
Ask Slim

By Steven Miller



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Dear Slim:

It is obvious that an investor relies on his broker for advice, guidance and knowledge. I am getting ready to become more active in the trading arena, and would like some advice on what I should consider when selecting a broker. Cost is an important issue to me. I understand that you get what you pay for, but I don't want to be overextending my dollar for service that I may find somewhere else cheaper. Besides cost, what are some suggestions for finding a broker? Also, how much should I inquire about the company with whom they work? I want to be thorough in my search, but am not sure as to where to draw the line. —Tyler L., via e-mail

Dear Tyler:

There are dozens of commodity brokerage firms; many employing a large number of brokers. Consequently, there are thousands of commodity brokers out there from which to choose. Finding the broker that meets all of your requirements can be quite a challenge. You're asking for a full-service broker that offers discount commissions. In this competitive marketplace, that is doable. I suggest the following course.

Start your search with the bigger, well-known firms. The tiny firms with two-inch ads offering cheap commissions are only going to employ young, inexperienced brokers ready to read from their script. Even at the larger firms, it will be hard to find a broker that has broad experience in all markets. So decide in which markets you plan to concentrate your trading. Then begin the process of interviewing brokers.

I suggest you call at least three firms. Ask for the sales manager and inform that person of your requirements. Be prepared to be asked how much capital you plan on funding your trading account with. It's likely you will be directed to the broker with the most experience in your particular market area and one that handles accounts of your size. Find out the broker's level of experience. Be bold in your questioning. I'd ask; how long have you been involved in the market? Are you registered as a CTA (Commodity Trading Advisor)? Do you take discretionary funds? Do you have trading floor experience? What are your methodologies? Do you trade your own funds? Ask for the broker's trading rules. Get an idea of his/her understanding of risk management. What are the commission rates? How do commissions differ if you trade online? If you enter your own trades electronically, will the two of you still be available to discuss market ideas? Find out their level of experience in derivatives. Be aware of the broker's ease in answering your questions, and listen for red flags of resistance or a lack of knowledge.

Once the brokers come up for air, they're going to know that you will be a customer that demands service. You want to build a relationship of trust with your broker. That's going to start with their willingness to be available to you, even though it's obvious you will be a demanding client. Before the conversation is over, have a good idea of range of commissions. Ask the broker if they have anything more to offer. Make sure they can reach you if they wish to offer any further information. Then say a very thankful goodbye, saying you'll soon be concluding your interviewing process. Once you've gone through this a few times, if you haven't found

your broker, you'll at least have a good sense of what you are looking for. It will be a great learning experience. Have fun with it!

Dear Slim:

I have just a quick question. Which contracts do you feel are most promising for short-term day traders? What advantages do they have? Obviously, they would need to be pretty liquid. Any suggestions?
—Sandra K., via e-mail

Dear Sandra:

The best contracts for day traders are those that are traded electronically. There are now numerous choices. However, if you want quick action, E-mini NASDAQ and E-mini S&Ps on Globex, and 10-year notes and 30-year T-bonds on the CBOT a/c/e system are the best choices. These contracts are so liquid that they offer nearly any size day trader great opportunities.

Advantages of trading in these markets are speedy execution and tight markets, offering lower slippage and lower commissions. The risks, however, are that these markets can move so fast that traders must always guard against a small losing trade becoming a monster.

Dear Slim:

Do you put time restrictions on how long you should hold onto a position? I've heard over and over how time is just as important as price when it comes to trading. Do you have any parameters for how long you wait before exiting or entering a trade? Or is it more of a gut feeling?
—Pete M., via e-mail

Dear Pete:

Much of my trading is based on cyclical studies. A cycle is measured from low to low on a chart of any time period. That makes time one of the most important factors in my trading. When I enter a trade, I immediately analyze the window of opportunity for this trade.

For example; S&P futures tend to trade in 12-bar to 19-bar cycles on the 60-minute bar chart (cycles are measured from low to low). During an uptrend, the advancing portion of the cycle is usually 10 to 15 bars. If I've entered a long position early in the cycle and the advance is holding, I gain confidence. Then I can hold or even add to positions if the up move strengthens. Once the chart enters into the topping period, I begin to take profits. If the pattern fails and begins to move lower during the window in which it should be rising, it holds a strong negative message, allowing the possibility of reversing to a short-side trade. This method can be used for longer-term investors also, as cycle patterns can be identified on daily and weekly charts on a high percentage of stocks and futures contracts.

