

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 have been trading options for six months and am starting to study some of the more intricate spread ideas. I am especially interested in the market-neutral strategies like the iron condor. Will you please expand on how you use this strategy? Also, when is the best time to enter this type of position? And when do I know if it's going wrong?

—Brianna B., via e-mail

Dear Brianna,

With all of the inherent risks in option trading, the type of strategies to which you are referring are certainly good choices. The iron condor is a "credit" option strategy constructed by selling two out-of-the-money vertical spreads. Another name for this position is a "dual-credit" spread. It is a four-option spread, constructed by selling an out-of-the-money *call* and buying a further out-of-the-money call, then selling an out-of-the-money *put* and buying a further out-of-the-money put.

An iron condor is best used in a security with relatively high implied volatility, so there will be high enough premiums for the option strategy to make economic sense. For example, MXIM has been trading between 45 and 55 for the past several months and is presently trading at \$52. We sell the August 55 calls for 1.40 and buy the August 60 calls for 0.40, for a credit of 1.00 point. Simultaneously, we sell the August 50 put for 1.50 and buy the August 45 put for 0.50, for another one-point credit. So the total credit, or maximum profit potential, is 2.00 points. To calculate the maximum risk, take the biggest possible loss on either side of the position, puts or calls, and subtract the total credit. In this case, the maximum risk is 3.00 points plus commission costs.

To make the two points, or \$200 for each spread, MXIM would have to close at August expiration between 48 and 57. Based on a margin requirement of \$500, the potential 60-percent return on what at this point is a seven-week holding period, seems quite tasty. Of course, if the stock moves outside of the desired range, the trader will have to be nimble enough to work out of a situation that could turn into the maximum \$300 loss.

So, as illustrated, an iron condor and many other market-neutral option strategies, like butterflies and time spreads, can be quite profitable, with the usual disclaimers: "Option trading can result in the loss of part or all of your money." That is even true in what seems like the safest spread.

Dear Slim,

Can you explain what single stock futures are? Also, what are single stock variance futures? Or are the two contracts one in the same? I have heard it said that single stock futures drastically change how option positions are hedged. Will you please explain?

—Ron K., via e-mail

Dear Ron,

Single stock futures (SSFs) are futures contracts on individual stocks. A single stock future contract carries an obligation to deliver and take delivery of 100 shares of the underlying stock on a specified delivery date. They differ from a stock in that SSFs usually have a 20-percent margin requirement, and you do not need an up tick for a short sale. The lower margins mean lower carrying costs. Thus, certain options strategies are more feasible using single stock futures than stock.

Also for your information, Howard Simons has written an article this month on, among other things, pairs trading in SSFs, and if you look back on past *SFO* issues, particularly during 2003, you will be able to learn a great deal more about these instruments.

Single stock variance futures are based on the historical movement of an index over a specific period. Essentially, they are a measure of stock market volatility. For detailed information on the CBOE S&P 500 three-month variance futures, go to www.cboe.com.

Dear Slim,

My question concerns stop loss-orders on option trades. I was wondering if I'm placing my stop-loss orders too close. I currently set it at about a two- to three-percent change in the price

of the underlying security. Do you feel this is too low? Should I switch to a point-loss system when figuring stop loss for my options trades?

–Anonymous, via e-mail

Dear Reader,

You are really going to have to be right on trades with stop-loss points set at two to three percent on options trades. If your stop is three percent on a \$50 stock, you are talking about \$1.50. That's just a twitch in a volatile market, which means you are setting yourself up for a poor win-loss percentage. Another problem with keying in on price points as stops is if the market or underlying security goes into a dull period, you could lose the entire value of your position through option decay, especially late in the option cycle.

I suggest using a maximum point loss or dollar amount to establish your stop points. My rule is 50 percent of the initial value of the trade, which must also be less than five percent of your trading capital. So if you were trading with a \$10,000 account, the maximum risk would be \$500 on a trade, meaning your maximum commitment on the trade would be \$1,000. The rule applies whether you are trading options outright or spreading.

One of the best ways to lower the risk of getting stopped out on option trades is to improve your entry. That means coming into trades on countertrend moves, rather than on breakouts or breakdowns. You'll miss a few trades that way. However, improved entries lower trade costs, improve your overall results and reduce the risk of the psychological zinger we feel when a trade is stopped out.

Dear Slim,

I have a passion to learn how to day trade the E-mini S&Ps. I have learned much about the stock market and have traded the E-minis. But

I have lost money because of my lack of knowledge in price movements, technical analysis, volume, etc. I also lack good hardware and software. How does a semi-novice like me learn to day trade? Do you have any suggestions?


–Scott, via e-mail

Dear Scott,

Trading index futures is very demanding, especially if you are a day trader watching every tick. To gain a clearer focus, the first thing you should do is improve your trading environment. That means buying good hardware and software. With the competitive pricing on computers these days, you will find a great setup, with dual monitors, for less than \$1,000. The choices of charting software can be exhausting. I suggest you compare eSignal, PCQuote and Prophet.net and Futuresource. They all have huge lists of analytical tools and tutorials on using them. This is the easy part.

Next, you need to build a knowledge base and gain experience in the markets. There are a number of workshops offered on E-mini trading, many of which cost thousands of dollars. I suggest you spend a month or two on a simulator to keep your costs down while you learn. Peregrine Financial Group (PFG) has a great one (www.PFGBest.com). Another great way to learn about trading is in forums or chats. The most active one I have seen is EliteTrader, www.elitetrader.com. They have more than 25,000 members, many of whom are very experienced and are amazingly willing to share trading and analytical ideas.

Once you have developed a comfortable method, have the analytical tools and discipline rules, and have made enough mistakes – enough times – chances are you will learn to trade E-minis with some success. Everything takes time and focus, and of course, you really do need enough risk capital to stay the course. **SFO**



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QUESTIONS!
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