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# Ask Slim

## By Steven Miller

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### Dear Slim,

Thank you for making your vast trading experience available to the readers of SFO. It's great to have someone who trades on a daily basis to point out the pitfalls along the way. My question concerns option strategies using butterflies. I have been warned that the butterfly strategy, while great for floor traders, isn't all that practical for retail traders because of the commission cost connected with them. I attended a class at the CBOE and was told that unless you can do them in fairly large numbers to not attempt this type of position. What's your take on this? What would your minimum lot size be?

– Ben Z., Billings, MT

### Dear Ben,

A butterfly spread is an options strategy that is constructed by buying a bull vertical spread and selling a bear vertical spread. Therefore, four option trades are executed to create this spread. Your instructor was correct implying that this is an expensive strategy. However, further examination may make it clearer whether this method is a fit for you.

Profitability occurs, in this type of spread, when the underlying contract (stock) trades and ultimately closes on expiration day within a specific range. For example, June 30-Year Bonds are trading around 99 (June bond options expire the last week in May). Buy the June 98-99 Call spread for a cost of 37/64 and simultaneously sell the June 100-99 call spread for a credit of 25/64 (this is entered as a single spread order). Notice, there is an overlap in the two spreads, with the short sides being the same options contract. At 99, the midpoint and most profitable point of the range, the bull spread closes at the full value of 1 pt (64/64) for a profit of 27/64 and the bear spread expires worthless for a profit of 25/64, netting 52/64 or \$812.50. The net outlay was 12/64 or \$187.50. Now add in four commissions at a moderately discounted commissions rate of \$20 a contract round turn (much lower commissions are available). The cost is now \$187.50 for the spread and \$80 for the commissions (4X\$20) for a total cost of \$247.50. With these costs figured in, profitability occurs if the 30-year bond ends at expiration between 98 16/64 and 99 48/64. The risk/reward ratio on this example is around 3 to 1. The calculation is the same, whether you do the spread once or any number of times.

The odds are low that the spread will work perfectly, with the contract ending at the most advantageous point. However, it is often the case nearing expiration, the decay of the options has made the strategy profitable and that the trade can be exited early.

As your instructor suggested, the spread will work better for one that trades actively and gets lower commissions. However, as illustrated, the spread can work well for retail traders. As an active off-the-floor trader, I use this method on a daily basis. Trading these more exotic spreads are great tools in gaining awareness to options valuations.

### Dear Slim,

Options on the S&P 500 Index are traded on the Chicago Mercantile Exchange and on the Chicago Board Options Exchange. Other than both contracts being cash settlement (CBOE is American style, the CME is European style), the markets vary in margin

requirements and commissions, with the most significant difference in liquidity. From an option writer's point of view, which is the better market to trade?

– Norman M., Albuquerque, NM

**Dear Norman,**

For the purpose of this discussion, the differences in margins and commissions are negligible. The differences in the style of contract and the liquidity are very significant.

American style options (CBOE) are exercisable on expiration day or any time before. European style options (CME) are only exercisable on expiration day. The risk here is on the CBOE. Assuming you have written (sold) a call on the S&P 500 and the market has been rising sharply, the call is now deep-in-the-money. Deep-in-the money options trade with mostly intrinsic value and little time value, increasing the risk of early assignment. Let's say on a particular day, while holding this position, some piece of negative news comes out after the close, sending the underlying S&P futures contract down sharply. Traders, wishing to create a short bias in their positions, taking advantage of the after-hours-news, assign their long calls. If you are one of the lucky shorts to get picked (it's a lottery), you're out of your position at the cash settlement of that day's close. You took all that heat, with the market rising sharply against your short position. Now the market finally turns your way and you are taken out of your position at a very disadvantageous time. (SCREAM!) Again, on the CME, that could not have happened.

Liquidity is the other issue. The CBOE S&P 500 pit is a deep market, though much less so than past years. It is a large pit, with many traders and great institutional representation. Bid/ask differentials are tight. The CBOE does a great job, in my judgment, consciously protecting the retail customer. Information is very available through most quote services, nearly always including bid/ask. The CME S&P 500 options pit is relatively small and less populated. Quote services offer last price information, but the bid/ask info is not easily available off the floor and spreads are quite wide, strongly favoring the locals (floor traders).

I have physically traded in both pits. I have tried to trade CME S&P options off the floor, finding myself very frustrated. Therefore, my active Index-option trading has all been done at the CBOE. For retail option writers, however, the edge must go to the CME. The risk of early assignment is too great.

What neither of us mentioned to this point is that the strategy of writing naked options carries one of the highest risk. Proceed carefully!

**Dear Slim,**

I am now on my second round of simulated trading. I have filled out the account papers and calculated my available risk capital. I have studied the markets well and have profited during the simulated period. I wish to trade with real money. However, I find myself unwilling or unable to make the leap. I

admit I have some fear. Do you have any advice on what will help me proceed?  
– George C., Iowa City, IA

**Dear George,**

As I wrote in my article "The Fear Factor," in the premiere issue of SFO, emotional response comes from messages we learned early in life. They are warnings from deep inside. Something is telling you that there is a great risk to you in making this decision to trade with real money. I invite you to look at where this message is coming from. Did you lose money in the past and pay a big price for it? Did someone in your family, one of your parents, perhaps, struggle with finances and leave you with some perception that you have carried all this time? Many children of the Depression era carry fears about what life was like for their families during that period. My guess is when you discover where this message originated; you will see that you are reacting to a potential consequence that is far greater than reality.

After you have looked at this issue, it doesn't mean that the fear will go away. It means that you will better be able to hold it to its appropriate level. For another view of how fear can work in our lives and how we might empower ourselves over it, please read this story:

This is the story of the lions. Lions prefer to eat gazelle meat. However, they are unable to catch the gazelle – it's much too swift an animal. So a group of young lions will herd the gazelles in a direction they want them to go. The gazelles easily outrun the lions, but they head off in the direction the lions are guiding them. They herd the gazelles towards a deep grassy area where a group of older lions are waiting. The older lions are too old and tired to be part of the chase, missing many teeth, and would never be able to catch their own meat. But they still have a place in the pride. The younger lions herd the gazelles toward the older lions, who are hiding in the tall grass. When the gazelles are practically on top of the older lions, the older lions jump up and ROAR loudly. Immediately, the gazelles, fearing for their lives, turn and run in the opposite direction, right into the mouths of the young lions, who usually catch them and kill them.

The moral of the story is that if the gazelles were to "go to the roar" – toward their fear – they would have a much better chance of survival. Our natural instinct, the survival mechanism we learned when we were young, is to run away from our fear.

Hopefully, George, this has given you some tools to move towards your desire of trading, with real money successfully. You have done well in spending time to grasp the marketplace through your studies and simulated trading. The story of the lions is a great metaphor and holds an invaluable lesson for all aspects of our lives: "GO TO THE ROAR"!