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The "Write" Way to Trade the S&P 500 Index

By John Summa

There are many ways to trade the S&P stock index, but there is only one way I know of that has a 90 percent accuracy rate—selling deep out of the money put spreads using options on S&P futures. This quarterly cycle S&P option strategy has limited risk and requires much less margin than buying or selling the S&P futures outright or selling naked options. A very nice feature of this trading strategy, furthermore, is the tiny amount of work it requires, as well as the psychological comfort of losing only 10 percent of your trades. As long as average losses on the losers are kept in check, this can be a very profitable trading approach.

Sell, Don't Buy

I would argue that being a net seller rather than a net buyer of options is generally a better approach for traders. While there are certainly long position trades that offer prof-

itable opportunities, I am convinced that selling premium offers a trader a strategic advantage for two central reasons—time becomes your ally and you no longer totally depend on directional movement of the underlying futures to profit.

There is evidence to support this claim. For example, in the case of S&P 500 options on futures, for the three years 1997 through 1999, an average of 83 percent of all S&P options expired worthless. Figure 1 contains additional data, showing a

breakdown of S&P options expiring worthless into put and call options during this three-year period. This shows why put spreads are a better bet, especially given the long-term bullish bias of stocks. Here we see an average of 94 percent of S&P put options expiring worthless. Certainly if you can find the right options to sell, there is a pretty good chance of winning as an S&P put options writer.

See **S&P 500 INDEX**

Continued on page 14

Figure 1

Chicago Mercantile Exchange
Expired Out-Of-The-Money Options
CME Total and S&P Options (1997 - 1999)

Year	CME Options	S&P Options	S&P Puts	S&P Calls
1997	76.3%	81.7%	94.1%	54.8%
1998	75.8%	82.2%	93.1%	43.9%
1999	77.5%	84.7%	94.5%	66.7%

Managing Risk with Options

By Jeanette Young

Risk and options are frequently linked together, but—managing risk? This article will discuss a few of the opportunities available for use in managing risk within the options market.

Options have suffered a bad reputation and association with speculation and gambling, often conjuring visions of roulette wheels and casinos. Such images may result from past speculative frenzies such as the European tulip craze. These options were traded before there were cars, electronics or even electricity. Yes, options can be and are used in this manner, but that is not their sole function. This wildly maligned financial instrument is a wonderful tool that can be used to increase earnings and decrease risk.

Before we go on, let's start with a few definitions. As you surely know, options can be bought, sold, or both. If an option is sold—be it a put or a call, covered or naked—the seller will be obligated to honor that contract. Under certain circumstances the seller may be forced, contractually, into action. On the other hand, the

purchaser of an option has no obligation to do anything. Seem easy? That's because it is.

There are six influences on the price (premium) of an option:

- The price of the underlying instrument.
- The strike price of the option.
- Time left until expiration (decay).
- Volatility of the underlying instrument.
- Short-term risk-free rates of return (T-bills).
- Dividends payable on the underlying instrument.

One of the most conservative options strategies is the "covered write" which works well in equity accounts and can be easily used to increase the earnings of the portfolio. One of the more obvious risks is, of course, that you may have to sell the securities. A covered call seller sells the buyer the right to purchase a fixed number of shares of an equity or future that is owned, at a predetermined price (strike price). This right expires at a date certain in the future (expiration date). For taking this action, the seller is paid cash, and that cash is called the premium. The premi-

um is not the sale price of the equity or future, but is paid to the seller and is a real credit in the seller's account.

For example, say you own 1,000 shares of XYZ, but you think the stock has stalled and will have trouble going up. You would be happy to sell your stock at \$50 for a profit. If someone would give you \$55 for your stock, you would be thrilled. You sell a call that will expire on the third Friday in September 2001, for a premium of \$2, which is equal to \$200 per 100 shares or \$2,000 dollars. The strike price of the option is \$55. Don't worry, you received the price you felt was fair so go on to the next trade. If XYZ is \$65 a share by the third week in September 2001, you sold your stock for \$55 dollars. Don't worry, you received the price you felt was fair so go on to the next trade. Actually, there are strategies you can use to capture the additional money but we are not going to go into those now. If the stock is under \$55 a share at expiration, you still own the stock and can sell calls

See **MANAGING RISK**

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Dear Reader,

The world has changed drastically since our last issue and the thoughts and prayers of all of us at CRB are with those who have been affected by the attacks of September 11. Our resolve is to continue to bring you the information you need to carry on.

In this issue we take a look at options. John Summa looks at how options can affect the way you trade the S&P 500. Jeannette Young looks specifically at how options can help you manage risk. And we are pleased to present an interview with Paul Stevens, the president of the Options Industry Council.

On other topics, Mary Ann Burns of the Futures Industry Association gives us a preview of Futures & Options 2001... the biggest futures and options conference of the year. Technical guru Lou Mendelsohn returns to our pages with a peek behind the times and behind the markets at what's missing in technical analy-

sis. Tom Busby of the Day Trading Institute offers his "Game Plan for Success," and author David Lerman of the Chicago Mercantile Exchange describes how you can use E-minis to hedge your investment portfolio.

Michael Bennett gets "Back to the Basics" with his dissection of calendar spreads in "Puts & Calls," Adrienne Toghraie defines full time trading in "Mind Over Money," and Jaye Abbate reviews Ross Jardine's new book, *Bear Market Game Plan: Strategies for Success in Choppy Markets*.

Our next issue will focus on technical trading. As always, we encourage you to contact us with your story ideas. Address your correspondence to:

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**CRB
TRADER**

Published by CRB

312-554-8456

800-621-5271

Fax: 312-454-0239

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CRB TRADER is published bi-monthly by CRB, 330 South Wells Street, #1112, Chicago, IL 60606.

Subscriptions: Free to all those actively engaged in the futures, options, and derivatives markets. All others: \$3.50/issue in US; \$4.00/issue overseas.

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FIA Presents EXPO 2001: The Biggest Futures and Options Conference of the Year

By Mary Ann Burns

Single stock futures, trading systems and strategies, and online markets will highlight the program at the Futures Industry Association's annual Futures & Options Expo November 28-30 at the Hyatt Regency Chicago.

The Expo exhibit hall includes more than 100 exhibitors from exchanges and software providers, to data vendors, publications, book publishers, brokerage firms, and trading systems.

Perry J. Kaufman, president of Strategic Market Systems, returns to Expo to chair a session on *Resolving the Dilemma of Sideways and Trending Markets*. Panelists will share their experience in identifying whether price movement is trending or stagnant. Once you know the type of market, there are many strategies that will capture profits. This panel will discuss what techniques can be used and what markets are likely candidates.

Professional coach and trader, Van K. Tharp, Ph.D., will run a simulated trading game to illustrate the importance of position sizing, expectancy, and discipline in trading. During the game debriefing, he will identify key biases that prevent prudent decisions and how to overcome these biases.

Chicago Board of Trade floor trader, Chip Kenyon will discuss successful trading of interest rate futures with the help of Rick Santelli, on-air editor for CNBC. Kenyon will discuss how he profits in an interest rate complex that includes identical and mini-sized contracts, traded in the pit and on the screen.

Tom Busby, president and founder of The DayTrading Institute presents *The S&P: Ultimate Trading Vehicle* on Friday, November 30 at 10:30 a.m. He believes the S&P index provides the five most important features that contribute to a trader's ability to find success: liquidity, volatility, accessibility, leverage and risk management. He will describe how each of these characteristics fits together to formulate the most complete trading platform available in today's market.

The program also includes a session on trading arcades, analyzing volatility, trading tools, and the new CBOT X-Funds.

Three sessions on Wednesday give information on the operational and legal aspects of trading security futures products. Uses for these new products will be explored in the opening session on *Institutional Use of Security Futures Products*.

Innovative Products for Changing Times features representatives from the Chicago Mercantile Ex-

change, Chicago Joint Venture, Nasdaq Liffe Markets and Peter Steidlmayer, president of Steidlmayer Software, Inc.

Jamie Dimon, chairman and chief executive officer of Bank One Corporation, will speak at the FIA Law & Compliance Division Luncheon on Wednesday, November 28. He is credited with putting Chicago's largest bank into the black.

Taste of Expo will take place on the exhibit hall floor on Wednesday,

November 28 from 4:30 to 6:30 p.m. Thursday night's reception is hosted by the CBOE, CME and CBOT Single-Stock Futures Joint Venture at the CBOE.

Registration fees include a three-day pass to all Expo events for \$650; single day passes for \$325; and single session passes for \$85. A pass to the exhibit hall is \$20.00.

The exhibit hall will be open Wednesday, November 28 from 9:00 a.m. to 6:00 p.m.; Thursday, Novem-

ber 29 from 9:00 a.m. to 5:00 p.m.; and Friday, November 30 from 9:00 a.m. to 2:00 p.m. Registration begins at 8:00 a.m. each day.

For full program information and a list of Expo exhibitors, visit www.futuresindustry.org.

Mary Ann Burns is senior vice president of the Futures Industry Association and editor-in-chief of Futures Industry magazine.

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Preliminary Program (subject to change without notice)

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- FIA Law & Compliance Division Luncheon
- Taste of Expo
- FIA Chicago Division Luncheon
- Chicago Board Options Exchange, Chicago Mercantile Exchange Inc., Chicago Board of Trade Single-Stock Futures Joint Venture Reception

Industry Issues

- The Industry Responds to September 11
- What's New Chicago?
- Growth Opportunities in Global Markets
- Innovative Products for Changing Times
- Getting A Handle on Transaction Costs
- National Introducing Brokers Association presents Brokering Futures for Success
- The Wise Guys

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- Analysts Roundtable: The Promise of Online Markets
- Where Online Markets Meet Traditional Markets
- The New Intermediaries
- The New Look in Trading Platforms
- Risk Management Online
- Clearing: The Ultimate Asset
- Developing Indices
- Insuring Your Risk

Trading Systems & Strategies

- Trading Arcades
- Position Sizing, Expectancy, and Discipline: How Traders Often Neglect What is Most Important
- Top Trader: Chip Kenyon
- Analyzing Volatility and Implementing Strategies for Successful Trading
- Finding the Sideways Market
- Winning Trades Made Easy Redux
- Trading "Composites" Electronically: CBOT X-Funds
- The S&P: Ultimate Trading Vehicle

Operations & Technology

- Risk Management in the E-World
- The Clearing Business
- FIA Chicago Operations Division presents Clearing Plans for 2002
- FIA Chicago Operations Division presents Straight-Through-Processing: Myth vs. Reality
- Facilities Management

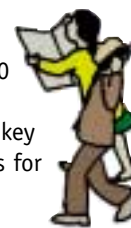
Security Futures

- Institutional Use of Security Futures Products
- FIA Law & Compliance Division presents Legal Challenges for Trading Security Futures Products
- Operational Challenges for Trading Security Futures Products

What is Expo?

