
Ask Slim

By Steven Miller



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Dear Slim,

I read your excellent article, where you described your trading style as a “witches brew.” I have been trading with the same mix of indicators, but I have a recurring problem. For example, I’m trading e-Mini S&Ps with one-minute charting intervals. The RSI and Stochastics get overbought and the candles also say sell. My problem is the indicators stay overbought, and I get stopped out or take a big loss because I keep selling into the buyers thinking that the market is going to come down soon. However, it never does when the trend is strong. How do you deal with this? What can I do to overcome this problem?

– Alice L., West New York, New Jersey

Dear Alice,

There are two parts to this answer. First, you are trading S&P futures using one-minute charts. That, in itself, describes a very short holding period. A one-minute chart gives an incredibly narrow perspective of the market. Even a three-minute chart does little to filter the “noise” out of the market. Also, the shorter the period, the more likely oscillating studies like Stochastics, RSI or CCI charts will stay overbought or oversold for relatively long periods of time. A five-minute S&P Stochastics chart normally will oscillate to overbought and oversold several times in a seven-hour day in which the futures are pit-traded. Additionally, for day traders, the 15-minute chart can give a good indication of the primary trend for the day. My suggestion is that you lengthen out your time horizon. For a very active day trader, a five-minute chart may be short enough. It will help slow you down and lessen the likelihood of overtrading.

Second, you say that when the indicators get overbought, you “keep selling into the buyers, thinking the market will come down soon. However, it never does when the trend is strong.” What a telling statement! It highlights the importance of keeping your trading “with the trend.” A one-minute chart can get overbought and still be an hour behind the five-minute chart doing the same and, then, giving a sell signal. We’ve all seen S&Ps jump ten points in well under an hour. That’s why I stress the importance of looking at charts of longer periods to identify the trend. Then use the shorter-period charts for entries and exits. In the case you’re describing, under a majority of conditions, the market is in a rising mode. When the market is doing this, it’s sensible and safer to go from flat to long, to longer, then back to flat. That may mean passing on the short-side trades when the market is overbought.

Chart studies are tools. Their actions may have different meanings than the obvious. When a chart becomes overbought or oversold and stays there, it is likely saying that momentum is strongly in that direction. Use charts intuitively rather than mechanically. Listen to your inner voice. When you sense the momentum, use it to your advantage. Don’t try to outsmart the forces of the market. This is where discipline comes in. It’s easy to say the market is overbought or oversold. It’s harder to keep your positions in the direction of that momentum in the face of market wiggles. It’s even harder to pass on the trades that seem obvious, like shorting into an overbought situation. Some of my best trades are the ones I never made.

Dear Slim,

Many markets are exhibiting sideways behavior, and I realize that this may be a hard time in which to trade profitably. However, I am just beginning to trade stock index futures and would consider myself to be fairly conservative at this stage of the process. Also, I don't want to be in and out of the market so frequently that I build up huge commissions. I would like your opinion regarding the best times of the day to day trade without emotion or the emotion arising from news entering into play.

– Daniel V., via e-mail

Dear Daniel,

I disagree with your statement that markets are “exhibiting sideways behavior.” This year alone, the S&P 500 had a 65-point rally in January, a 145-point crack into March and then another 130-point rally. I'd say that is volatility! On a monthly chart, the market does look like it's moving sideways. Is that what you're looking at? I get a sense you are a day-trader wannabe who is operating in a long-term paradigm. So your first challenge is recalibrating yourself to a shorter perspective. Do that by focusing on daily and intraday studies. Then work on a method and risk parameters that help remove some of the emotion from your trading.

Regarding your question on how to avoid the emotion from news coming into play; most of the news releases come out early in the trading day. Many days there is a large move in the pre-market based on the release of earning reports or economic data. There is no rule as to whether the market will continue its pre-market momentum or reverse. So the most emotional time is the first hour or so. One of the most common mistakes day traders make is making a large commitment to the market too early in the day. Then if they get behind early, they are spending their energy focused on the money rather than on opportunities in the marketplace. I like the rule of watching the market for at least 20 minutes before making the first trade and then only trading 30 to 50 percent of maximum position for the first hour. That'll keep the emotion down and help you get a better sense of what the market has in store for the day.

Dear Slim,

Do you have any words of wisdom for the buy-and-hold investor to consider trading options? What are the advantages, and do they outweigh the disadvantages? Are options for the more conservative investor? Is it a matter of how dedicated one is to educating themselves?

