
Ask Slim

By Steven Miller



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Dear Slim,

I am hearing mixed reviews regarding the importance of economic reports and their effectiveness as indicators of market movement. Have these reports had any consistency on how they have affected markets in the past? Which reports do you find most meaningful today, if any? — Stan E., via e-mail

Dear Stan,

I can remember so clearly my first months of trading on the floor of the Chicago Board Options Exchange. It was the summer of 1974, and a devastating bear market had Wall Street in its grips. I was trading in the IBM options pit at the time. On Thursday afternoons the floor would quiet as we all stared at the news ticker, awaiting the release of the “Money Supply.” The final hour of trading would often “rock” as traders responded to the whether the news would give the Fed leeway to take an easier stance. At that time, that was the big economic news release each week.

Over the years, the focus on economic reports has shifted between monetary figures, growth indicators, inflation gauges and sentiment indicators. The indicator that has tended to have the greatest effect on the stock and bond market in recent years had been the University of Michigan “Consumer Sentiment Index.” This index is said to be a measure of upcoming consumer behavior. In recent months, however, no economic report has had a lasting effect on the markets as participants concentrated on news out of Iraq. Reduction in war news brings focus back to the economy. Expect news on economic growth and sentiment to once again take the forefront. The most commonly watched indicators in this category are Philadelphia the Fed and Richmond Fed indexes of manufacturing activity and the aforementioned Sentiment Index. For trade purposes, I find it best to believe the market momentum caused by these releases. “A body in motion stays in motion.”

Dear Slim,

As a general rule, do you find that your personal exit strategies are more important than your entry strategies, or vice versa? Please explain. Your column is a great read, and I look forward to your responses in every issue. — William R., Norfolk, VA

Dear William,

I do not wish to diminish the importance of a good exit strategy. Maximizing profits, by holding or adding to winning trades, is a key to successful trading. However, it’s difficult to get to that point without having made a good entry. I have spoken several times in this column regarding my strategies for favorable trade entries. Generally, I like to enter a trade in a counter-trend move. Then if the timing of the trade is premature, there is not as much risk of getting shaken out.

Dear Slim:

Can you discuss how contingency orders work on an electronic system – e.g., in the Mini S&P futures? Is the procedure for use any different than for pit-traded futures? When would you use this type of order? — Ellen K., via e-mail

Dear Ellen,

A contingency order is an order that is executed when one or more specific conditions are met. Examples of this kind of order are “Stop” or “MIT” orders. These two types of contingency orders are activated when the contract trades at or beyond a specific price and are accepted for use on most online trading platforms. The procedure for using online contingency orders is much the same as pit-traded orders.

I highly recommend using this type of order for managing risk. You can also use contingency orders for entering trades or adding to a winning trade when the contract hits an important break-out point. One word of caution, however – there is no guarantee that your order will be executed anywhere near your stated price. In a rare event, E-mini S&Ps, which is a very heavily traded contract, can hit a void and trade many points above or below the full S&P contract. I have seen E-mini S&P stop orders filled many points away from the stop price. Thinner contracts offer a greater probability of getting this “bad fill.” Be conscious of the risk.

Dear Slim:

How do dividend-paying stocks fit into the options equation? Will the dividend be paid out if the option is exercised? Or does it matter at which time the option is exercised?

— Jacob L., via e-mail

Dear Jacob,

Companies pay dividends to investors who are shareholders-of-record on the ex-dividend date. If you are long call options on a stock paying a dividend, you must exercise the option by the day before the ex date if you wish to collect the dividend. Based on your option position, there may be other considerations. Here are a couple of examples.

Stock option prices reflect the dividend as time grows close to the ex-dividend date. If you have a covered write that is “in the money” on a high-paying-dividend stock, it is likely the premium (time value) is out of the option, leaving only intrinsic value. In that case, odds are that your stock will be “called” away from you before you can receive the dividend. That may be fine with you, since you have made all the money you’re going to make on that covered write. However, if you want to hold onto the long stock, you may choose to “roll” out of the option into a different covered write that has premium.

An option spread might also be affected by stock dividends. If the long side of the spread goes in the money, you may choose to exercise and collect the dividend. If the short side of your spread goes deep in the money, you might get assigned. In that case, you will be short the stock and be required to pay the dividend. So, as you can see, it is very important to be aware of the dividend information on stocks in which you hold option positions.

