

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!



Slim,

For a day trader trading stocks, what rule allows one to buy and sell for many times the dollar amount in one's trading account? I thought there was a required settlement time of three days.

Example: an account has \$30,000. This allows \$120,000 to be traded on 4X margin for day traders. It seems that a trader should only be allowed to trade \$120,000 for that day and wait three days for settlement. But a trader can enter and exit positions repeatedly for many more dollars during the day and can potentially trade millions of dollars. Please explain this.

Thanks,

-John H., Prairieville, LA, via email

Dear John,

The late '90s brought vast improvements in technology and skyrocketing growth in day trading. There was a need to accommodate these very active traders, who essentially brought huge liquidity to the markets, giving them better use of their capital. At the same time, regulatory agencies wanted to be sure these traders were appropriately capitalized.

In September 2001 the SEC and NASD passed Rule 2520 which defined a "pattern day trader." This is a trader who buys and sells, or sells then buys the same security on the same day, and does this four or more times in five business days.

Under this rule, these traders must maintain a minimum equity of \$25,000. As you said, they get 4X margin, which gives them "buying power" of four times their cash balance. Here's why these rules allow day traders to use many times that maximum buying power in a day. Margin is calculated at day's end, determined by the maximum aggregate dollars the trader used at any given time during the day. So if a trade is closed, those funds are available for another trade.

The rules state that if a trader's cash balance drops below the minimum \$25,000, he cannot trade on margin until the balance is brought back above the minimum requirement. Also, if a day trader exceeds the day-trading buying power, this will generate a day-trading margin call. The call must be met within five business days and held in the account for two more days.

This rule was an excellent way to steward the growth of the day trading business while increasing the percentage of professionals that participate in what can be a very risky trading style. I judge that the depth day traders provide to the market warrants the extraordinary margin treatment they receive.

Dear Slim

Please explain why mutual fund transactions are priced at the Net Asset Value determined after receipt of the order rather than at the NAV calculated just prior to receipt of a trade.

-Lawrence A.T., Morristown, N.J., via regular mail

Dear Lawrence,

The Investment Company Act of 1940 requires that mutual funds calculate their net asset value (NAV) at the end of each trading day. This share value comes from the total assets, minus liabilities, divided by the total outstanding shares. Rule 22c-1 requires "forward pricing" meaning buyers or sellers of shares "receive the next day's share price, after the receipt of the transaction order." To put it simply, it's the law.

Dear Sir,

Thank you for the opportunity to write to you. It's not easy to come by really good sound information about the markets. I have a large library on the subject and I am amazed at the contradictory advice offered by many professionals. My question is on option trading in the futures markets.

I sell naked out-of-the money options on futures and then place a buy-stop order near the option strike price. The strategy looks fine at first glance; however, it can open a can of worms. As long as the market stays below the option strike, it works fine; options expire and I get the premium. But, if I get stopped and am now long futures and short options, and the market heads south again, I lose, lose... OK, I can then dump the futures. However, if it starts to head upward again, I'm right back in the same trouble.

I have several questions: Am I handling this trade the best way? Will the long futures contract absolutely hedge the short options? How do margins change from the naked option position to the hedged position? What happens at expiration to the hedged position if the options are in-the-money, will I be "flat the market?" I really appreciate your taking the time to answer.

Thanks in advance,

-H.V. S., Sacramento, CA, via regular mail

Dear H.V.

You are describing what often turns into a big problem for naked option sellers. In your strategy, which offers a limited return with virtually unlimited risk, you are forced to baby sit these positions.

Your choice of limiting risk is to hedge the naked call position with the future once it begins to threaten you by approaching the strike price. However, your short-term sense of safety is an illusion, as you are discovering. Once you have hedged, you've essentially locked in your loss and have now added risk in the opposite direction, opening yourself up to a "whipsaw." The only way, then, to recover, would be for the future to sit still at the strike price until expiration. Fat chance! If you wanted to be in a "covered call," you'd have put it on in the first place. I prefer to just cover the naked position when it reaches your stop-loss point and to reevaluate the market again for the next trade.

Another choice, which limits both risk and reward, is to sell a vertical call spread. In this strategy, you still make money on option decay and if the market takes off against you, you know your maximum loss potential and there is no reason to reach for futures.

Assuming you do stay with your present strategy, the long futures will completely hedge the short calls, as long as the contracts are sized the same. So a short position in S&P calls on the Merc is hedged with the full contract. If you are hedging the same calls with eMini S&Ps on Globex, you'll need five contracts to be fully hedged.

At expiration, if the short calls are in-the-money, you will be "assigned" and owe the underlying commodity. If you are long expiring commodity futures (covered call), you will end up "flat." If the position is in index futures and options, they expire to the cash value of the index at expiration, and you will still end up flat.

Placing a hedge on open-option positions with futures will likely require additional capital. So check with your brokerage house regarding their margins on these types of positions.

Dear Slim,

I'm pretty sure that the dollar is going to fall against the Euro currency over the next year or so. There are so many choices among ETF's, futures, options and I don't know what else. What's the best way to bet on the Euro?

Thank you,

-Ron S., Princeton, NJ, via email

Dear Ron,

Deciding the best vehicle to use to "bet on the Euro" is a lot like deciding the best vehicle to drive. Do you drive an "orthopedic shoe" type of a car, like a Volvo S40? It's going to keep you real safe and get you there with relative comfort in an unhurried fashion. Or are you a Dodge Viper Venom type, which is going to give you the thrill of a lifetime, going from 0-60 in 2.9 seconds?

Options on the Euro currency offer a lower cost, safer way to travel. A big risk, of course, is option decay. If you buy "calls," however, you know what you can lose. Euro currency futures, which trade on the Chicago Merc (open outcry) and Globex (electronic) will have the most volatility of the trading choices. With this choice, you get futures margins, and when they start to move, they'll pin your ears back. A good middle ground is the FXE, an ETF that tracks the price of the Euro currency. This security trades and is margined like a stock.

A big problem for foreign currency traders in the U.S. is that the greatest volatility often comes when we are sleeping. That's why when you look at a daily chart of the currencies, they have so many "gaps." It raises the need for stop-loss orders and may bring a few wakeful nights.

If you're not sure of your best fit for trading the Euro, take a test drive and see how each of the choices feel. Then, assuming you're on the winning side, you'll get better mileage out of your trade, bumps in the road will be easier to take and you'll enjoy the ride. ■

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SEND ME YOUR
QUESTIONS!
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SFO Stocks Futures & Options

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