Expo showcases products, services and information for market professionals and participants. Hundreds of risk management products, trading tools, books and exchange and technology products are presented by more than 100 companies from around the world.

Expo also offers a variety of sessions that allow participants to discuss industry trends, hear expert views on key issues, improve trading skills and learn about new products, systems and practices. Our program includes sessions for business, operations and technology professionals and traders.



Who Attends?

More than 4,000 people from more than 20 countries will attend Expo. Attendees range from senior staff at brokerage firms and exchanges to floor traders, pension fund managers, corporate treasurers, CTAs and CPOs, and individual investors. This year Expo includes a focus on developers and participants in the growing arena of online marketplaces from bandwidth to chemicals to agricultural and energy products.

View the full program and register online at:

www.futuresindustry.org/expo

Futures Industry Association

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Options Industry Council: A Trader's Resource

The Options Industry Council, a non-profit association that provides investor education about equity options, presents an interview with Paul Stevens, its president. Stevens offers his perspective on the growth of equity options and discusses strategies for the current market.

Q: What is The Options Industry Council and how was it founded?

Prior to the formation of OIC, we found that there were many myths and a general lack of understanding about options in the marketplace. OIC was formed in 1992 in direct response to address misunderstand-

ings and provide education about options. Through a unified effort from the leaders of the nation's options exchanges and The Options Clearing Corporation, OIC serves as the primary industry resource for options education. We believe OIC's resources provide both education and insight for investors to help them make well-informed decisions.

Q: Do you think the attitudes toward options have changed since OIC was established?

There is no doubt that options have earned a reputation as a viable investment alternative over the years.

I think the numbers speak for themselves. Since OIC was founded, volume has grown 535 percent, year-to-date average daily volume is around three million contracts per day, and even in the current economy, we continue to see a growth in options volume over last year.

I also think, the financial press has a much better understanding about options than they did 20 years ago. The options market now receives greater media attention, which reflects that options have become more mainstream. The media has also done a good job of educating viewers and readers about options.

Financial advisors/brokerages have benefited from these strides and now view options investors as valuable clients.

Q: What do you attribute the dramatic growth in volume and change in attitude to?

I think there are several factors that come into play. In particular, increased automation, intense competition and more readily available information.

Today, there are five options exchanges that are all highly automated. They process millions of contracts in a single day—this would have been unthinkable years ago.

The competition between the exchanges makes it a good time to be an options customer. Competition has grown even more in the past couple of years. With the change to multiple listings in 1999, 80 to 90 percent of total volume now comes from these listings. All multiple listings are on two or more exchanges and some are on all five exchanges.

In addition to competitive factors, the increase in investor education has had a profound effect of options volume. OIC wants to counter the "get rich quick" people in the options world who guarantee instant wealth by using options. Options aren't about getting rich quick; they are a tool. We want options to be used properly and we're doing that through free seminars, our call center, newsletters and the Web site.

Q: Have you seen any changes in the international options marketplace?

OIC has taken an active role in internationally expanding options. We know there's a fair amount of business in Europe and in 1998, we opened an OIC London office. By reaching out internationally, we can increase business here in the U.S. In addition to Europe, OIC has entered into Pacific Rim alliances with The Australian Stock Exchange for educational materials. We have also presented educational roadshows in Hong Kong and Singapore. We see these as venues that will enable OIC to expand its reach.

Q: What strategies are options investors using in the current market conditions?

Collars can be very useful in this market when a stock's future is neutral or bearish, or when the goal is to sell the stock at the strike price of the call. It is also a good choice when the investor is wary of the cost involved with protective puts. By holding shares of an underlying stock, purchasing a protective put and writing a covered call on the underlying stock, the collar uses the proceeds from the sale of an out-of-the-money call to help pay for the purchase of a put. This gives the stock position some downside protection (below

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the put strike price), but retains some upside potential (up to the strike price of the call sold).

Q: Can you provide an example of a collar strategy?

Definitely. Let's say that XYZ stock is currently trading at \$58 per share (we're assuming our investor owns 100 shares of this underlying stock). The investor finds a 90-day XYZ call with a strike price at \$70, priced at 2.70 a share (a total of \$270 per contract) and a put with a \$50 strike price offered at 2.55 (a total of \$255 per contract). The investor can write (sell) a 70-strike call and simultaneously purchase the 50-strike put. The resulting option position puts a "collar" around the stock's future price.

At expiration, the position breaks even at the stock price of \$57.85 per share; however, below \$57.85, there will be losses. The break-even point is calculated as the current price of \$58 minus the net premium of .15 (2.70 - 2.55). Those losses will be completely offset below \$50 per share because our investor can exercise the option. On the following business day after the exercise request, the stock will be delivered at \$50 per share. That places a downside "loss limit" on the stock position of eight points or 13.8 percent from its current price of \$58.

On the other hand, the position will generate profits if the stock price is above \$58 per share. However, if the stock price is higher than \$70 (the strike price of the short call option), another investor who owns one of the 70 calls has the right to exercise and take delivery of the stock. If that exercise notice is assigned to our investor, they will be required to deliver the shares the next business day at \$70, no matter what the current market price of the stock may be. The sale of the 70 call limits the potential profit for 12 points, or 20.7 percent.

Q: Where can professional traders get more information about strategies?

A good place to start is our call center at 1-888-Options (1-888-678-4667). It is staffed with options experts who can give professional traders and individual investors insight into options strategies. OIC has a variety of free resources on its Web site, www.888options.com, including its Strategies section that lists a number of different bear, bull and neutral market strategies and OIC's brochure called, "The Equity Options Strategy Guide." OIC also offers free nationwide seminars.

Q: What advice would you give to a professional trader looking into investing in options for the first time?

Education. Education. Education. For a professional trader, the use of options can be highly speculative to very conservative. A trader would be irresponsible if he did not take the

time to learn about options. He may decide options aren't for him, but he needs to learn about them first before making that decision.

Once you start to learn, it's important to understand the benefits and maximum risks affiliated with each strategy. There's a wealth of information out there about options, but it's not always good. The good information will present both the ups and downs of using options in your portfolio. As I said earlier, be wary of "get rich quick" claims. Take advantage of free information out there from reliable sources like OIC and the options exchanges. Once you start trading options don't stop asking questions and looking for information. There's always more to learn.

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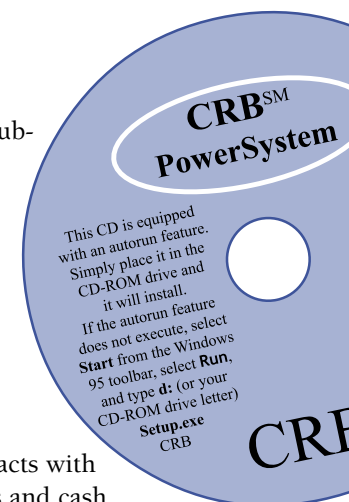
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MANAGING RISK

Continued from front page

again. Perhaps you will have to roll the strike down.

Note: the one event that is usually forgotten is the case where the stock goes down. In this case, the strike price can be rolled down. This covered writing can be done in futures accounts as well.

Here is what is considered to be a risky option strategy: do exactly as noted above but don't own the stock. Now you are naked the equity and have sold a naked call. This is risky because you have unlimited upside risk. This also can be managed with other strategies to negate some of the risk. For example, you could capture

the premium of \$2 per option and use some of that premium to purchase a call with a higher strike, say a strike of \$60. Your risk then is only \$5 per share. When you use a spread option position, your margin is much less than a position with a naked option. You have actually covered your naked call on the upside.

SELL September 55 CALL \$2000.00

BUY September 60 CALL \$500.00

RISK = \$3500.00 @ \$60.00/SHARE

RISK = \$3500.00 @ \$70.00/SHARE

What if you sell a put? You must really want to own the stock or the future. You are promising to purchase the stock at a given price at a time certain in the future. For this risk, you will be paid a premium (real money). Assume that XYZ

stock is nearing its support level and it is a stock you would love to own. You can sell the put for \$2. You are agreeing to purchase that stock for \$40 a share at a given time in the future. For taking on that risk, you are being paid \$2. As above, there are other strategies that can be used to remove some of the risk, e.g. you could purchase the \$35 put and limit your downside exposure. This type of put spread will reduce the amount of margin you will have because you have limited your risk.

SELL September 40 PUTS COLLECT \$200.00

BUY September 35 PUTS PAY \$100.00

RISK = \$400.00 Maximum risk

Now let's combine some options and see what happens. You are long XYZ at \$50, sold the September \$55

calls, and now you purchase the September \$50 puts. Just to add some spice to this, the stock goes X-dividend September 1, 2001. So, the situation is that you have agreed to sell your stock, you will get the dividend and if the stock crashed before the third Friday in September, you will not lose money. By purchasing the put, you have bought and paid for insurance until the expiration of that put. You can sell your stock at that price even if it goes to zero as long as that occurs before the expiration date.

Options are either American-style or European-style. Equity options in the United States are the American-style. American-style options can be exercised at any time up to and including the expiration date, while European-style options can only be exercised at option's expiration date. European-style options are used in futures contracts and European equities traded abroad.

These are all simple but usable options strategies. Margins on these types of trades vary from house to house, but the one thing you must remember is that the purchase of options is not marginable—they must be paid for.

Using futures and futures options to create money and manage risk can be more profitable than using equities and with them it is also relatively easy to manage risk and keep the portfolio neutral. All of the previously mentioned strategies can be done in the futures arena.

Futures have a favored tax status. Sixty percent of the profit or loss is considered long-term and the IRS considers only 40 percent short-term. (Equity trades that are short-term in duration are considered ordinary income.) So, if you have a short-term gain of \$100, all of the income will be viewed as ordinary income for equities. With that same amount in the futures arena, \$60 is given long-term capital gains treatment and the remaining \$40 is ordinary income. Thus right away you see there is an advantage in futures. Another advantage is the margin requirements which, because futures are in the future, the deposit to purchase those futures (in the future) is lower than the margin required to purchase stock now or the margin required for equity option trades. In the futures markets, T-bills are usually used to meet margin requirements; of course, you could use a T-bill for equities as well. (The interest earned on the T-bills is yours.) The bottom line is that you need less margin in a futures trade vs. its stock counterpart.

For example, the margin that is required to purchase one mini Russell 1000 contract is \$1,500. The contract's value is 624 times 50, which is \$31,200. If you were to purchase an equivalent amount of the IWB shares, which is the AMEX Russell 1000 product, you would use the same \$31,200 but your initial margin would be \$15,600. With the IWB, you would have purchased 500 shares of stock. True, you could sell

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five covered rights, but the premiums will be less. Why? Because there is a difference in the strike prices between futures and equities in this case.

In the futures for the Russell 1000 contract option strikes are in \$2 increments. For example, 624, 626, 628, 630 and so forth. In the equity equivalent, the strikes are in \$5 increments. For example, \$65, \$70, etc. Perhaps you have noticed another difference: the strike price of the futures seems to be high because it is. This allows the seller, or the buyer, more flexibility. By using the futures, you have more flexibility and a much better tax advantage than by using the equity equivalent.