Dear Slim:

Will you please explain what it means to write a covered call option? If you do not own the underlying stock outright, can you still write a call? What are other call-writing option strategies? What are the risks?

— Alex W., Dallas, TX

Dear Alex,

By definition, a “call” is the right to buy a stock by a specific time and at a specific price. A “put” is the right to sell a stock by a specific time and at a specific price. If you sell a call, you are selling this right to the buyer. In order for you to be “covered,” you must hold a long position in the underlying stock great enough to meet the demand of delivery of the underlying contract. So, if you wish to write covered equity calls, you will need to hold a long position of 100 shares of the underlying stock for every call you write. In a rare circumstance, a stock split or stock dividend may change the number of shares covered by the option to a number other than 100 shares.

There are ways to write options without owning the stock and still get the benefit of option decay, with a calculated limited risk. A common method is to write a call that is at or “near the money” and then buy a call with the same expiration date and a higher “strike price.” This is known as a vertical bear spread. Essentially, your risk in the spread is the difference between the strike prices, less the premium you took in. For example, say you sold XYZ June 50 call at 6 and you bought XYZ June 60 call at 1 3/4. You took in a net of 4 1/4 points premium. The difference between the two strike prices is 10. So your risk is 5 3/4 points plus commissions. Your maximum profit is 4 1/4 points, less commissions.

Another less-common strategy is to write a call option that expires within the next few months and then buy a “leap” call option that has an expiration date a year or longer out. In this strategy, the leap has a much lower holding cost than buying the stock, and there is less downside risk in the strategy. However, if there is a lot of time premium in the leap, it will not rise as fast as the near-in call you wrote. So, there may be some minimal upside risk if the stock has a big run.

The riskiest option strategy is to write a “naked” call. This is when you sell a call without owning the underlying stock. In this case, the risk is unlimited on the upside and appropriately carries the largest margin requirement. This method is best saved for highly capitalized traders with nerves of steel. I have witnessed the demise of very experienced traders who sold naked options and ended up in forced liquidation of their positions, never to return.

Dear Slim:

I am interested in the T-bond futures market at the Chicago Board of Trade. I think that it is dominated by institutional money, however, and wonder what your thoughts are on individual traders using this market.

— Glen D., via e-mail

Dear Glen,

T-Bond futures have undergone a major upheaval in recent years. The “bond” pit on the Chicago Board of Trade was, for many years, the best trading pit that existed. The following explains the two factors that ended the long reign of the T-Bond pit.

During the final years of the long economic expansion of the '90s, the government ran large budget surpluses. In response, the United States Treasury Department reduced the amount and frequency of 30-year auctions. Then, in October of 2001, the Treasury, saying, “We do not need the 30-year bond to meet the government’s current financing needs, nor those that we expect to face in coming years,” cancelled the issuance completely. This action sent a large portion of trading volume out of the 30-year bond pit and into the 10-year note pit. The second factor that essentially destroyed the viability of the bond pit was the huge acceptance of online trading on the a/c/e system (Alliance between the Chicago Board of Trade and Eurex).

Now, a large proportion of trading volume in these longer-term financial instruments is traded online in the 10-year note contract. And, yes, trading is largely dominated by institu-

tions and the trading rooms of large firms. However, if you’re called to trading the 30-year bonds, the a/c/e system offers a deep market where bonds are still a great trading vehicle. My guess is that when the Treasury figures out that the days of surpluses are gone and, in fact, they need to borrow significant sums once again from the marketplace, issuance of 30-year bonds will return.

Correction:

In the February issue of SFO, I commented on websites that offer stock-option trading and quotes. At that time I said that commission rates at ThinkorSwim.com were on the high side for smaller traders because of a ticket charge. However, closer inspection of the website shows they charge a per contract price or a reduced per contract price plus a ticket charge, the lesser of the two. I contacted the company for clarity and they said the ticket charge is actually waived for the first six contracts. That actually makes their commission rates very competitive with other stock option brokerage firms, maybe the lowest. Commissions aside, I still think this is the very best all around online stock-option execution platform. You must see it! <http://www.thinkorswim.com>

