# Ask Slim

## By Steven Miller

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**Dear Slim:**
My question deals with both the volatility we are seeing in the market and the downward bias. Do you ever use the combination of short stock + long call = synthetic long put? Example: Stock price @26.39 Short 200 shares, long 2 Aug 30 call @ .30.

This seems to be a very good way to play the downward bias, while still being able to sleep at night. I don't like the risk of being short stock over a period of days to weeks without protection. Can you please comment? —Ben Z., Parma Heights, OH

**Dear Ben:**
Regardless of the direction of the market, the use of options is a great way to limit risk. The most basic and least expensive to execute is to buy calls when you believe the underlying stock or future will rise and buy puts when you believe the price will decline.

The use of synthetic options, essentially a hedge, (long stock/long put or short stock/long call) is a tool that is best used for a more active, sophisticated trader. There are many ways to maneuver these positions to take advantage of short-term market swings. For example, short stock XYZ at 50 and buy the October 50 calls at 5. If the stock were to fall to 45, you have a few choices. You can cover the stock for a 5-point profit and sell the call for about a 2-point loss, for an overall $250 profit before commissions. Or you can cover the stock and stay long the calls, playing the stock for a bounce to then sell the calls or re-short the stock.

Another factor to consider when trading synthetics is that there are twice the commissions and twice the slippage. When I'm trading a stock in which I'm not normally active, I buy puts or calls outright. When I'm trading a stock that I trade regularly, I much prefer the flexibility of synthetics.

**Dear Slim:**
Like many other Americans, my 401k in recent months has taken a beating. I am 57 years old and consider my investments to be quite diverse, however a good portion of the stocks I have listed in my 401k have all gone down tremendously. Do you have any suggestions that at this late stage will help make a significant rebound in my retirement funds? My "long-term" goal is to retire comfortably. However, my "long-term" is running out. Although I am willing to take some risk in order to bounce back from my losses, I do not want to end up more in the hole than I am already.

This is a pretty general question, and I am simply looking for some advice. —Raymond W., Portland, OR

**Dear Raymond:**
So the question I hear you asking is; "can I help you make your money back?" What I can offer is some history and some market opinion. The rest is up to you.

Over the last century there have been several major secular bull markets, each followed by a corrective secular bear market. The panic of 1907, brought on by several large corporate bankruptcies and a run on the banking system, was the first major low in the 20th century. The following bull market lasted for 22 years, gaining around 1000 percent. The correction that followed, of course, beginning with the crash in '29, lasted for 13 years and included the Great Depression and the onset of WWII. At its worst level, the market had lost nearly 90 percent of its value. The year 1943 began the next secular bull market, which lasted 23 years, through 1966. Those were the years of the "Nifty Fifty," with the likes of Polaroid and Xerox trading at 150 P/Es. The 1966 top of around 1050 on the DOW had seen the market gain nearly 2000 percent. Though the DJIA tried to break through those highs in 1968 and 1972, the correction ultimately lasted eight years, with the market losing over 45 percent of its value at its 1974 low. It really wasn't until 1982 that the next major bull market began, so it can be said the correction from the 1966 high lasted 16 years. In both of the secular bear markets described here, there were major rallies that truly looked like new bull markets. Every one fell to a new low until the major bear market was completed.

The last bull market, which topped in 2000, saw the DJIA gain more than 1300 percent in 18 years. The driving force in the final stages, of course, was the fantasy that technology and the Internet had created a "new world economy." There has been a dramatic correction over the last two years. And as you have described, Raymond, stocks have fallen "tremendously." However, this correction is only two years old. If there is any doubt about whether this is a secular bear market, just look at the NASDAQ's 75-percent loss.

The market has recently rallied sharply off of its lows. There will likely be an economic lift as mortgage refinancing brings a last gasp of real estate equity into the economy and a more stable stock market gives investors confidence. The next year or two will see wide swings, with rallies that appear to be a real bull market. The NASDAQ, the worst hit of the index, might even double off its recent lows. However, this will be a fool's rally. The FOMC is waiting to take back some of the 11 rate cuts. Once the fuel from the consumer sector dries up, the economy – and the stock market – will be headed south again. This most likely will be the pattern; attempted rallies and then major declines, with the ultimate low many years away, maybe a decade.

The 18 years of bull market, from 1982 to 2000 was a one-decision market, "buy and hold." The next period is going to be very different. When the market looks the worst, consider buying companies that have longevity and balance sheets that can withstand dramatic economic downturns. When the market looks the best, go to cash equivalents or government bonds, sidestepping the next major wave down. There is no way to time this perfectly. At times, it will feel like you missed a good rally. But this strategy will save you in the long run.

