Ask Slim

By Steven Miller

Stocks Futures & Options

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Dear Slim:
I'm a CTA who has a question concerning the liquidity of the E-mini S&P contract. Assuming that it is a normal volume day of trading, (and I know that trading volume varies throughout the day) what do you think is the greatest number of contracts that can be traded without adversely affecting fills? My entries are on stop-limit orders, and I'm looking to capture 3-4 point moves.

—Todd W., via e-mail

Dear Todd,
The growth of the E-mini S&P contract has been truly amazing. In just a few years, the volume in this contract has increased some 20-fold. Very often the bid or ask is in excess of 1,000 contracts. Additionally, if you look at the depth of the market, much of the time there are 500 to 800 contracts on the bid and offer every quarter of a point in either direction. The E-mini S&P market is truly one of the best markets I have ever seen.

A large factor in the growth of the E-mini contract has been the huge attraction to arbitrageurs. These nimble traders work both the pit and the E-mini markets, trying to capture a minuscule edge in one contract and hedging in the other one. This can be deceptive, however, to traders like us. As arb opportunities disappear, these orders are cancelled, literally, at lightning speed. So what looks like a solid bid or offer disappears without really getting traded. Nonetheless, these markets can handle very good-sized orders. Under existing conditions, the E-mini market can handle trades of many hundreds of contracts without moving the market.

Your method of entering this market with a stop-limit order has merit. It removes the risk that exists with a regular stop order of getting caught in a void and getting a really bad fill. Of course, with a stop-limit, you could miss the trade. By the nature of your question, another point comes to mind. Your choice of this type of order to enter the market suggests a specific methodology. It is highly likely that the market has already had a significant move to get to the chart point that has given you a buy or sell signal. It means that if the market does not continue its momentum and meet your objective of 3 to 4 points rather quickly, you're susceptible to sitting through a retracement. With this method, I suggest a tight time parameter along with your regular loss limit.

Dear Slim:
In an issue earlier in the year, in response to a question, you outlined your trading hardware. In the article, you indicated you use a "Dell Inspiron 800 laptop." I need to replace my laptop, and I would like the functionality of a dual monitor set up like you referenced in your article. I can't find an 800 model on Dell's website. Perhaps there was a typo in the article? I would appreciate it if you could please confirm the exact model of your laptop. Also, have you since become aware of any other laptops that provide that functionality? (I know my older Dell laptop doesn't.)

Keep up the good work and great advice. —Jason, via e-mail

Dear Jason,
You are correct! My answer to the question you are referring to in

the January 2003 issue of SFO, regarding my computer hardware, did contain a typo. I said I use a Dell Inspiron 800 laptop. Actually, it is a Dell Inspiron 8000 laptop.

The functionality that is unique to this top-end Dell laptop is the ability to add a second monitor that extends the desktop on the laptop's LCD to the second screen. Most laptops offer the ability to add an additional monitor. However, the second screen mirrors the LCD on the laptop, offering no additional workspace.

The current Dell laptop with this function is the Dell Inspiron 8500. The basic model offers an Intel Pentium 4, 2.0 GHz processor, with a 40 gig hard drive and 256 MB RAM. The base price is about $1,500. If you look online, there are usually free upgrades and an online discount. Of course, this basic model is much more computer for the money than I got two years ago. It will be best to call and order by phone so you can ask the salesperson to verify that the computer comes with the "extended desktop" video card. Many of their sales staff does not know about this functionality. If you get a weird reaction to your request, ask them to check with a manager.

Also, Dell offers three-year in-home service. Take it! I had my LCD screen go bad three times in the last two years. Their tech was here with a new screen within a day each time. To a trader, the only thing more frustrating than a losing streak is tech problems.

Dear Slim:

In flipping through some back issues of SFO, I have found some very informative articles. Although it appeared a while back, I found the article, "Fibonacci Clusters and the Power of Confluence," in the March 2002 issue to be very interesting and detailed. I find these numbers to be very fascinating, particularly how they occur almost naturally. Is there an exact formula that is used to figure these clusters?

—Dean R., via e-mail

Dear Dean,

Bernard Mitchell's article on "Fibonacci Clusters" indeed was very interesting and quite complex. Mitchell states that the normal .382, .50 and .618 retracements are not "accurate" enough when determining support and resistance. So, using the 89-bar moving average, he first determines the underlying trend. Then support or resistance levels are identified using the Fibonacci retracement levels from high and low points and swing points (minor reaction levels within the trend). This gives additional data points. When the data from the different trends line up, it creates a "cluster," offering a more powerful support or resistance level. That's about as formulaic as it gets. I use this method often and find it to be a great tool! Fibonacci cluster software can be found online at www.feargreed.com/cluster.htm. I have not personally tried this software.