We now have to introduce delta. Delta tells you how much an option will move for a one point move in the underlying security or futures contract. Delta is also a measure of probability and therefore helps you determine your margin requirements. Another term to introduce is Theta. Theta is the amount the option will decrease in value as one day passes. Vega is the measurement of how a stock or futures volatility affects the price of the option. Rho is a value that a change in interest rates would have on the option. For this article, Rho will not be considered. It must be stated, however, that Rho is important when considering either the purchase or the sale of a LEAP option. As defined by Larry McMillan in his book *McMillan On Options*, Gamma "...measures how much the option's delta changes, when the underlying changes in price by one point. Essentially, it is a measure of how fast the delta changes." The art of the option seller is to remain gamma- and delta-neutral.

Let us say, for example, that the delta of the option on XYZ stock's September \$60 call is .14. Call options have deltas ranging from .00000001 (the small number was made up) to 1.00. Put options have the same range but the numbers are negative. A delta of 1 or of -1 tells you that the option will move point-for-point with the equity or future. This option has a .14 delta, which lets you know that for every point the stock rises, the option will also rise but only \$.14. The delta helps you calculate your risk. In the futures market, it is always desirable for the option seller to remain delta neutral.

Another example, you sell the September Russell 1000 calls with a strike price of 650, which is sold on the Russell 1000 futures contract. The Russell 1000 contract is 616. You receive \$1.75 for selling that option (\$875.00 premium collected). To keep the position neutral, you must go long .14 of one contract. The options are sold against the regular size Russell 1000 contract. What you now know is that your position is short. There are things you can do to correct this, for instance just buy two mini Russell 1000 futures contracts. You certainly don't need a whole contract and two minis will do just

fine, as a matter of fact, you will be a tiny bit long. What if you don't want to buy a future anything? Well, we can neutralize most of the position by selling a Russell 1000 September 570 put. For this we will collect \$2.90 (\$1450.00). The delta on that put is -.12. Adding +.14 and -.12 gives .02, which is pretty neutral, and we don't own a futures contract.

SELL RUSSELL 1000 September 650 CALL 1.75
SELL RUSSELL 1000 September 570 PUTS 2.90
TOTAL PREMIUM COLLECTED 4.65
(divide by 2 for dollars/option)

This position can be adjusted easily with the addition or subtraction of the mini contracts. If the market goes up, buy the appropriate amount of minis needed and, if the market goes

down, sell the appropriate amount of minis. Your delta will change especially with any big change in your vega. Notice also that you are not adjusting the option position, which is called a strangle. The position is a time-decaying one. Time is the enemy of the option buyer and the friend of the seller. In this position, you are the seller. The theta of the position is .10 for the call and .15 for the put. So, you can measure the decay of the position. Even as the position nears the strike price, the erosion of the option keeps that position making money. This is only one small example of what can be created with options.

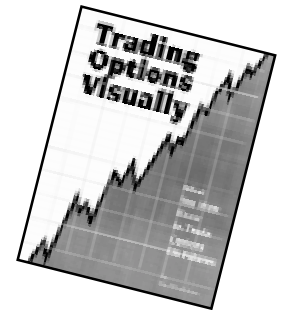
Options are flexible and offer-

many strategies that can be used to create income and manage risk. If you can imagine it, then it probably can be done with options. Let your imagination go wild and you will create strategies for fun and profit.

Jeanette Young, C.F.P. is a floor broker on the NYFE, Technical Analyst with S.G. Martin Securities and a Winner in the National Investment Challenge Pro Option's division. She can be contacted at OptnQueen@aol.com. Weekly market letters can be found on, www.nybot.com, www.gertfehu.com, and coming in the fall of 2001, financialfirefighters.com

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Puts & Calls

Back to Basics: Dissecting a Calendar Spread

By Michael Bennett

What do calendar spreads, butterfly spreads, condors, and iron butterflies have in common? They're all options strategies that can be used to take advantage of sideways moving mar-

kets. Now you may have no idea what any of these strategies are, and might even be a bit intimidated by them; in which case, you may never have bothered to take the time to learn about them. Well, nobody said making money was easy, and when stocks

don't move up or down, we either need to stay out of the kitchen, or learn to use the new food processor, regardless of how cumbersome it may seem.

As silly as it may sound, the most difficulty traders have with spreads, whether they are vertical (different strikes, same month) or diagonal (same or different strikes, different months), lies in understanding just how they become profitable. This is due to the multiple affects that delta, volatility (vega) and time (theta decay) have on each leg of a spread as expiration approaches. This is also the reason why spreads rarely become profitable as quickly as just buying calls and puts (and adversely, why they don't lose money as quickly either). Since I can't cover all

these spreads today, let's just pull apart the calendar spread.

Calendar spreads are diagonal spreads in which a shorter-term option is sold against a longer-term option of the same kind of contract (calls or puts). In other words, a calendar spread is nothing more than a unique way to finance the long-term option, without taking on margin or putting up additional capital. Inversely it can also be viewed as a method for purchasing a long-term contract at a discount. Here's how it works:

Suppose on July 9, you decided that EMC Corp. (EMC) had taken enough of a beating after collapsing from a price of \$30 to where it stands at \$22.32 in a single session. You feel that it will rebound eventually, but will probably do so only after a period of consolidating sideways for a month or two. The January \$25 calls are asking \$3.60 (\$360 per contract) and the August \$25 calls are bid at \$1.00 (\$100 per contract). This being the case, you can purchase the January call and opt to sell the August call against it to form a calendar spread, thereby lowering your net debit to \$2.60 (or \$260 per contract). Now, as long as the stock does not exceed \$25 before expiration Friday in August, the August contract will expire worthless because there is no intrinsic nor time value left in the option. However, there is still plenty of time value left in the January contract. Just how much depends on the price of the stock at August expiration, and is exactly why you should be using some sort of analysis software (such as our Platinum site) to help you see theoretically just how much that January option will be worth.

Now there's a couple of scenarios that would make this play profitable in a short period. Taking a look at the following risk graph of this very play, according to the chart, we should realize a profit at August expiration if the stock were anywhere above \$21.56 and below \$32.27. Our maximum profit is reached at exactly \$25. The question most people have at this point is "Why?" (See Figure 1)

Here's where it gets a little confusing. Remember that we bought the spread on July 9, with the stock trading at about \$22.32. Both the January and August calls in this play are out-of-the-money, and therefore contain only "extrinsic" value (time value). Time value decays most quickly in the last 30 days prior to expiration. Suppose that the stock remains at \$22.32 on expiration. Since both contracts are \$25 strikes, it makes sense that the August contract will expire worthless if the stock sits below \$25, while the January will continue to carry a premium; though it too will lose a bit of time premium, or extrinsic value. However, the August contract will lose value more quickly than the January. This is known as the spread "widening." As Figure 2 points out, if all things remain equal by then (volatility, etc.), you can actually close the play out at this point for a

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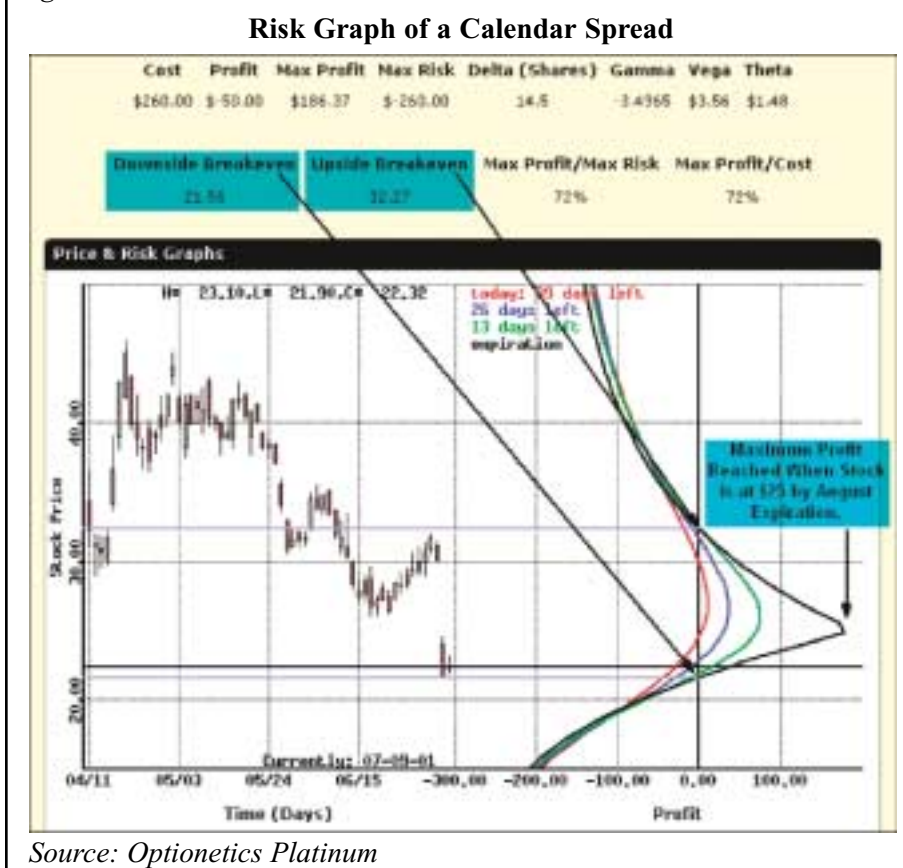
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Figure 1



profit of \$50 because the January contract can theoretically be sold for about \$3.10. (I derived that number by adding the \$50 or \$.50 per contract to our original debit of \$2.60).

So you see, the premium of the January contract has actually diminished from its purchase price of \$3.60. Since it lost only 50 cents, while the August contract lost \$1, it's easy to see how the spread widened and became profitable.

So how is it that we can reach maximum profitability if the stock rises and finishes at \$25 on expiration? First, time decay wiped out the August contract, rendering it worthless. However, although the January contract will experience time decay, the contract itself carries a delta close to 50. Delta is how much the option rises in value for every dollar the stock rises. In this case, the contract will rise at least 50 cents per \$1 rise in the stock, giving the contract a boost of about \$1.40. At \$25, the spread has reached maximum profitability because at that point, the short contract (August) begins to incur intrinsic value, which works against our play; as we would need to buy the contract back to close the position and avoid assignment.

This brings me to the next point about how it is we start to lose money on the spread as the stock falls above and below our breakeven points. Since we shorted the same strike as we purchase, as EMC rises, the delta of both contracts will approach 100 on anything over \$25 and thus trade at parity, or dollar for dollar with the stock. By the time this happens, the contracts are so deep in-the-money, they have no more time value in them.

In other words, if EMC traded at \$60, both contracts would be asking \$35 apiece. Any time you have a short position in-the-money at expiration, you can be assured of assignment, which is cancelled out by exercising

the long contract. So by the time true parity does occur, even though they cancel each other out, you're original debit in the play is \$2.60. This is also your maximum loss.

