

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 a question about prices on the E-mini. I have noticed over the last 6 months that the prices shift. In other words, the original high was 1657.75; it is now 1654.75, and it kept sliding down by a point every so often. The same thing is happening with the low. Why?

—Dennis H A., Island, WA

Dear Dennis,

I can see how this may be confusing. There are several ways that a quote system may show the high and low of a contract. The obvious and expected way is to show the real high and low as it was traded at the time. However, some vendors use the "life-of-contract" high and low, which only reflects the presently traded front-month contract. Some reflect the high and low from a continuous chart, which is created by overlaying the presently traded front-month contract over previously expired contracts. Still others may reflect only the past 12 months. So you can see why these statistics can be in flux.

For all of the stock index futures, I suggest using the cash indices as your guide to specific data points. Make sure your data vendors are supplying information that goes back at least through the past major market cycles. Today, that would be at least four years.

Dear Slim:

I know that a credit spread in options involves the simultaneous buying and selling of calls or puts that expire at the same time but have different strike prices. Are there any cautions you would offer in this strategy?

—Grant D., Sturbridge, MA

Dear Grant,

The greatest risk in this strategy is in early assignment. Let's say you are short a vertical (credit) spread in XYZ stock, and the stock has a very sharp rally. At this point, the spread has widened and you've suffered nearly your maximum loss. The short side of the spread has gone deep-in-the-money and is trading at its intrinsic value (no premium). Because equity options trade American style, exercisable any time before expiration, you may get assigned early.

Your position, which seemed relatively innocent, may now have become a problem. You would now be long calls and short stock. The risks at this point are that the stock is on a "do not short" list which means the stock cannot be borrowed, it might be going ex-dividend, which means you will have to pay the dividend, or the position is subject to margin. In any of these cases, you will be forced to look at covering the short stock position and either shorting a different call or selling out your long calls. This will either add costs to your original trade or take you out of it completely, with no chance of recovering your losses. A put credit spread has similar risks of early assignment.

Some index options have even a greater risk. Let's assume you are short a call vertical in OEX and it goes deep-in-the-money. If some bad news comes out around the market's close you might get assigned on your short calls. In this case, the options settle for cash, meaning you are taken out of your short calls at the settlement price of the OEX index, and left with only your long calls. Again, what seemed like a relatively safe position now might become a nightmare. If the market opens sharply lower the following day, you would get blindsided and lose well beyond your anticipated maximum risk. Note that this risk does not exist in S&P 500 options on the Chicago Mercantile Exchange, which are European style and can only be exercised on expiration day.

These risks aside, credit spreads are still one of the safest ways to trade. You just need to react and adjust your positions when they go against you, and the threat of early assignment exists.

Dear Slim:

Though the DJIA is the best-known index due to its public persona, the S&P 500 is the benchmark used by institutional investors against which to measure their performance. Both have

futures contracts based on these indices. I know that both contracts are liquid enough, but is one of them a better contract to trade? Or is it a matter of choice?

—Jeff T., Forest Hills, NY

Dear Jeff,

Although these two stock market indexes equally offer a broad representation of corporate America, there is a vast difference in their representative futures contracts. While trading the S&P futures market has exploded, the comparative growth in DOW futures has been modest. If you are a large speculator, institutional trader or an arbitrageur, you will most certainly be drawn to the incredibly deep and tight markets of S&P futures or E-minis. A smaller trader, who trades one to 50 lots, could certainly trade the DJ futures with little liquidity risk. I have traded both of these markets extensively. My choice most certainly goes to S&Ps.

Stock Market Predictions for 2004:

In the January 2003 issue, in response to a reader's question, I gave my stock market prediction for the coming year. So now is the time to own up to my misses and celebrate where I hit the mark. The following is reprinted from that issue:

"I strongly believe that 2003 will be a good year for the stock market. The combination of a slow-growing economy, low interest rates and reduced pressures from geopolitical issues will be the perfect setup for this "Bull Hook." Though I expect the market to be very volatile, especially if we go to war or there is another (heaven forbid) terrorist attack, the intermediate trend should remain up. I'll go out on a limb. I'll predict a low in the DJIA of 8250 (early in the year) and a high of 9700 (sometime in the fall). Enjoy it while it lasts. The year 2004 should resume the secular bear market."

So how did I do? The closing low in the DJIA was actually 7552. I underestimated the effects of the war in Iraq by quite a bit. I was correct as to the timing of the low, which came on March 12. As of this writing, the high on the DJIA, which was made in mid-October, was 9800. I'd score that a near bull's-eye. Overall, I'd say I did really well. Anyone who bought in the spring certainly had a huge ride up.

So let's see if I can get close to last year's success. The following are my predictions for the stock market for 2004.

I expect the stock market to paint nearly a mirror image of last year. The rally should continue well into the late spring of 2004, with the DJIA topping out in the area of 10,150. Then the secular bear market will sink its teeth deep into this mini-bull. By the fall, the market will be well on its way back down, with an expected low of 8540 occurring in October or November. So what's up with all this negativity? This year I'll include the basis for my predictions.

The History

In the past century, the stock market has had two full cycles of secular bull markets followed by secular bear markets. The first began with the "panic of 1907," which was brought on by a falling economy that caused a "run on the banks." The bull market that ensued lasted 21 years to the peak made in 1929, gaining nearly 400 percent. The following secular bear market lasted for 14 years, with the market

giving up 88 percent at its worst level. There were three major rallies in this period that certainly looked like bull markets, with each one surrendering its gains in dramatic fashion.

The next secular bull began in 1943 and topped out in 1966, a 23-year run, with the DJIA achieving 11 times its starting level. The secular bear market that followed lasted 16 years, from 1966 to 1982, with the market giving up 46 percent from peak to trough. In this period there were four mini-bulls, again with each one ending with a big bad bear.

The cycle we're presently in began in 1982, with the DJIA at 780. The rally, as we surely know, topped out in the 1st quarter of 2000, with the DOW gaining a whopping 1400 percent. So far, this bear is just 3½-years old, with possibly a decade left to go. Presently, the market is 14 months off the major low. Based on the historical length of around 18 months for rallies that occur within a secular bear market, this one has little more than four to six months left to live; thus my expectation of a spring high in 2004.

The Technicals

The 2003 stock market low was made with an inverted "head and shoulders" pattern that appears clearly on a weekly chart of the S&P 500 index. The upside measurement for this pattern is at around 1130. Also, the 50-percent Fibonacci retracement level clusters with other major resistance at around 1160 on the S&P 500. Coinciding with these numbers is the Fib 61.8-percent resistance level on the DJIA at 10,120; hence, my anticipated high in the DOW at 10,150. My prediction of 8540 on the low would be the major support if my high was met. **SFO**



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QUESTIONS!
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