– William V., via e-mail

Dear William,

Options are a great trading vehicle for both the most conservative investor and the wildest speculator. The options markets are the most complex sectors of the derivatives markets. So, yes, to your question, it is essential that one is very dedicated to educating one's self on option trading. It's easy to decide a stock or commodity is going up and then buy a call option. However, that is speculating on a depreciating asset. The forces of time are working against you. Only a deeper knowledge

of the intricacies of the options markets will allow you to take advantage of situations within those markets. Even the most conservative investor will find opportunities and enhance their ability to manage risk.

For buy-and-hold type investors, the options market does offer a multitude of possibilities. The most obvious tactic is a “covered write.” In this strategy, the investor sells a call against each 100 shares of long stock. Here, time (option decay) works to the trader's advantage. For extra protection, you can buy a deep-out-of-money put against the position. Another very conservative strategy is buying or selling a vertical spread. In this case, one buys a put or call and sells another one, with the same expiration date, against the position. These types of positions limit profits and losses. For a more detailed description of these strategies, please refer to my column in the May issue of SFO.

If you do wish to buy options outright, avoiding more complex strategies, you want to buy them when risk is the lowest. Two important factors are “implied volatility” and entry. Implied volatility is how the marketplace values options. The factors that make up implied volatility are interest rates, dividends, time left to expiration, stock price and the historical volatility of the underlying security. Most option services offer daily option values derived by plugging implied volatilities into a pricing model. When implied volatilities increase, option premiums increase, which makes it the riskiest time to buy options. So, if you wish to buy a call option on a stock, the best entry will likely be during a corrective period, with the stock spending several days in a narrow range, having allowed premium levels to drop.

The greatest advantage to option trading is if you're a buyer, you can participate in the market with relatively low capital. The greatest disadvantage is that nearly all traders are forced to be option buyers because margin requirements are astronomical if you are short selling (naked writing) options. That's why the majority of novice option traders lose money; they're always forced to buy premium. Do the advantages outweigh the disadvantages? Only for the Pros!

Dear Slim:

I love SFO's great articles and topical content! Could you please comment on the special tax treatment on stock index futures (i.e. S&P 500 futures). I am clueless on which tax forms must be filled out in addition to the Schedule D. The IRS has been vague in their email responses.

– Gary S., via email

Dear Gary,

The tax code says that gains and losses from the sales of 1) any regulated futures contract, 2) any foreign currency contract, 3) any non-equity option, 4) any dealer-equity option, are considered to be “Section 1256” securities. These futures are then said to be subject to the 60/40 rule. What that means is

that 60 percent of gains or losses will be taxed as long-term, and 40 percent of losses or gains will be taxed as short-term. S&P futures are a regulated futures contract and are subject to this rule.

For example, let's say you have \$20,000 in profits for the year trading index futures, and are in the top 38.6-percent tax bracket. The tax liability for 60 percent of the gains would be \$2,400 (20 percent of the long-term rate). The next 40 percent would be taxed at the top bracket of 38.6 percent, for a tax liability of \$3,088. The total taxes would be \$5,488, for an effective tax rate of 27.44 percent. For the sake of comparison, assuming the same tax bracket, a \$20,000 gain in equities or mutual funds would generate a tax liability of \$7,720. That's a whopping 40 percent more you'd have to give the IRS. Ugh! That sure makes a case for trading futures vs. equities when one has the choice.

There are some costs to this election, however. The tax rule requires that 1256 securities are "marketed to the market." This means that profits and losses on these securities must be

reported at the end of the year, even if the trade has not been closed. Also, if you have losses in futures, since part of the losses are considered long-term; they cannot offset short-term gains you might have in other securities. Section 1256 of the tax code is quite lengthy with all kinds of special rules and elections. What I have given you is very general information, with all the usual disclaimers. I'm in no way a tax expert. I suggest you read this statute, on the following website, and consult your accountant with your questions. Here is the link: <http://www.fourmilab.ch/ustax/www/t26-A-1-P-1>

Of course, the IRS has a special form for gains and losses of securities that fall into this category. The results of your commodity trading must be reported on tax form 6781. If you'd like a copy of the form, go to the IRS website and type that number where it says "search for forms and publications": <http://www.irs.gov>. In case you have trouble finding it, here is the direct link: <http://www.irs.gov/pub/irs-pdf/f6781.pdf>. It's a PDF file. You will need "Adobe Acrobat" to retrieve it, which can be downloaded free on the Internet. I'm assuming this has been more help than you received from the IRS.