On the contrary, were EMC to continue its slide down, we already know that the August contract will be worthless. But the January contract still has some time value on its side. Therefore, for the contract to lose all of its value, taking our original debit with it, the stock would have to fall well below \$20. (See Figure 3)

As you can see, these spreads can be quite intricate; fully understanding them certainly requires a learning curve. But those who take the time to study these types of strategies have a better shot at achieving the goal of actually making money in virtually any type of market.

Figure 2

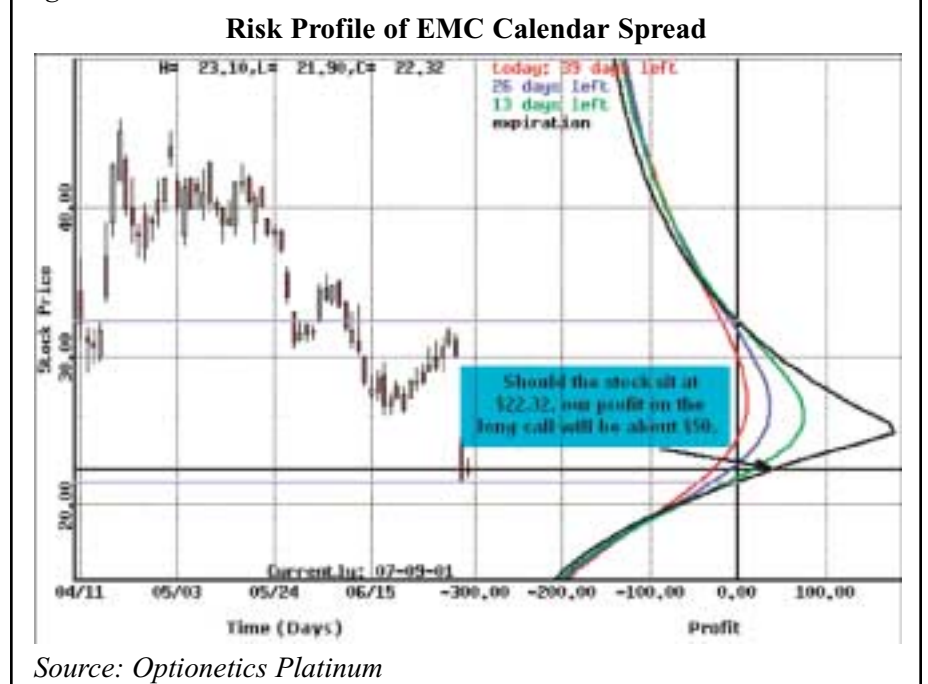
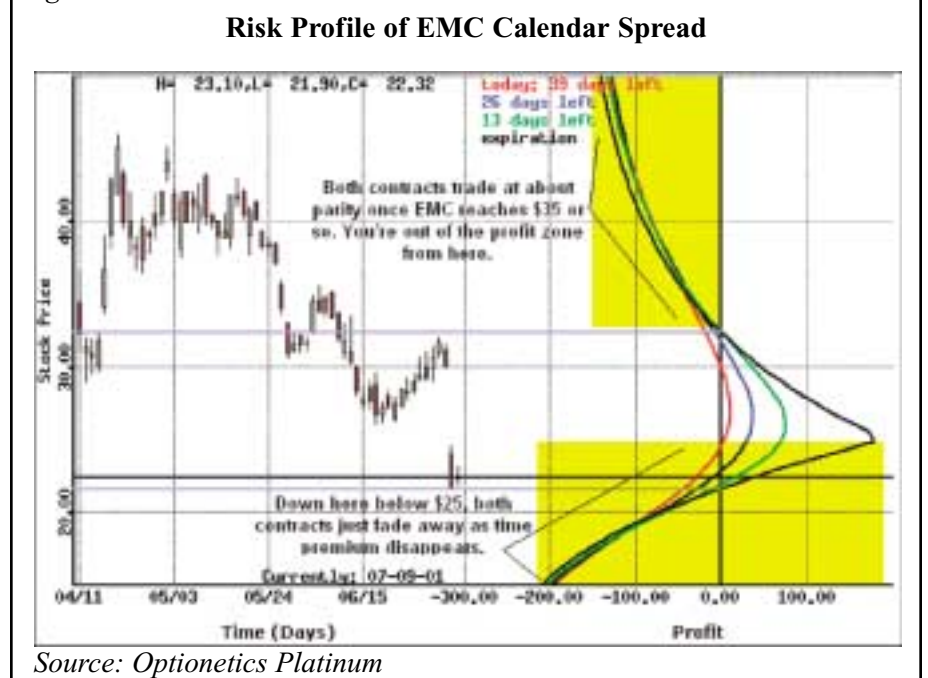


Figure 3



Until next time, happy trading...

strategist and staff writer with Optionetics.com. He can be reached at mbennett@optionetics.com

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Behind the Times - Behind the Markets: What's Missing in Technical Analysis?

By Louis B. Mendelsohn

Over the past quarter-century participation in the financial markets by individual traders and investors has grown tremendously, both directly and through company-sponsored retirement programs. Personal computers have become more powerful and less costly, while technical analysis software has become more prevalent. As a result, an ever-increasing number of traders have come to rely upon technical analysis as the basis for making their trading decisions.

Yet, war stories publicized in the mass media suggest that traders today are no more adept at trading than they were decades ago—before the age of personal computers and technical analysis software. What's behind this paradox? On one hand recent technological advances have put more powerful computers and trading software onto the desktops of traders than were used by NASA to send astronauts to the moon in the late 1960s. On the other hand traders now are no more likely to make profits than their predecessors who relied

on nothing more than paper charts, rulers, #2 pencils and hand-held calculators.

The answer can be found through a better understanding of the structural changes that have transformed the financial markets since the mid-1980s. Due to the globalization of the world's economies, coupled with advances in information and telecommunications technologies, domestic and foreign markets began to move in concert, affected by common financial, political and economic events. Individual financial markets today no longer trade in isolation from related markets. Instead, intermarket forces increasingly affect daily price action and the underlying trend direction of each market.

Despite improvements in the speed, power and user friendliness of personal computers since the late 1970s when I began developing trad-

ing software, the underlying basis of technical analysis that is implemented in the current generation of software is hardly different from that which existed prior to the advent of personal computers.

Technical analysis remains fixated on the analysis of a single market's past price data, using a wide assortment of technical indicators,

...traders now are no more likely to make profits than their predecessors who relied on nothing more than paper charts, rulers, #2 pencils and hand held calculators.

most of which were developed decades ago. This restricted approach ignores the ramifications of the interdependencies between markets and thereby fails to utilize relevant intermar-

ket data from related markets that could be instrumental in developing more effective trading strategies for today's global markets.

Clearly, these structural changes in the financial markets suggest that this single-market approach (with its emphasis on trend-following lagging indicators), while reasonably effective in the past when the markets were more independent and less volatile, is no longer adequate and should be broadened to encompass intermarket factors. Yet, to date it hasn't. That's one major reason why so many traders have not benefited from computing technology to the extent that one would have expected by this time.

Traders can no longer afford to analyze each market in isolation, no matter how many single-market technical indicators are used or how much back-testing and optimization is conducted. Remember that past performance is not indicative of future results!

Whether you trade individual stocks, exchange traded funds, options or futures, you should understand the implications of this paradox on your own trading and incorporate intermarket analysis in some form into your trading game plan. Otherwise, you risk being part of the road kill that has taken its toll on individual traders, exacerbated by the high tech and Internet bubble burst that began in early 2000.

Most traders now, when asked, acknowledge that the financial markets are intertwined, and that intermarket dynamics strongly affect the daily price action and trend direction of each individual market. Yet, interestingly, intermarket analysis remains a mystery to many traders, particularly newcomers to the markets. The ones I talk with have hardly begun to apply any sort of intermarket analysis to their trading. Instead, many still limit their analysis to only one market at a time, while others "eyeball" intra-day or

daily charts on one or two related markets. Typically, this is done subjectively simply by comparing price charts. The outcome is an incomplete picture of what is happening today in the markets that they are trading, and more importantly what is most likely to happen in those markets in the immediate future. No wonder traders continue to swap war stories about their trading losses.

Admittedly, it will always be necessary to analyze data from each individual market. However, it is no longer sufficient to look only at each individual market. The markets are now so interrelated that a thorough analysis of any one market cannot be conducted effectively without an intermarket perspective.

Intermarket analysis is by no means a new or radical concept that corresponds to the recent economic globalization. With both cash markets and numerous contract months trading simultaneously on specific commodities, and with closely related commodity complexes such as the grains and meats, intra-commodity and inter-commodity analysis has been performed by commodity "spread" traders for the past 100 years or longer. With the more recent proliferation of financial futures on stock indexes, currencies, interest rates and energies, intermarket comparisons between various futures markets and equity markets, as well as between sectors within the equity markets, are performed to identify short-term confirmation or divergence, which provides insight into impending changes in market trend direction. Futures on the S&P 500 Index, Nasdaq 100, The Dow, Treasury bonds and notes, as well as other financial futures markets including crude oil, the CRB Futures Price Index and the U.S. Dollar Index are now recognized as having strong influences on domestic equity markets, and therefore are followed by many stock traders.

Although easily discernible relationships appear to exist between these markets when their price charts are compared with one another, such apparent relationships are often ephemeral. This is because market relationships are dynamic, with changing strengths, as well as varying leads and lags to one another that shift over time.

Due to the complexity of the relationships between so many related markets, both domestic and international, it is difficult for an individual trader to perform intermarket analysis, even at a rudimentary level. Typically two markets are compared to each other by calculating linear correlations or by subjectively comparing their price charts. Traders assume incorrectly that the effects of one market on another are either

NATIONAL FUTURES ASSOCIATION

NFA's rules regarding security futures products approved by the CFTC

NFA received notice on August 20 from the Commodity Futures Trading Commission approving NFA's rules regarding the trading of single stock futures and narrow-based security indices (security futures products).

The new rules, which have also been submitted to the Securities and Exchange Commission, became effective upon CFTC approval.

With the approval of these rules, NFA has met the obligations that the regulators required it to meet by August 21, paving the way for the trading of security futures products on a principal-to-principal basis.

NFA's new rules address the following issues:

- Obligations to customers and other market participants
- Supervision
- Suitability
- Promotional Material

NFA has posted all of the rule amendments relating to security futures products on its web site (www.nfa.futures.org).

For more information, contact Kathryn Camp at 312-781-1393 (kcamp@nfa.futures.org) or Regina Thoele at 312-781-1327 (rthoele@nfa.futures.org)

direct or inverse in a sort of one-to-one causal relationship, which occur without any leads or lags. These approaches, based upon unrealistic assumptions with respect to how the global financial markets operate, fail to capture the simultaneous combined effects of numerous related markets on a specific market.

