

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,

It seems that at the beginning of each quarter the entire FOMC team pans out across the U.S. to give speeches about the economy. More than ever it seems to have an impact on the market. This week (early September) it's been pretty negative, as all have warned of rate increases for the foreseeable future. My question is two-fold. First, is this a quarterly event starting at the beginning of each quarter? If so, I can plan around that week. And second, are the members of the FOMC regulated or controlled in any way in their message? It is very frustrating to lose a week of trading because these guys are out and about.

—Anonymous

Dear Reader,

This is truly a time when FOMC members are quite effusive, and in my experience, this is not a typical quarterly event. In fact, with soaring energy costs, elevated home prices, frequent natural disasters and Chairman Greenspan about to retire, this is a very rare time indeed. I think the increased "Fed speak" was meant to assure us that under a new leader they will remain a cohesive entity. It's also to soften the blow of higher interest rates ahead. If the stock market wasn't ready to go down anyway, all of the chatter wouldn't have had much effect. Come January, when Ben Bernanke, Chief Economic Advisor to President Bush, replaces Alan Greenspan, Fed members will be tighter-lipped once again. **[Editor's note: See David Silverman's article on Greenspan's legacy in this issue.]**

Dear Slim,

I am an active options trader, mostly using credit spreads as my strategy of choice. As I write to you, the VIX is hitting a five-month high over 16. With volatility coming back into the market, I am looking to expand my option trading strategy arsenal to include more aggressive option spreading strategies. I have heard that ratio "back spreads" are a good choice when looking for an aggressive move in the underlying security. Before I try one out, I would appreciate your professional opinion on what exactly this strategy is and how I can set it up to effectively take advantage of market volatility.

—Peter S., via e-mail

Dear Peter,

A back spread is a delta-neutral option strategy in which you buy more options than you sell. The buy side is usually out-of-the-money, and the sell side is usually near or in-the-money. The nature of the spread requires that you buy more premium than you take in. Thus, it is advantageous to enter these spreads when implied volatility is low.

The question is: When is volatility low? For years, the VIX – the CBOE Volatility Index – traded between 20 and 50. For the past couple of years, as markets went into the tightest range in a decade, the index has traded between 12 and 20, once dipping near 10. Hence, even if you entered back spreads in this environment of extremely low implied volatility, you probably struggled to make a profit.

Once the stock market moves out of this range, back spreads again will offer an excellent opportunity to make money in options without taking excessive risk. And yes, at this time (mid-October), with the stock market in a steep slide, that just might be happening.

Dear Slim,

How could Kmart get away with a five-billion-dollar swindle in a pseudo-bankruptcy, wiping out all old shares of Kmart stock and reissuing closely monitored new stock? Where is the SEC?

Thank you for your help.

—R.N. Jordan, via fax

Dear R.N.

I'm sure there are quite a number of "old" Kmart shareholders asking the same question, disgusted as they empty-handedly watched the new stock soar well over \$100 a share. First, I'll share a little history.

Kmart was born in 1899 as the S.S. Kresge Co. It became a public company in 1918. In 1966, it had more than 900 stores, including 162 Kmarts, topping \$1 billion in sales. In 1977, the company officially changed its name to Kmart. Through the '80s and early '90s, Kmart went on an acquisition binge, buying Walden Books, Home Centers of America, The Sports Authority, OfficeMax and Borders. Then just a few years later, choking on all of the buyouts and reeling from competition, Kmart spun off or sold all of these companies. In January 2002, with 2,100 stores in operation, it filed for Chapter 11. After 18 months, closing 600 stores and securing a \$2 billion loan, Kmart emerged from bankruptcy. The company's "old" shares, then trading on the Pink Sheets, ceased to exist, and the new shares were issued. Barely a year after coming out of bankruptcy, Kmart bought Sears for more than \$11 billion.

How did the shareholders, who held on bravely (I'm being nice), get such a bad deal? There is a principle used in bankruptcy called "The Absolute Priority Rule." It says that "a senior class of creditors must receive full payment before a junior class receives anything at all." Furthermore, "no class of equity securities may receive any payment until all creditors and senior equity security holders have been paid in full."

What happened was that some very savvy investors came and bought up Kmart's bonds for pennies on the buck and then helped them secure the \$2 billion loan. In accordance with the above law, the deal was that in order for Kmart to come out of bankruptcy, the infusion of cash and proceeds from new shares were to be used to satisfy the old debt. Old share holders, in their junior position, got nothing. The investors in the seemingly worthless bonds, however, who saw the store of value in the huge real estate holdings and some \$24 billion in sales, made many times their money.

Of course, there were lawsuits. Kmart's trouble, however, was that it happened to run into Wal-Mart and Target, companies with which it is very hard to compete. The courts ruled that there was no fraud and therefore, no case. Simply, the company was run by inept (ousted) management.

Born out of the bankruptcy was a new, leaner Kmart. Operating profitably, the new management saw a similar opportunity in Sears, another company with huge sales and massive real estate holdings. The combined companies, with more than \$50 billion in sales and 3,500 stores, is Sears Holdings, symbol SHLD. By the way, we had six months to buy this stock under 30 before it took off for five-fold gains. ■

This Article was printed in the December 2005 issue of SFO Magazine.



SEND ME YOUR
QUESTIONS!
AskSlim@sfomag.com or
Ask Slim
SFO magazine
3812 Cedar Heights Drive
Cedar Falls, IA 50613

SFO Stocks Futures & Options

Provided by permission of SFO Magazine. Originally published December 2005.
© 2005 Wasendorf & Associates, Inc. • 3812 Cedar Heights Drive • Cedar Falls, IA 50613