you please explain the mechanics of "busting a trade" to this part-time trader? I understand that I can't have a trade busted because I don't like the way it turned out, but I have read of trades being busted and I'm not clear how and when this is done.

– Chet R., via email

Dear Chet,

If someone wants to bust a trade, be assured that an error is involved.

Here are a few examples: A broker incorrectly executes a trade, selling when he has a buy order, or executing a limit order at the market. A broker executes a trade that is outside of the current bid-ask. Or news comes out on a stock and trading is halted, and trades slip through at prices the exchange determines are invalid.

Busting the trade is easy if the error is caught before it is reported; the buying and selling broker just agree no trade has been made. If the trade was processed, both sides have to inform their "clearing house" that the trade is busted. If the trade is reported, the broker might have to eat an error to satisfy an irate client.

Dear Slim,

I read and enjoy your column and I find your answers very comprehensive. I am an aspiring hedge fund manager. I have been testing systems for the past few years and believe that I have found very sound, robust strategies. I am writing to you for your honest opinion on whether or not I should pursue this course.

Recently, I met with a fund of funds manager, who also runs hedge funds on his own, for advice and assistance in getting started. I presented my strategies to him. He told me the following: To make it in the hedge fund world, low drawdowns and small standard deviations were the key. Although the strategies I presented have a long history of significant market-beating returns, the drawdowns were in the 17-percent range on average. He felt that, despite strong returns, the historical drawdowns should be five to seven percent maximum, and investors, especially the big ones, care much more about volatility than absolute return.

Now I am in a quandary, as I do not want to alter the strategies. Is there a contingency of investors in the hedge fund world that would agree to suffer through drawdowns of about 14-17 percent in anticipation of higher returns, or am I fighting a losing battle? I appreciate your insight!

– Nathan, via email

Dear Nathan,

You have quite a distance to travel before you get to the place where you have anything to show to potential investors in your hedge fund. Assuming you get beyond the hurdles of fund formation and seed money, you can get to the business of building a track record. After you have a period of positive audited returns, then you can show your results to accredited investors and post on hedge fund websites.

Competition for investors is extraordinary, with thousands of hedge funds operating within countless models. Thus, sophisticated investors, while doing their "due diligence," look at many aspects of the fund, its general partner and the experience of the investment manager. Yes, they want low drawdowns, the measure of a losing period calculated from peak to trough, and a low standard deviation, the measure of range of returns. However, they also look at the "Sharpe ratio," which compares the portion of a fund's returns that are above risk-free type investments to its standard deviation. In addition, the "Sortino ratio" compares the returns that are above risk-free investments to the fund's downside standard deviation.

So, you can see that your fund is going to have to measure up to some tough standards to attract investments from large sophisticated investors. Investors want their capital safe, and they want good odds of getting above-average returns. What they *don't* want is volatility. Unless your returns are well above average and very consistent, your drawdowns of 17 percent are going to skew the numbers unfavorably, and growing the fund will be difficult. In trader

language, hedge fund investors do not want their money with someone who eats like a bird and dumps like an elephant.

*Dear Slim,*

*On expiration day, many deep-in-the-money options still have open interest. I also notice that, day after day, there is not any volume on those options before expiration. Why would someone hold an option that long and lose that profit? Do they actually expire worthless due to no volume?*

*– Mark M., via email*

Dear Mark,

As options get deep in the money, because of their higher price, there is less demand. Scalpers would rather trade cheaper options. Speculators will liquidate to lock in profits as the options move up, or they will roll down to lower-priced options. Sophisticated traders may hold deep-in-the-money positions on spreads or hedge strategies, and to maximize profit will exit through exercise or assignment on expiration. Thus, for all of these reasons, as an option price increases, volume and open interest decline.

If an option gets very high priced – and essentially has stopped trading – you do not lose all your money. For example, if XYZ is trading at 68, and you are long the December 60 calls at expiration, they have an *intrinsic* value of eight points. You can either sell the calls in the market to exit, or you can exercise the option, which will give you the stock at a price of 60, and then sell the stock at 68 to get out of the position with the same eight-point equity.

For yourself, or for readers who may just be getting started with

these concepts, please read some of the many primers on listed options before you start to trade with real money.


*Dear Slim:*

*I don't trade any futures; I only buy puts or calls on individual stocks or indexes as extraordinary opportunities present themselves, primarily using Elliott Wave and stochastics, together with trendlines. I don't have a lot of time for fancy strategies or day trading. Am I too obsolete for the options market, or is this workable for five to six trades per year?*

*– Dale S., via email*

Dear Dale,

In my judgment, there are four essential elements to chart analysis. One is a study that gives you a perspective of the trend, such as a trendline or momentum measurement. Second is a tool that identifies the condition of the security to get a sense of when it is overbought or oversold or when the trend is changing. Examples are oscillators like stochastics, Wilder RSI and commodity channel index (CCI). Also, moving average crossovers and moving average convergence/divergence (MACD) are helpful. The next key element is chart-pattern recognition. You should be able to identify the basic patterns like head and shoulders, flags and gaps, and candlestick patterns. The final aspect is one that most traders omit, a tool that measures time. I use cycle studies, and spend endless hours counting repeating time periods on charts. Elliott Wave, the study you use, is very similar and, for many, equally as effective as cycles. Your combination of analytical tools has most of this covered. When chart analysis gets a little more complicated, it tends to get a lot more confusing. **SFO**



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