I am neither suggesting that single-market analysis be replaced entirely by intermarket analysis, nor that intermarket analysis be ignored because it is just too difficult to implement. This is not a choice of having to decide between using one or the other technical approach. Intermarket analysis builds upon the strengths of single-market analysis, adding another dimension to the analytic framework, so that markets can be analyzed both internally and externally. Combining single market with intermarket analysis offers traders the best of both worlds.

So how can this be done with reasonable effort? One way that I have been successful at integrating intermarket analysis with single market analysis is through the use of a mathematical tool called neural networks. This tool is useful for finding hidden patterns and relationships between related markets, which afford early warnings of impending changes in market direction—often days before they become apparent on traditional price charts.

In a simple sense, neural networks model how the human brain processes information. They are used to perform pattern recognition and market forecasting. Neural networks are comprised of individual neurons organized in layers and interconnected through network architecture with mathematical weights attributed to each connection. The architecture includes an input layer, hidden layer and an output layer. (See Figure 1.)

For example, one neural network-based model that I have developed to forecast the U.S. Treasury bond market is based upon 10 years of historical price, volume and open interest data on Treasury bonds. Additionally, the raw input data includes the following related markets that through research have been found to have a strong influence on bonds: New York Light Crude Oil, the CRB Futures Price Index, Comex Gold, the Japanese Yen, the U.S. Dollar Index, the Eurodollar, the S&P 500 Index, cash bonds, and the Deutsche Mark. Similarly, to forecast the Dow Jones Industrial Average, data from related markets including the Nasdaq 100 Index, S&P 500 Index, bonds, the New York Stock Exchange Composite Index, and the Dow Jones Utility Average are incorporated into the model.

Once the raw input data has been selected, it is preprocessed using various algebraic and statistical methods of transformation, in order to assist the neural network to learn the patterns and relationships be-

tween the data during a process known as "training."

The hidden layer is used by a neural network for internal processing to store its "intelligence" during the training process. This layer is composed of neurons where the network recodes the input data as the patterns and relationships in the data are identified.

The output layer is where the network's forecasts are made. Various types of forecasts can be developed, such as predicting the next day's high, low and close, as well as forecasting different technical indicators such as a predicted 5-day moving average for two days in the future or a 10-day moving average for four days in the future, which can then be used as part of more complex trading strategies such as moving average crossovers. (See Figure 2.)

There are numerous learning algorithms that can be used to train a neural network. Each one has unique performance characteristics. All of the algorithms attempt to minimize the overall error in the network's forecasts.

Training a neural network involves an iterative process in which the neural network learns underlying hidden patterns, discerns leads and lags and identifies nonlinear relationships within the data from repeated exposures to the input data. Learned information is stored by the network in the form of a weight matrix, with changes in the weights occurring as the network learns. Then the neural network generalizes through the training process to related but previously unseen patterns. Once trained, a neural network can be used as a market forecasting tool.

Overtraining, which occurs when a neural network memorizes the subtleties and idiosyncrasies particular to specific training data without

forming the capacity to generalize to new data, should be avoided. This problem is similar to curve-fitting or over-optimization when performing back-testing and optimization on rule-based trading strategies. An overtrained network performs poorly on out-of-sample test data and subsequently when making its forecasts during real-time trading.

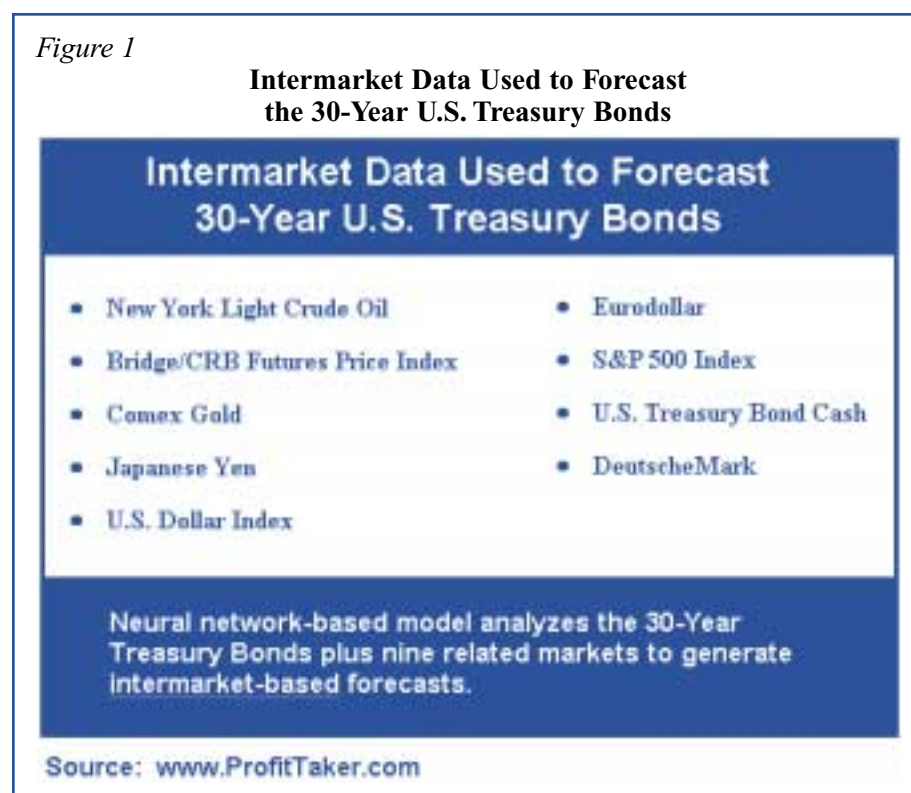
Testing is done by creating an independent test file made up of data that had not been seen by a neural network during the training process. In the testing mode the neural network is given these new inputs and uses the representation that it had previously learned to generate its forecasts. This allows the network to be evaluated under simulated trading conditions. This is analogous to "walk-forward" or "out-of-sample" testing of rule-based trading strategies.

Performance results from various neural networks on test data can be compared before deciding which specific neural network to apply in the real-time application. Depending on the comparative test performance results, changes may need to be made in the selection of input data, preprocessing, network architecture, etc., and retraining performed before selecting the final application network.

With the world's financial markets continuing to meld together, technical analysis as an analytic discipline should be broadened to encompass intermarket analysis. Before long, intermarket analysis will become more widely adopted by traders as they recognize its importance to their trading, just as

See **WHAT'S MISSING?**
Continued on page 15

Figure 1



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Full Time Trading

By Adrienne Laris Toghraie

"I work eight hours, I sleep eight hours, and I have eight hours of fun." Trading full time can translate to anything from grueling 16-hour workdays to one hour per day or any combination of time in between. It is important to discover what time frame is right for you in order to get the most benefit out of your trading results while maintaining a good and happy life. Too many traders get trapped into thinking that they should put a certain amount of time into their trading day and the amount of time that they choose can be either too much or too little for getting the best results.

"He Works Hard for the Money"

Being a consistently profitable trader takes just as much time and energy as any profession where rewards can be exceptional. The problem for many traders is that the pattern of long hours becomes an addictive behavior that is difficult to overcome. Traders begin to think that if they do not keep up with long hours, their trading results will suffer. It is highly advisable for traders to put a considerable amount of time into study while they are in the process of becoming a trader. But, if a trader continuously pressures himself for too long, the imbalance in his life will have an adverse effect on his trading results. For a trader to maintain a consistent top performance level, he must be physically, emotionally, spiritually and socially in balance. In short, this means that he must also have a life beyond trading.

"It Ain't Necessarily So"

The old work ethic would have you believe that in order to earn a living from your work, you must work at least eight hours per day. By observing the patterns of clients, I have found that many of them would earn considerably more money if they did not put as many hours into their trading. Sometimes it takes a coach. . .

. . . To Point it Out to Them

When I restate to a client what he has verbalized to me about the activities of his trading day, he becomes aware of the obvious solution, which is to use his time more effectively. For example, Ron traded on the floor of an exchange for years. He has been diligent to be there at the opening and closing of almost every day for the last 10 years. He has consistently made money, but working in the pits has taken its toll on his body

to the point that trading has stopped being fun.

He said to me, "Yeah, sometimes I think it's just a waste of my time to come in the afternoons. I lose a lot of the money that I make in the mornings because I've never been good with handling volatility when I'm tired." I asked him, "What do you

imagine your results would be if you hadn't traded in the afternoons for the last five years?" He said, "Hell, I'd be ahead by twice the amount, or more."

Now, Ron is trading only in the mornings, enjoying the rest of the day at the gym and feeding the ducks by the lake. He is also earning considerably more money than he was and is enjoying trading once again.

. . . To Recognize the Patterns Themselves

The best way to improve your system or methodology is to be consistent in following your trading rules over a period of time. Patterns will emerge showing when and where you earn the most profits. Some-

times, a trader is too close to notice it himself. In Tom's case, he simply did not want to notice the obvious.

Tom was trading two time frames. Trading the long-term time frame was supporting the short-term trading and his life style. After I held a mirror up to Tom so that he would admit to his day trading gambling addiction, he decided to choose computer war games as a substitute for his compulsions. Now, he is earning a full-time salary working one hour per day on his long-term position trading.

. . . To Get Permission from Someone to Work Less

Traders get models of what is an appropriate amount of working time from their parents, their teachers,

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their peers, and other traders. Most of them don't get to experience the many good traders who work a shorter day and earn good profits doing so. They are more likely to believe someone like me, a trader's coach, because of the vast experience I have had working with many traders than people in their family who tell them the same thing. For example:

When Marty first started trading, he made mistakes that cost him a great deal of money. Since his mistakes, he felt that he had to rethink his trading decisions over and over before he made a final decision. I asked him how many times did he have to look at a chart before he recognized an opportunity. "Only once," was his response. Marty finally understood that he did not have to recheck him-

self and it was okay to spend less time analyzing the markets. In fact, he is making more money now, feels less stressed, and has more time for his family and friends.

. . . To Plan to do Something That is Compelling with the Extra Time

Watching a trading screen for some traders is more exciting than other activities in their lives. For people who love this intensity, trading is hard to walk away from unless there is something equally compelling to anticipate. For example:

Tim once had a wife, children, community activities, and hobbies to keep him balanced and happy. His wife who was his "activities director" passed away and his children went out on their own. Tim did not

know how to do things on his own. He started spending more and more time behind the computer screen until it consumed all of his time. He missed his old life, but did not know how to get himself interested in other things beyond trading. When I worked with him, I gave him weekly assignments of activities that he had to accomplish. At first, he was reluctant and told me that all of my suggestions were not as interesting as sitting and watching the screen. One week some old friends asked him to a party. Normally, he would have refused, but I insisted that he attend the party as his weekly assignment. At the party, he met a woman who was like his wife and had a very active social life. She took over as his "social director" and he is back to

a balanced happy life working on trading six hours per day instead of 16 and is earning just as much if not more money.