For an investor like yourself, with deep losses and portfolios heavily weighted in stocks, look carefully at holdings that were high flyers in the high-tech mania. Those should be the first to be sold as you raise capital to move into higher quality stocks or cash. The question now is not how to make the money back. It is "how can I best navigate the treacherous markets that lie ahead and protect my capital?"

**Dear Slim:**
I have heard the terms "active and passive portfolio management" used before. Could you please explain the difference between these two and make any comments on how investors should view their investments as part of either management strategy? Any insights would be much appreciated.

—Stanford H., via e-mail

**Dear Stanford:**
The difference between active and passive portfolio managers is like the difference between an investor and a trader. Passive managers tend to have extremely low position turnovers. They manage funds that may hold stocks for years, limiting overall cash to just a few percentage points. Also, they are mandated, with rare exception, to be only on the long side of the market. Passive managers tend to buy as the market rises as new funds come in from investors and sell as the market falls as investors withdraw funds.

Active managers have much greater flexibility. Depending on the fund's model, they can be short stocks, hedge with options or even trade index futures against the positions. Usually these managers run hedge funds.

Passive managers have had their day. With the market basically rising for 18 years, until 2000, they could do no wrong. Now their life is much tougher. Overall, active managers have fared much better over the last two years. A great way to invest with active managers, yet get broad diversification, is with a "fund of hedge funds". These are investment vehicles that spread the risk over a group of active managers. That's my play.

**Dear Slim:**
My wife and I have been trading stocks and stock index futures for the past four years and have been enjoying mostly positive returns. I'm trying to convince my wife that we should look into trading options. I've explained the benefits as well as reassured her that we will risk minimally at first. She is mainly concerned that we do not know enough about options to jump in and is worried about the risks involved. I feel like I have done a significant amount of research on options and I am comfortable in making a move. Can you suggest any tactics to restore her confidence in the fact that we've done well in the past, and using a new tool could be advantageous?

—Randall G., via e-mail

**Dear Randall:**
You have trading experience, you are conscious of risk and you have done a "significant" amount of research on options. It sounds to me like you have many of the tools necessary to begin trading options. Now you want me to be the one to convince your wife to trade options? I'm laughing. I believe it's up to you to prove that you have a workable methodology and discipline.

My first suggestion, in the early stage, is to avoid options on stock indexes or stocks that are thinly traded. Especially avoid options in S&P futures on the Merc, which can be very difficult to execute and have very wide spreads. Then consider using strategies to limit risk. Options decay amazingly quickly in the final week before expiration. So if your position hasn't worked by then, consider exiting before it disappears on you. Have a dollar-loss limit and stick to it. Use stop-loss orders if necessary. Trading in units of a minimum of two can be helpful. If the position goes your way, you can lock in some gains by exiting half and let the other half run.

I have traded options for 28 years and have made every mistake a multitude of times. That can be very expensive. Know going into option trading that there will be a learning period. Set up an acceptable budget and a reasonable learning period between your wife and yourself for this process.

**Dear Slim:**

As a technical trader, I feel that I thoroughly analyze strategies before carrying out any trades. I am usually confident in the moves I make. However, when a trade backfires and I lose money, I become entranced with what went wrong. I go over my charts, confirm that my system is at the right settings and mull over what I could have done to prevent what has happened—almost going into an instant panic attack. While I feel that I'm not risking more than I should, I think I should reduce the size of my positions. I enjoy trading and, fortunately, do not often experience large losses, but when I do, I practically lose it. As a long-time trader, I'm sure you have dealt with your fair share of losses. How did/do you handle them?

—Matthew L., via e-mail

**Dear Matthew:**

Your question contains two very telling phrases; when a trade backfires and you lose money, you find yourself "almost going into a panic attack." Also, you say you don't often experience large losses. But when you do, you "practically lose it."

My guess is that these emotional reactions affect your trade selections and your ability to maximize profits. As I've discussed in previous columns, these types of emotional reactions are a result of experiences in your past that have nothing to do with trading. At some time in the past, something might have happened in your life, with the consequence leaving you feeling fear or shame. Those old emotions can inappropriately contaminate the present trading situation.

When I have a big loss, I get out of my positions so I can think clearly. Then I spend time acknowledging the aspects of myself that are great, how I make a difference in the world and to the people close to me. This process helps me to recenter so I can proceed with a clear mind to the next trading opportunity.

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