

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!



Dear Slim,

I recently signed up with an advisory service that recommends trades in specific option strategies. I am mainly interested in calendar spreads. This service identifies what they say are 1:1 or 2:1 risk-reward ratios. Could you help me understand how they arrive at these ratios? Thank you in advance.

–Shree, Kendall Park, NJ

Dear Shree,

A calendar spread is an option strategy in which you sell one option and buy a longer-term option of the same strike price. Profitability comes from the inherent accelerated rate of decay of the near-in option. The most favorable result comes when the security is trading at the strike price on the expiration date of the near-in option. Then the short side of the spread loses its entire value, and the long side of the spread has a month to go until its expiration date.

The risk is that the security may move far away from the strike price. Were the options to go deep in the money, there would be lower demand, causing both sides of the spread to lose premium. Because the long side of the spread has more premium to lose, the spread narrows and becomes a loss. A similar phenomenon happens when the options move deep out of the money. As the security falls and the options lose their value, the higher-priced option – the long side of the spread – loses value faster, again causing a loss.

Calculating your risk on the spread is easy enough. How much did you spend? For example, if you bought 10 AMZN Sept 40-Oct 40 call spreads for \$0.70, you paid \$700 (plus commissions, negligible for this calculation).

Calculating the reward side is a bit more involved. Remember, the best place for this spread to end up is at 40 on September expiration. Most option-execution platforms offer an "option analyzer," which allows you to find the theoretical value of options based on specific variables. Plugging in Sept 40-Oct 40 call spread for September expiration (September 17, 2004) – assuming the same implied volatility as of this writing (late July) – we find the value to be roughly \$1.25. The cost of the spread was \$0.70, and value at the most advantageous point is \$1.25. So we have a 1.78:1 risk-reward ratio (\$0.55 profit divided by \$0.70 cost).

In truth, it's rare to hit a bull's eye on a calendar spread, achieving the most advantageous result. I prefer to assume I have about half the risk of the debit paid on the spread and use that as a stop. Then to achieve a favorable risk-reward, you don't need to hit the spread right on the numbers, and you can exit the spread if it widens before expiration.

Dear Slim,

I enjoy reading your column in SFO and have recently come across your website. I trade condors and other credit-spread strategies. Is there a way to hedge what I term "event risk?" If I do a spread with \$10 strikes way out of the money on SPX and take in \$1.00, I then have a potential downside risk of \$9.00. I realize this amount will rarely be lost. However, who knows? If I hedge with out-of-the-money puts on a highly correlated stock (QQQ), how do I judge how many to buy and at what strike? I am interested in having some insurance "just in case," while not wanting to give up too much of my profit from the credit.

–Chris, via e-mail

Dear Chris,

If you sell 10 deep out-of-the money SPX condors (see "Ask Slim" in September *SFO* for a description of the iron condor strategy; also the final article in that issue by Mike Parnos, who touches on them) for \$1.00, you have a potential \$1,000 profit and \$9,000 loss; a 1:9 negative risk-reward. Your assumption is correct. Unless you fall asleep on this strategy, the only way you can lose the whole \$9,000 is on a very rare day, like on 9/11, when the market fell more than five percent when it reopened. If you want to protect yourself against this risk, whether you use SPX puts, QQQ puts or any highly correlated security, you still need to buy enough downside protection to make \$9,000 if the market has a huge down day. And if you carry this position throughout the year, rolling it every expiration cycle, you would need to carry this insurance full time. Even in this environment

of historically low implied volatility, it still would cost more than your profit over the year. So, fully insuring against event risk on a far out-of-the-money SPX condor is like paying a \$20,000 per year insurance premium on a \$10,000 car. The real question is if there is economic justification for doing this variation of a condor at all. The stock market, during this year, has been in an amazingly tight range. Still, the declines of greater than 60 points in the S&P 500 Index which occurred in March, May and July, had to cause you grief. If you traded this strategy in the previous three years, nearly every month was a challenge. Only a very seasoned option trader would be nimble enough to maneuver your position in a very volatile market environment. The best way to use condors is in stocks, where the strategy offers close to a 1:1 risk-reward. Choose moderately priced stocks with high implied volatility, which have been trading in a relatively tight range. Then babysitting your position won't be a full-time job.

Dear Slim,

I spend my investing time writing covered calls and selling some naked puts on stocks that are traditionally considered blue chips (primarily dividend-paying stocks). I do this without any help from an online service, but do trade electronically. I'm looking for a website that can help me do option analysis for this type of activity that would provide technical analysis and estimates rates of return for the above strategies, plus some help on spreads. I'm not interested in purchasing software or downloading it to my system, but would prefer for all of that to remain


resident at the website. Do you have any sites you would recommend for this kind of investing?


—Joe V., via e-mail

Dear Joe,

The design of most online stockbrokers' platforms is for investors or stock traders and not for option traders. Thus, they lack the more sophisticated tools for analyzing options strategies. Many option execution platforms offer the ability to analyze an existing or theoretical option strategy and to manipulate the data to reflect valuations on specific dates or on variations in the "Greeks." Only highly sophisticated option analytical software allows you to scan the markets for trades based on your specific criteria. Usually, to gain access to these advanced analytical features, you need to open an account.

An excellent web-based site that offers a variety of analytical tools is Ivolatility.com. Its selection of premium services includes calculators for option valuations, intraday portfolio monitoring and scanners for trading strategies, which includes a tool that looks for the best opportunities in covered writes and naked puts. This site answers your need to avoid downloading software and have it all reside on a remote server.

If you can download software and wish to have a platform on which you can do all the analytics and then execute the trades at very competitive prices, our favorite is still ThinkorSwim.com. Their execution software has been designed by option professionals to meet every option trader's needs. They are about to roll out advanced scanning. Contact them for a demo at www.thinkorswim.com! 



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AskSlim@sfomag.com or
Ask Slim
SFO magazine
3812 Cedar Heights Drive
Cedar Falls, IA 50613

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