. . . To Convince the Significant People Around You that Working a Shorter Day Does Not Mean that You Have Become a Handy Man

When one member of a family is working 10 to 12 hours per day and making perhaps half as much money as the trader in the family, it sometimes becomes an issue that their spouse is not at least "putting in his time" for the hard stuff in the relationship. Many traders waste time at the screen because they do not want to become the errand boy or the Mr. Mom that would be expected of them if they did not sit behind the screen all day. Here is an example:

Linda was always complaining that her trader husband, Harry, failed to get chores done around the house. I suggested that Harry ask Linda for a list of the chores to be completed and agree that if the chores got done, he could do what he wanted with his time. Harry found people to handle most of the handyman stuff. As a result, he spent less time at the screen and easily handled the added expense with the increase in income working fewer stressed hours.

. . . To Prepare in Such a Way that They Do Not Feel that They Are Missing Out on Something

Every trader has a war story of the big trade that they missed when their attention was diverted from the screen. For this reason, traders glue themselves to the screen through countless hours waiting for the "big one" to hit. Most of the best traders that I know do not look for killings, but consistently pull profits out of every day trading. These traders at the top pace themselves to have a life while enjoying the time that they do spend trading. This strategy prevents the build up of tension that most traders develop by not allowing themselves time away from the screens. For example:

Yes, there was that time that Joe missed that big trade when his wife dragged him away on vacation. And yes, there was that time when he was sick that afternoon and missed another big trade. He still talks about the big trades that got away. He was spending so much time watching the screen that he over-traded and missed opportunities that were smaller fortunes. I asked Joe to give up 50 percent of his trades and work a four-hour day for one month and check the results. While he reluctantly committed to my suggestions, he accomplished giving up 20 percent of his normal trades and worked a six-hour day. He made more money in that month than ever before. He was still uncomfortable, but the profits were strong evidence that he was missing larger profits by gluing him-

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S&P 500 INDEX

Continued from front page

The Importance of Time Value

Since we are essentially selling time value, it is possible to profit without any movement of the underlying futures. Time value decay is not a function of movement of the underlying futures, but of the passage of time. While it can be affected by changing volatility levels, time value nevertheless marches to its inevitable terminal end—zero. Therefore, as a seller of time value, the option writer actually needs fewer conditions to profit.

For example, a writer of an S&P put spread would profit given the following scenarios:

- 1 The S&P trades sideways (trading range).
- 2 The S&P is bullish (prices rise by whatever amount).
- 3 The S&P is moderately bearish (prices fall by no more than 10 percent).

Condition 3, it is worth underscoring, produces a profit as long as the S&P decline is not too big. As you will see below, I will set my exit point at 10 percent below the level of the S&P at the entry point of the trade. As long as the S&P futures do not trade lower by more than 10 percent, the trade will expire a full winner. As Figure 2 shows, during past quarterly cycles the S&P has traded lower by more than 10 percent only seven times in the 18 years of our study. By exiting at this 10 percent

swing-low point, my losses are kept under control. But as you will see, an exit at this 10 percent mark may produce small partial winners due to help from time decay.

Constructing a Put Credit Spread

The strategy emphasized here for trading S&P 500 options on futures is the basic credit spread, which is also known as a bull credit spread if written with put options. These are the opposite of bull call spreads or bear put spreads, which are net buying trades. With S&P 500 futures credit spreads a trader has an excellent hedged approach to trading, and one that, if done correctly, does not eat up loads of your trading capital through onerous margin requirements associated with either taking outright positions in S&P futures or selling naked options on S&P 500 futures.

In order to construct an out-of-the-money put credit spread we need to sell one option and buy another in the same named option month. More specifically, the trader sells the higher strike and buys the lower strike to generate a credit when writing a put credit spread. For a credit to be generated with a call credit spread, it would be necessary to sell the lower strike and buy the higher strike to generate a credit.

While there are numerous ways the basic credit spread approach can be constructed and managed (*i.e.*, you can also sell a call spread with the put spread, as well as hedge the position instead of exiting), I like to sell a put on the S&P, 15 to 20 percent out-of-the-money, preferably near to or at the start of each quarterly cycle (March, June, September, December), and try to collect about \$1,000 in premium. This premium will sometimes be higher or lower depending on how much implied volatility exists in the option premium. But on average it is possible to collect between \$750 and \$1,000 (four premium points worth \$250 each). Average initial margin is \$2,500.

I should point out that S&P futures options trade based on the underlying futures. For example, if you write a September put spread, the spread would expire with the September S&P futures on the third Friday of September. Therefore, once a put spread is established, it will usually stay open for a three-month period unless it is closed at our pre-determined exit point, which I will come back to below.

Figure 3 shows a profit/loss chart for a September S&P put spread written with just two months remaining on the options and the September S&P futures trading near 1215. This

Figure 3

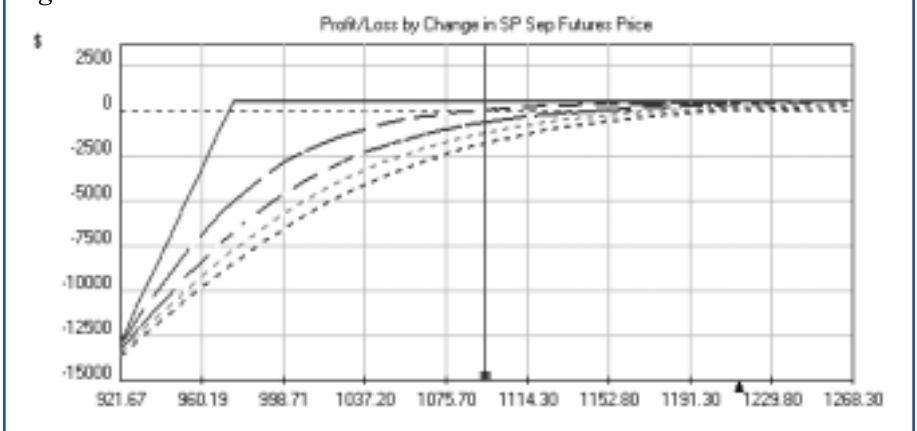


Figure 4



is later than I like to enter the quarterly cycle but will still work to illustrate the point. By selling the 975 strike, we collect 2.3 points ($\$250 \times 2.3 = \575). We then buy the lower strike at 875 for a debit of .5 points ($\$250 \times .5 = \125), leaving a net credit of 1.8 points or \$450. As already mentioned, the basic idea is to profit from time decay. By writing deep-out-of-the-money credit spreads, there is a high probability that spreads will profit. Since this trade would be established already one month into the quarterly cycle, less premium is available. But there is also less probability that the trade will be a loser. While maximum loss is the distance between the strikes (100 points, or \$25,000 minus the initial credit), in practice using an exit target, losers can be contained to an average loss close to the amount of the average winner.

Trade Management

Historical ranges of the S&P futures starting in 1982, the year the contract was launched, show that most of the highs and lows of a calendar quarter stay within a rather well behaved range. The key question for an option spreader is this: what boundary should be set for establishing a put or credit spread? Based on my experience and analysis of the data, quarterly options spreads work best when placed 15 to 20 percent out of the money (the short leg), using either a maximum money loss amount or a percentage move of the underlying futures as a stop-loss exit target.

Statistical data in Figure 2 reveals that the S&P futures trade inside an identifiable band, which I measure from the previous quarterly close to current quarterly high and low. Past data shows that for swings low, the 15 percent mark contains over 95 per-

cent of the periods. For swings high, 91 percent of the periods of the study fall within 15 percent. But I will use the 10 percent band for swings-low. As Figure 2 shows, the S&P futures have traded lower by more than 10 percent just 10 percent of the periods. In other words, only seven periods experienced swings low during 72 periods between 1982 and 2000.

The trick to making this system work is having the ability to exit at the right time. By exiting at a swing-low target of 10 percent, losses are kept to acceptable levels, and the high probability of success for each trade is retained (90 percent). For example, taking our example of a September S&P put spread with strikes 975 and 875, if we have a swing low of more than 10 percent during the two months left in the quarterly cycle, the trade would be closed. The size of the loss will depend on when the 10 percent mark is hit. An alternative exit plan is to close the spread when it widens by a predetermined amount. For example, the exit point may be set at a point spread 1.5 times the size of the initial point spread when the trade was established. Either way works well.

Let's look at my 10 percent swing-low stop-loss exit plan. Figure 4 has different profit/loss functions for our September put spread at different time intervals during the quarterly cycle. If the 10 percent mark is touched less than two weeks before expiration, the trade will be a partial winner since the spread will have decreased due to the erosion of time value. An exit here is tough because there is the temptation to hang on for a full winner. Best to stick to the plan. If the 10 percent mark is touched one

Figure 2

Quarterly Swings—Low Frequency Tabulation (1982 – 2000)

Swings	More Than	More Than	More Than	More Than
Low (%)	5%	10%	15%	20%
Frequency	23	7	3	1

See **S&P 500 INDEX**

Continued on page 23

WHAT'S MISSING?

Continued from page 11

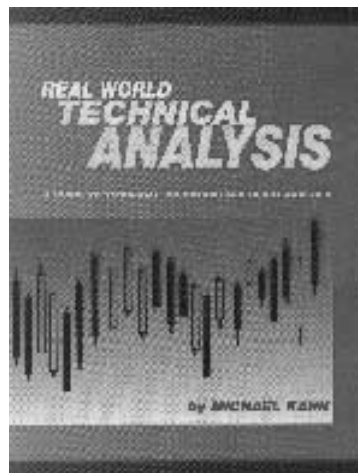
back-testing and optimization of single-market trading strategies became the mainstay of computerized single-market analysis in the last two decades of the twentieth century.

Nothing remains constant. The interconnectedness and interdependence of today's financial markets is unprecedented. The need to incorporate this reality into technical analysis methods is undeniable. Fortunately, mathematical tools such as neural networks are well suited to analyzing market data from both a single-market as well as an inter-market perspective. Through the use of such tools individual traders can bring to bear the full capabilities of today's powerful computing and quantitative technologies to achieve the ultimate goal of technical analysis: to identify and anticipate impending changes in prices and trend direction in sufficient time to profit from this insight. It is time to apply 21st century tools in order to profit

from the tremendous financial opportunities that the 21st century financial markets have to offer those in the know.

Louis Mendelsohn is president and chief executive officer of Market Technologies Corporation, Wesley Chapel, Fla., a trading software development firm founded in 1979, that specializes in quantitative trend forecasting. His firm's software, VantagePoint, uses neural networks to perform intermarket analysis and predict market trends with nearly 80 percent accuracy for interest rates, currencies, stock indexes and energies. Mendelsohn's recent book entitled Trend Forecasting with Technical Analysis: Unleashing the Hidden Power of Intermarket Analysis to Beat the Market (MarketPlace Books) is available at Market Technologies Corporation's Web site, www.ProfitTaker.com. Mendelsohn can be reached by e-mail at Louis@ProfitTaker.com or by phone at 813-973-0496 or 800-732-5407.

