

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,

I have traded condors and am trying to utilize butterfly spreads more often, as I prefer the risk/reward characteristics of this option strategy. Is it better to leg into them rather than to enter all sides at once? If so, is it better to do the bull portion or the bear portion first?

Assuming I'm doing a call butterfly, it seems that if I am expecting a small pullback, I should put on the bear call side first. If correct, the decrease in the stock will offset the cost of the spread, as the bear spread will make some money and the bull spread will be cheaper to buy.
-Chris Kemp, via email

Dear Chris,

For clarity, a "butterfly spread" is a neutral option strategy that is made up of four option trades, using three different strike prices in the same month. To buy the spread (most common), you sell the middle strike and buy the "wings." Essentially, you are entering two vertical spreads: a bull and a bear spread.

Maximum profit on a butterfly comes when the underlying security closes right at the middle strike price on expiration day. Then the bull spread portion closes at the maximum value and the bear spread closes worthless.

Your assumption is correct, Chris. It may be advantageous to "leg" into the spread by placing one of the vertical spreads first and then, on a favorable move in the stock, placing the opposing vertical. What if the move doesn't come? You might be stuck in a losing spread when you wanted to be neutral.

I suggest only legging into butterfly spreads when your short-term analysis justifies having only one side of the spread, and that you set an appropriate time parameter to complete the spread.

For example, if your analysis gives you a negative technical signal, you place the bearish vertical. If that downside movement doesn't come within your expected timeframe, say one or two days, then you either complete the butterfly at that slightly disadvantageous price or take a loss on the first half. If it works out to have taken the leg, you're in good shape to complete the spread or just take the profit.

Dear Slim,

Crude oil had a huge correction last year, as did natural gas. What is your opinion of the energy markets for the coming year?

-Rebecca L., Dallas, via email

Dear Rebecca,

Yes, energies did fall sharply off of their highs last year. Crude oil dropped from near \$80 a barrel to around \$55 and natural gas plunged from its high near \$16 in December of 2005 to near \$4 in September of 2006.

Technically, favorable weather and growing inventories took a toll on these markets. Crude had a normal correction. The drop in natural gas was brutal, wiping out a major fund.

For 2007, I think the biggest factor for the energy markets will be the Iran situation. This country will have to be confronted, as they blatantly threaten Israel ("Small Satan") and the United States ("Big Satan"). They cannot be allowed to develop nuclear weapons. U.N. sanctions will probably do nothing, as Russia and China have huge energy deals with Iran and are not likely to be strict enforcers.

If we don't stop Iran, Israel will. This was clearly stated by Benjamin Netanyahu, Israel's past and possibly future Prime Minister. Israel will stand by its "never again" creed. Iran's first responses will be to attack Israel, block the Straights of Hormuz and attempt to destroy the oil infrastructure in the region.

If this doesn't play out in 2007, energy markets should be range bound, with crude trading between the low 50s and high 60s. If the Iran situation is dealt with, crude oil could spike to \$100, \$150 or more.

Dear Slim,

I am glad to see that you are continuing to give great advice in SFO! Please give me your opinion of a trading plan that I have begun to use.

What I have been doing is selling puts, slightly in the money, four months out. Ideally, with four months to expiration, the stocks would rise and the puts would expire worthless. That has happened. However, a few options have been put to me. So now I own the stock, which is okay because now I can collect the quarterly dividends as I look for opportunities to write

calls against the stock. I plan on writing calls, four months out, at the same strike or higher as the puts that were called.

Is this a sound strategy? Are there any precautions I should take, or any suggestions you could make to improve the strategy?
-Kevin G. via email

Dear Kevin,

I do like this strategy, especially for a market participant with a longer-term perspective than a day or swing trader. Yes, I do have precautions to offer.

First, these trades should be in stocks that you are willing to own, based on your analysis of the charts or of the company. Then, for proper risk management, your unit size for these trades should be the same as the number of shares of the underlying stock that you are willing to own, in case the stock is put to you or the trade goes against you. So, if your account value and risk tolerance will have you own a maximum of 500 shares of a company, sell five naked puts. Also, based on implied volatilities, you might consider selling puts only two months out, rolling the positions more often.

If you do end up taking delivery on the stock, writing calls may give you income and downside protection. However, you still must apply

proper risk management to these stock positions. So set downside loss limits or place stop-loss orders.

Dear Slim,

What would be your recommendation on a book for a novice stock investor wanting to learn more about fundamental and technical analysis? There are so many books and services available.

-Greg L., via email

Dear Greg,

Technical analysis is used to predict the price movement of a security based on charts and statistics. Fundamental analysis uses the financial information and underlying nature of the company to predict stock price.

These two analytical methods are so different that there are only a limited number of books to be found that cover both. One highly-rated book like this is *Stock Investing for Everyone* by Arshad Kahn and Vaqar Zuberi.

Because I have a strong technical bias, I still think John Murphy's book, *Technical Analysis of the Financial Markets*, is the best around for traders at all levels. ■

This Article was printed in the February 2007 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 February 2007.
© 2007 Wasendorf & Associates, Inc. • 3812 Cedar Heights Drive • Cedar Falls, IA 50613