No matter what trading method you are using, it is important to predetermine your risk parameters as well as your maximum holding. You don't want your money sitting where it's not working for you.

Dear Slim:

I know that open interest is an indicator of market liquidity, but have never seen anything written about whether minimum open interest indicates enough liquidity for traders to feel safe entering (and exiting) the market. Eurodollars, S&Ps, bonds, etc., all have huge open interest, and a good portion of that is institutional, while some contracts have 10,000 or 15,000 or less. Is there a general rule of thumb and does that vary between futures and stock options?
—Marty B., via e-mail

Dear Marty:

The importance of minimum open interest varies greatly with the individual trader and the particular market. A small trader probably wouldn't be affected by a small open interest in most futures markets. However, a larger trader will not go near a futures contract with a very small open interest. Front months carry the majority of open interest in most futures complexes. A commercial trader, however, might enter trades in a back-month futures contract with a relatively small open interest if he is hedging a product and expects to hold the position for a long period of time.

Options do differ from futures in the importance of open interest. Generally, options that are front month and that have strike prices near the price of the underlying equity or future have the largest open interest. Thus, they get the heaviest trading volume. Options can present a trap. Some stocks have options that have so little interest that they literally don't trade for days, even weeks. Or if an option becomes deep-in-the-money, open interest can drop off quickly as positions are closed or exercised. When that happens, spreads widen and costs of execution increase.

Since I'm a day trader, I look more at average daily trading volume than open interest. If you're a larger trader who has a long holding period or puts on exotic, back-month spread trades, I suggest you stay in futures deep in open interest, where the institutional types play.

Dear Slim:

I recently read an article about trading systems that claim an outstanding track record, but their performance is much more based on data than the system itself. Can you comment, please?
—Joe M., via e-mail

Dear Joe:

So what you're getting when you read these articles about trading systems is some claim of past results. You're asking why they're not giving you more information about the how the system works. Guess what? You have to pay for that!

Some of the companies only offer buy and sell recommendations, keeping their proprietary methods a secret. Many of these companies offer trial periods. That's a great way to learn about the system and test it out at a lower cost. Most of these systems are mechanical, you know – e.g., if X happens, then

you Y. Their results may be published based on a computer simulation and may not figure in commissions. That doesn't figure in the physiological factor of a human being actually having to execute the system.

Try a few different trial periods and get a feel for what's offered out there. Whatever system you use, stick to your own rules of discipline. Don't take excessive risks on someone else's bold claims.

Dear Slim:

Regarding trading systems, I have heard that if you have experienced a string of losses with your system, you should push on and continue to trade according to it. When or how do you determine if you should stick with the system, or if it's time to pack it in and research another type of system? I enjoy reading your column and look forward to your advice on this issue.

—Joel L., via e-mail

Dear Joel:

Every trading system goes through losing periods. If you have a proven system but are going through one of those rough periods, there are several steps you should take. Your first action is to stop the bleeding. That means reducing the size of your trading units to minimum size. Then begin to analyze why you have suddenly started losing.

A losing streak can come along for many reasons. A common occurrence happens during a prolonged winning period. Traders get overconfident and increase their risk. Then a couple of losing trades wipes out most or all of the profits and traders have a hard time getting back to their basic system. Another mistake is increasing the size of your trades after a couple of losers to try to get the money back, usually just digging a bigger hole. Sometimes the market changes and the trader is slow to recognize it. When volatility increases, it means adjusting risk and widening stops. Traders are often slow to react to this change. If the market turns from a directional market to a choppy one, momentum traders often get hurt. Outside factors affect trading and can cause a trader to execute his system poorly. It could be problems with family or illness.

I suggest keeping good data on your trading. Keep records of every trade. Make notes of market factors. Analyze your win/loss ratio. A trader that has 55 percent winning trades and whose winners are 50 percent bigger than losers will make a lot of money over time. Those statistics leave a lot of room for losing streaks. So if you have a proven system and it goes bad for awhile, look hard at the factors that might be causing the tough period and make adjustments. You should soon be back to winning ways.