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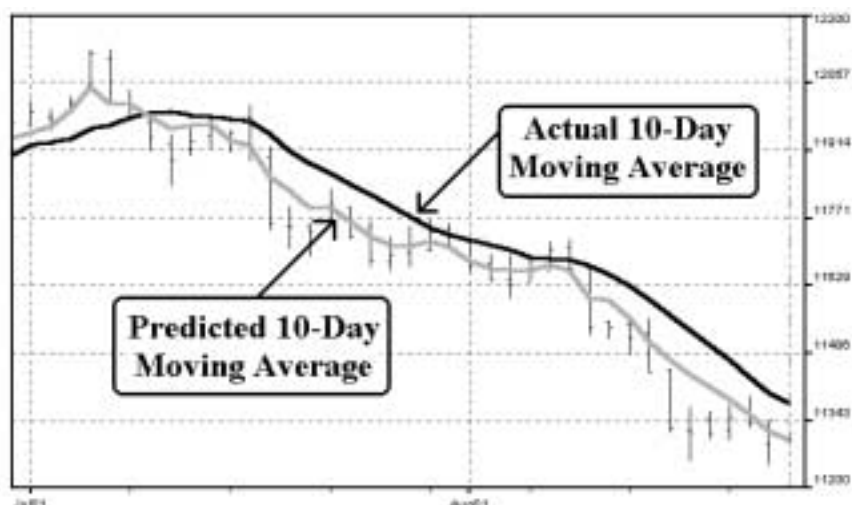
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Figure 2

**U.S. Dollar Index
Using a Predicted Moving Average Crossover Strategy**



Source: VantagePoint Intermarket Analysis Software

Chart of daily prices of the U.S. Dollar Index with a 10-day predicted moving average and a 10-day actual moving average crossover. Notice the difference in lag between the predicted and actual moving averages.

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The Game Plan for Success

By Tom Busby

For traders to succeed, they must have a game plan, specific strategies and tactics to approach the market, and achieve a balance in their trading. Defining a game plan provides preparation and knowledge. Specific strategies and tactics that work yield the consistency traders must develop. In addition, a trader must find a balance with which he is comfortable. Balance keeps the trader on a steady path that provides the ability to diverge when necessary. This article will examine all three of these elements traders must implement before

being able to attain long term trading success.

Game Plan

"Know Thyself"—Socrates—It is vitally important to know yourself as you approach the trading arena. Are you the individual trader, or an institutional investor? Institutional investors have enough weight to make their own waves in the market, while the individual trader is best served by riding the waves made by others. Many new individual traders tend to get carried away, thinking they can shape market consequences like larger investors. In reality most

traders are miniscule in relation to the markets. Only when a trader accepts his place in the market and sets his own course can he benefit from the ride provided.

Know Your Risk Potential—Can you afford to lose? It is a harsh question, yet one that must be asked. The term risk capital applies to the balance of your account. It is the money you can afford to risk. Being in financial positions where the loss of money impinges on your financial well-being is not advisable. If you cannot afford to lose, then the overriding factor becomes the money, which can

cloud a trader's judgment and cause anxiety. Trade numbers, not money. Market analysis needs to be pure, untainted by financial concerns.

Managing risk capital is another area of concern. The entire balance of a trading account should never be on the line. An "all-or-nothing" approach will make for either a very short or a very costly trading career. If the market is going against you, don't lose all of your risk capital trying to force it into going with you. Understand when it is not in your favor, and get out. It is very important to come to this conclusion before your risk capital has been depleted.

Understand Your Goals—While everyone would like to make a quick fortune, a trader's goals should be attainable. You need to start at the bottom and build yourself up. IBM is not going to hire a recent college graduate to be their CEO. Gradually build up risk potential by gradually increasing the size of profits. The more you have, the more you can afford to risk. Unless a trader approaches his trading career as a building process, early losses aimed at unrealistic goals will end a trading career before it ever begins.

Strategies and Tactics

Time—There are times during the day when the market tends to move in patterns. Knowing these patterns and adhering to them can make all the difference in the world. A smart sea captain would not try to navigate through a shallow reef during low tide. A trader should demonstrate that same constraint. If you were trading during a time where the market traditionally rises, it would be unwise to be taking a short position, or vice versa. The key is to recognize these patterns and ride them to profits.

Be cautious of times zones when a churning market can play havoc on a trend trader. The first half hour and the last half hour of the day markets are extremely dangerous and can pull the unwary trader under. Other times to beware are 1:30 p.m. and 2:00 p.m. CST, and occasionally 10:30 a.m. through 11:00 a.m. CST. Position traders are best served by avoiding these time periods.

As a trader, you may find that there are certain times during the day where you can't help but be right, and there may also be those times when you can't win for losing. Identify these times quickly, and make advantageous use of these zones. In my history of trading, I have found four time zones that are most profitable for me, including the early morning, the morning, the noontime, and the afternoon. While the best time zones may vary greatly from person to person, each trader must learn to identify their own "prime times" and stick to them.

Indicators—Time can only do so much. It puts you in the right place,

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but knowing where to go from there is the real measure of talent. The primary determination that must be made before trading any market is whether to be long, stay out, or short the market. An easy way of remembering this initial decision is the acronym LSD.

Long: Trade positioned with an expectation of rising market prices.

Stay Out: No trade positioned due to no expectation of movement, or no understanding of the fundamental reasons for a market move.

Down (or Short): Trade positioned with an expectation of falling market prices.

In the early morning trading I have found the best indicators to be found in the foreign markets, specifically the European markets, as they are the active markets for the early day. We generally look for alignment. If the major European markets (the FTSE, the DAX, and the CAC), are all moving higher, it can be expected that the S&P, my primary trading vehicle, will follow.

As the day takes us from the early morning shadow of the European markets to the bright lights of New York City, we look for other indicators. At the beginning of New York's trade day, all eyes are focused on the NYSE, and its many indicators including statistics like the TRIN and the TICK. As the clock continues to turn, examine the futures markets in Chicago. At the Chicago Mercantile Exchange you can track the NASDAQ 100 Futures and our trading vehicle, the S&P 500 futures. In addition, just down the street is the Chicago Board of Trade where you can follow the Dow futures and the ever influential bond market.

Key Numbers—Learning when it is best for you to trade puts the market in front of you only when best and indicators show market direction. However, trend traders must complete the picture, knowing not only where a market is, but where it is moving, and at what point a chosen direction is proven wrong. This is where key numbers come into play. Key numbers are those numbers that bear the greatest import on the markets. They can be breaking points, pivots, or targets. We determine key numbers through three means: common focal points, previous day's action, and historical data.

Common Focal Points—Common focal points are those numbers that hold obvious significance. Examples are Dow, 10,000; S&P, 1200.00; or NASDAQ, 1600. These numbers are often referred to as "round" numbers. They are typically fifties, or hundreds, and can sometimes be thousands. On rare occasions, as seen in the Dow, these "Round" numbers are in the 10,000s. As the power of 10 rises, so does the significance of the number.

Previous Day's Action—Finding the numbers that were important in the previous days trading can often help a trader's knowledge of their immediate surroundings. If the mar-

ket approaches the previous day's low, you can expect the number to either provide support, causing a directional change; or to fail, spurring a quick run at new lows. Other numbers of import aside from the open, high, low, and close include time-based numbers that I feel are important. Among these are the 12:30 PM CST number and the 3:30 a.m. CST number.

Historical Data—Historical data consists of the compiled information from previous days. The numbers that bear notice in the forefront are those that continually show up. For instance, the number 1212.00 has been a 3:30 number, a 12:30 number, a high, a low, an open, and a close. All have occurred more than once, and all on varying days. Thus it has earned the distinction of being considered a historically significant number.

Balance—Greed/Fear

The Courage to Act—Knowing what is happening, and getting involved do not always fall under the same category. Once the decision has been made as to what direction the market is going, where protective stops need to be placed, and what your likely target is, you must quickly make the transition from analyst to trader. Making the transition from an effective paper trader to that of an actual trader is a stumbling block for most. If you have a sound methodology, you need to have faith in it. If you do not fully believe in the method you are using, your emotions will take over your trade decisions, resulting in financial disaster.

The Fear of Staying Too Long—Often traders will enter a trade, but then start to doubt their analysis. This voids the time spent identifying the risk and possible reward. It is a fact that the market may change, but if your methodology is proven to be accurate, you need to give it the opportunity to succeed. Quick profits are nice, but the old axiom of the market is cut losers quick, and let the winners run. The quick cut is determined through key numbers with the use of a protective stop. If your stop gets hit, then you were wrong. If it doesn't take you out, you may still have a winning trade on your hands. Take your losses with a grain of salt and wait for the next opportunity.

The Greed of Not Taking Profits Soon Enough—On the opposite end of the spectrum is greed. Greed has the capacity to nullify decisions made through a methodology. If the target price has been reached, some acknowledgment of that fact needs to occur, whether profit taking, or tightening of stops. The worst kind of loss is when your analysis was correct and your target was reached, only to find your desire for more, leaving you in a falling trade that becomes a loser. Accept your goals and acknowledge a "win" by taking your profits and/or tightening your stop.

Confidence/Humility

The Confidence to Trust in Your Own Judgment—If you have a method that works, use it and do so with confidence. You need to believe in yourself. Without confidence in your own ability, you will not succeed.

The Humility to Listen to the Market—Try not to let confidence go to your head. No matter how successful the trader, the market can always prove the trader wrong. A trader needs to let the market tell him what to do. A good trader does not get caught up in the frustration of attempting to tell the market what to do.

The Judgment to Know the Difference—Balancing confidence and humility is perhaps the greatest feat any trader will face. There is no black and white. Traders must be able to admit when they are wrong. Without admission of error, the best trader can wipe out an account that took months to build in a matter of days, if not minutes. I use stop orders to force myself to adhere to this principle. If I am long in the market, there is a sell stop out there protecting me both from the market and from myself. I reject the proposition of mental stops. In the heat of trading, mental stops can be discarded, or even forgotten. If stops are moved, they should not be moved away from the market, but towards it. The name of the game is elimination of risk and protection of profits. Becoming an investor just to prove that eventually the market will listen to you will only result in losses.

Repetition/Innovation

Consistency—If you have a method that works, then diverging from it because of short-term pitfalls could take you out of the next great trade. Don't change to suit the moment. A moment is just an instant in time, it does not define a pattern. If you start changing things on a whim, you will not be able to settle into the subtle pace of confidence.

The Flexibility to Change and the Maturity to be Consistent—A trader needs to understand that what worked last year may not work this year. You need to be open to the prospect of change, but not too quick to embrace it. Change should not occur by the actions of one day, or even one week. The key here is consistency. If your method is consistently not working then you need to improve it.