Dear Slim:

I've started to take an interest in options trading. In reading about the role of market makers, I was curious as to how market makers hedge their trades? How do they make their money? If they are correct, must we be wrong? What risks do they take?

—Ron M., via e-mail

Dear Ron,

The role of an option market maker is to facilitate a fair and orderly market in the pits of the options floors. That means that this person is obligated to make a two-sided market; thus, they're always quoting a bid and ask price. The number of market makers in a pit can vary from just a few to upwards of a hundred, depending on the volume in the pit. Market makers can either trade solely for their own account or work for a group called a DPM (Designated Primary Market Maker). Market makers trade competitively against one another, creating depth in the marketplace.

Market makers profit in several ways. Some of these traders are "scalpers," who try to buy on the bid or sell on the offer and then quickly exit the trade for a very small profit. Others get the same "edge" and then take the trades into their inventory, using other options or the underlying stock or index future to hedge the position and stay in a market-neutral condition. These traders can either profit by changes in implied volatility, by allowing option decay (theta) to work in their favor or by trading out of the spread positions profitably when opposing orders come into the pit.

Market makers do take risk. If the underlying security is moving quickly, and their bias (delta) is in the wrong direction, they might not be able to adjust their position easily. Also, they can lose if they are on the wrong side of a change in implied volatility. Some market makers like to play option's decay by holding naked short positions in puts or calls. However, they can get in trouble when the underlying security moves up or down very quickly. I knew traders that made $50,000 to $100,000 every expiration day by writing thousands of naked out-of-the-money options. When the markets became much more volatile in the late '80s, many of them were blown away, and their day was over.

Option trading is a finite game, meaning the sum of all wins equals the sum of all losses. That does not mean that just because the average market maker makes money, you have to lose trading options. These markets are just too huge to be concerned with that. Stick to what you know works for you and don't worry about the pros.

Dear Slim:

First, I love your monthly article; it's usually the first thing I read.

On page 135 of the April 2003 issue, you address an issue from Stewart M., in San Diego. I seem to be in the same position as this guy – not making money yet and not wanting to return to being a self-employed marketing consultant or to the corporate world (working for someone else). I didn't understand what you meant by the last sentence: "... In your case, until you accept that you someday may again paint houses, it's likely the fear of it will keep you from succeeding in trading."

I don't understand how that fear will hold him back as a trader. I thought it would give him the incentive to work hard at becoming a successful trader. Please explain.

—Paul, via e-mail

Dear Paul,

I judge the goal of success is incentive enough to work hard and succeed in any business. And, yes, many times fear provides fuel to drive forward and conquer. In my experience, negative reinforcement does not work for traders. Trading is loaded with traps that can trigger a person into an emotional reaction. There are few vocations where having things go wrong is a way of life. As a trader, assuming we're executing our method correctly, even if we're wrong 40 percent of the time, we're going to make money overall. If you're a doctor or an architect, just make one mistake and you could be finished.

In Stewart M.'s case, when a trade goes bad, he is in a "lose-lose" situation. If he stays with a bad trade, he loses because he breaks his discipline, allowing for the possibility that the trade will get worse. If he gets out of the trade, he believes he loses because he feels he doesn't have the chance for the trade to come back, therefore booking the loss and bringing him a step closer to going back to house painting. So he hangs on to bad trades, hoping. A similar thing happens with a winning trade. He gets out quickly on the first threat that the trade is about to turn on him, minimizing his winners. So he's stuck! It's a losing paradigm that brings big losers and small winners. It's a trader's common malaise.

Magic comes when a trader discovers there is a win in losing. If Stewart gets out of the losing trade appropriately, he's following discipline and minimizing losses. It's a win and something to feel good about! If the loss on the trade threatens his trading capital, the win is realizing that he will survive and is in control of his own life. He has the choice to go back to house painting, in which he made a good living, or can he can do anything he wants. Again, no matter what, he will survive. Trading from that place takes him out of the fear paradigm, which makes him constantly feel threatened. Then he'll see the markets much more clearly and trade appropriately. At last, success will be within his (your) grasp.

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