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,
Maybe you could help my confusion by answering a few questions pertaining to trading. While watching the ticker on CNBC pre-opening, I note most trades are in the hundreds of shares. After the opening, I note the trades are predominantly in the tens of thousands per trade. Then, when I access a Level 2 time and sales ticker, even after opening, I note, once again, predominantly trades in the hundreds of shares with no sign of those big trades.

If I am looking at Level 2 and see a market maker showing 100s @ $20.05 (for example), what is the impact of all of those big shares that are not showing up on my trading screen? Does it have any effect at all on the bid/ask? Would that volume not move the stock price, even if no trades are currently showing up on my screen?
–Ron P., via e-mail

Dear Ron,
During an active business day with hundreds of thousands of transactions made on the exchanges, it is impossible for all of the trades to hit the ticker tapes. Therefore, tapes selectively choose the trades that are seen scrolling at the bottom of the screen, based on specific criteria, including how widely a stock is held. Also, the type of information displayed will change, depending on how active the markets are at that moment. If it is very busy, the tape may only show stocks that are actively traded or blocks of 10,000 shares or more. During pre-market or after-hours trading or when markets are very slow, the tape will show a much higher percentage of the trades.

When a brokerage house gets a large order, they can trade it with other brokerage houses through "electronic communications networks" (ECNs). This often is the source of blocks that appear to be the phantom trades that show up on the tape. Though you may not see the trade go by on your screen, it does show up in the volume. It is an excellent system, which allows a large number of shares to be traded without greatly affecting the market.

Hi Slim,
Can you give me any info on Wolfe Wave Software? Is it user-friendly? How accurate is it? Is it worth the price? If you know nothing about the software, would you know someone who has tried it? Any info you can give me would be greatly appreciated.
Thank You,
–Larry G., via e-mail

Dear Larry,
Wolfe Wave is not trading software. It is a trading methodology that identifies the rhythms of the markets by determining key high and low price points achieved in five wave counts. The premise is that after the completion of the five-wave pattern, the market is in a state of imbalance, which sets up a reactionary price motion. Plotting this information on a chart sets up "target lines" that project the time and price of the subsequent move as the market seeks equilibrium. Though the methodology uses counts similar to Elliott Wave, it applies the information differently.

There is a course available. After you sign up, you will receive a 35-page manual and ten days of instructional faxes that can help the student through the complexities and the nuances of the method. For information on pricing, extensive details of the course, testimonials and other questions, go to www.wolfewave.com. I have not taken the course and cannot comment on its merit or value.

Hi Slim,
My interests are in options trading. I had been doing short puts (evolved from covered calls) on equities, and overall I am ahead despite several large losers. I've evolved into credit spreads and some iron condors. I'm getting hurt this month (November 2004) by the surprising non-stop rise of the market nine days in a row.

I'm evaluating my loss management strategy. I've been very good at not risking more than a specific percentage of trading capital on any one trade, but not paying enough attention to the loss on a trade as compared to the reward. In some cases, I've allowed losses of four times the maximum possible profit. In my readings, some say don't risk more than $1 to make $2, others say don't allow a loss to exceed the maximum profit.

Thus, I'm fine-tuning my system and have a couple of questions (for the veteran):

1. *Risk: What do you think is a reasonable risk/reward on credit spreads?*
2. *Adjusting: I allow pretty good protection zones. But sometimes the markets or underlying securities move more than I had expected. I can close for a loss or can roll out to a further strike. I don't like to roll to another month because I don't want to extend a bad trade. What considerations do you make in deciding to roll out to a further strike on a credit spread?*
3. *When to act: I have been allowing trades to get to the breakeven level before closing or adjusting them. This approach allows more time for the trade to correct. However, if the trade moves against me quickly, it can be very expensive to close at the breakeven level on the underlying security. If I take an approach such as closing the trade when the loss equals the maximum profit, then I would have many more losers (albeit smaller ones) and close trades that potentially could become winners. What thoughts do you have on this?*

--Brooks, via e-mail

Dear Brooks,

The beauty of trading credit spreads, like verticals and condors, is that you have limited risk. The danger, as you have experienced, is that you can still lose all the money you risked. If you have several of these trades on at once, and they all go bad, it can be quite costly. For vertical bull and bear spreads, I like to use a minimum risk/reward of 1:1 and often look for 4:1. Condors can be as low as 1:4, but only if both sides are far out-of-the-money and you are experienced enough to react quickly to a problem.

So when do you have a problem with these types of positions? Most traders look at the position much like you have described; it's a problem when the security gets to a level that would be breakeven at expiration. I prefer to add in technical analysis. For example, I only do a bear vertical spread on a stock that my analysis says is negative, rather than to place the trade only because the dollar-value risk/reward seems attractive. Then I use the stop points on the chart to tell me if I am in trouble on the spread. Thus, if the analysis on the stock changes, I'm out of the spread. I only roll a spread when expiration is going to take me out and I want to stay in the strategy. Never roll a problem!

For active traders who may have several credit spreads on at one time, I think it is important to keep overall market bias near neutral or slightly directed with market trend. Then the risk of getting caught in a market that goes for many days in one direction is greatly reduced. Work to find a balance in your bull and bear credit spreads, and you'll find it much easier to stay out of trouble and let option decay work for you. SFO

SEND ME YOUR
QUESTIONS!
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