Review

In the world of the trader, one must combine knowledge of self

with knowledge of the markets. Understand and appreciate your goals and risk potential and be able to approach the market with a concise strategy. Strive to achieve the balance necessary for success. Don't let either greed or fear influence your decision making process. Be consistent while allowing yourself the flexibility to adapt to the ever-changing market. Confidence is the hallmark of a good trader. The ability to temper that confidence with humility is the sign of a great trader.

Thomas L. Busby is the president and founder of The DayTrading Institute. Tom has more than 23 years of experience in day trading.

In 1996, he founded the DayTrading Institute located in Mobile, Ala., a program designed to teach its students how to trade in the S&P 500 and the Dow Jones Markets.

In his trading approach, Tom uses technical analysis combined with money management to trade the futures market.

The DayTrading Institute was founded in 1996 to provide specialized training and education for individuals interested in learning to trade the futures markets, specifically the S&P 500, but also the NASDAQ and DJIA as well. You will be taught in DTI's state of the art training facility using newly available technology that gives individual traders the same information and technology that was previously only available to Wall Street professionals.

The goal of DTI is to teach a proprietary method of trading that can be applied to the S&P 500 futures markets. Tom's "RoadMap" methodology is based on his more than 22 years of experience trading the equities, options, and commodities markets. The "RoadMap" method is comprised of three main elements: time of day, key numbers, and the RoadMap (tracks key indicators). Using a combination of technical analysis and money management techniques, Tom will teach you a comprehensive strategy for trading the S&P 500 that emphasizes capital preservation and risk management.

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Tom is also a featured speaker at the Futures Industry Association's Futures and Options Expo 2001 taking place November 28 - 30. For registration information, please visit www.futuresindustry.org/expo.

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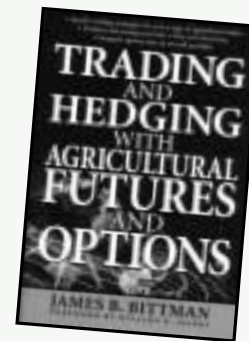


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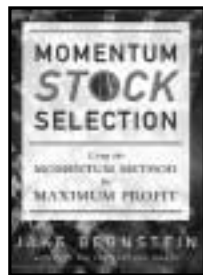
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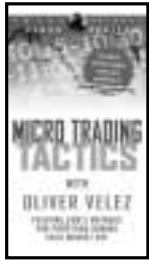
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Hedging Investment Portfolios Using E-mini Stock Index Futures

By David Lerman

Over the last 19 years, the U.S. stock market has enjoyed one of the greatest run-ups in history. As measured by the benchmark S&P 500 Index, the annualized compounded return on the market was around 15 percent. Investors small and large have become more market literate as the number of mutual funds exceeds 9,000 and the number of 401(k) accounts in the U.S. exceeds 41 million. In fact, for many, the 401(k) account represents one of their largest assets, if not the largest. Trillions of dollars also reside in taxable mutual funds and with private money managers.

But as we all know—especially during the last 12 to 18 months—stock values don't only move upward. Stocks slid nearly 20 percent in just a few months in 1998's third quarter, causing jitters among investors in the U.S. markets. In addition, investors experienced declines during the 2000 calendar year as the S&P 500 showed double digit losses and the Nasdaq-100 was also down substantially. Eight months into 2001 the market continues its downward trend from last year as the major averages continue to show losses. Many wonder how bad it could get and if there is a way to protect their portfolios from significant losses.

In fact, there are ways to protect a portfolio of stocks using a variety of futures strategies. This section will focus on one in particular—using stock index futures to hedge equity portfolios. We will also illustrate how investors can use stock index futures to gain market exposure—the so-called “anticipatory hedge.” Before we outline the strategies, there are a few items to consider:

- Size of portfolio
- Construction of portfolio
- Correlation of the portfolio to

- CME's stock index futures
- Tax considerations

Size of Portfolio

CME's flagship S&P 500 contract had a notional value (or contract size) of around \$335,000 as of January 2001. The E-mini S&P 500, which trades very closely to its larger brother, has a value about one-fifth the size, or \$67,000. Hence investors with IRAs/401(k) accounts or portfolios less than \$67,000 in size would not be able to use these products effectively. For example, an investor has \$25,000 in an index fund that replicates the S&P 500 composite. If the investor wanted to hedge using the CME's mini S&P 500, he would be hedging a \$25,000 portfolio with an instrument with a value of \$67,000—he would be “overhedged” by \$42,500 (you could say his hedge would be out of balance).

Construction of the Portfolio

To benefit from using the various CME stock index products, the investor's portfolio must have a significant component of U.S. equities. Many investors, especially more conservative investors, have sizeable stakes in bonds, money market funds, convertible securities, and so on. CME stock index futures are not designed to hedge fixed income instruments, but to hedge equity portfolios that correlate highly with a particular index such as the S&P 500, S&P MidCap 400, Nasdaq100® and the Russell 2000®.

Correlation of Equity Portfolios to CME Stock Index Products

Assume that you have a large enough portfolio and that it is composed mainly of U.S. equities. The next thing would be to determine how closely the portfolio tracks the underlying indices on which CME stock index futures are based. For

example, the S&P 500 comprises mostly larger capitalization stocks such as General Electric, Cisco, Microsoft and Exxon (and 496 other issues). If you owned shares in an S&P 500 index fund or even a fund/portfolio that had a lot of large capitalization stocks, the correlation of the fund should be high and the S&P 500 or mini S&P 500 futures contract might be a good vehicle to hedge against a declining market. On the other hand, if your portfolio were to include smaller capitalization stocks or even mid-size stocks, the correlation of these stocks to the S&P 500 would be lower and a futures contract based on the S&P 500 may not be suitable for your hedging purposes. A more appropriate hedge might be constructed using Russell 2000 futures or S&P MidCap 400 futures. Of course, you would first have to determine how well your portfolio tracks these indices.

Tax Considerations

The taxation of futures is different from other investments and depends on the status and strategy of the taxpayer. Is the taxpayer a trader? Investor? Dealer? Hedger? Any gains or losses arising from these transactions usually are subject to both the mark-to-market and the 60/40 rule at the end of the tax year. Generally this type of transaction is reported on the appropriate IRS form (Form 6781—Gains/Losses from Section 1256 Contracts and Straddles) and transferred to your Schedule D filing. You should consult your tax advisor to determine which rules apply to you. While tax treatment of an overall hedging strategy may be complicated, the protection that can be offered by such a strategy merits consideration.

Protecting Your Portfolio

Figure 1 displays several mutual

funds along with investment returns and other information during a period in 2000, a year of generally declining stock prices. Why did I pick these funds? When the market heads south, certain mutual fund investors that have a modicum of knowledge of hedging begin to call CME. During a couple of nasty weeks in the market, I received numerous inquiries about hedging mutual fund holdings and other portfolios using the E-minis. Some of the funds listed were, in fact, held by these callers. Instead of identifying them by name (and I don't always get their name), I use the fund holdings they were interested in hedging as the identifier. These calls were received over a two-month time frame, an intriguing coincidence. But when the market breaks, fear sets in and some investors worry that the extraordinary gains they have earned over the last several years will evaporate in a bear market. While I have no idea if these investors ever acted after these conversations took place, I will briefly recount some of the discussions.

Along with fund name and amount invested, we have price data for an eight-week period, including the percent decline. We have also included the performance of the underlying cash indexes and their corresponding futures contracts since those would be the instruments used to hedge the funds. The table also includes some data on R-squared values. R-squared ranges from 0 to 100 and reflects the percentage of a fund's movements that are explained by movements in its benchmark index. (Caution: R-squared is not a predictor of relative performance or profitability.) An R-squared of 100 means that all movements of a fund are completely explained by movements in the index. Thus, index funds that invest only in S&P 500 stocks will have an

Figure 1

Using E-mini Stock Index Futures To Hedge Portfolios

Investor/Fund	Amount Invested	Price 3/24/00	Price 5/24/00	Percent Return	R-Squared	Comments
Vanguard 500	\$400,000	140.74	127.54	-9.38	100	Could use futures
Janus Fund	\$110,000	50.34	40.65	-19.25	72	Tracking error, not great fit
T Rowe Price Blue Chip	\$52,000	39.75	35.56	-10.54	95	Inadequate investment size
Mutual Qualified Fund	\$900,000	17.14	17.64	2.90	67	Low correlation to futures
S&P 500 Cash	n/a	1527.46	1399.05	-8.41	n/a	
June S&P 500 Futures	n/a	1555.40	1401.70	-9.88	n/a	

On 3/24/01, S&P 500 futures continued trading until 3:15. On this day futures ran up considerably after the cash markets were closed. Their “fair value” was approximately 1545.00. At this level, the percent decline from 3/24 to 5/24 would have more closely matched the cash decline. In fact, it would have been 9.4 percent.

Strategy I: Hedging a Portfolio with Stock Index Futures—The Short Hedge

Suppose you own a mutual fund or portfolio of stocks that is highly correlated with the S&P 500 composite index (R-squared = 98). The current value of the portfolio is \$140,000.

Time frame: Early November

Outlook: Short-term bearish—looking for a decline of at least 10%-15%.

Strategy: Sell 2 E-mini S&P 500 futures contracts to hedge portfolio.*

Current S&P 500 index (cash): 1,400.00 pts.

Current E-mini S&P 500 futures (Dec futures): 1,415.00 pts.**

* Each E-mini S&P futures is worth \$70,750 (1415 x \$50 per pt. = \$70,750); thus, two contracts would be required to hedge a \$140,000 portfolio.

** Futures contracts usually trade at a premium to the cash index due to cost-of-carry factors. As expiration of the futures contract nears, this premium will converge toward zero.

Outcome:

Four weeks later the S&P 500 declines 15% to 1190.00.

Investor's portfolio declines 15.5%.

December future declines 15.5% to 1195.00.

Profit/Loss picture:

Value of portfolio early Nov:\$140,000

Value of portfolio early Dec:\$118,300

Profit/Loss on portfolio- \$ 21,700

Value of E-mini S&P 500 early Nov: . \$70,750 (1415 x 50 = \$70,750)

Value of E-mini S&P 500 early Dec: . \$59,750 (1195 x 50 = \$59,750)

Gain on short hedge+ \$11,000

x 2 (\$140K portfolio required two futures)+ \$22,000

Hedged Portfolio:

Loss on portfolio- \$21,700

Gain from futures hedge+ \$22,000

Overall profit/loss+ \$ 300

Unhedge Portfolio:

Loss on portfolio- \$21,700

Gain from futures hedgen/a

Overall profit/loss- \$21,700

In this hypothetical example, the hedge using E-mini stock index futures fully protected the portfolio against a decline. The decline in your portfolio was offset by gains in the two E-mini S&P futures contracts. You preserved the value of your portfolio despite a significant decline in the market of 15 percent! On the other hand, if the market had advanced, the portfolio's gains would have been offset by losses on the two E-mini S&P 500 futures contracts. If this were to occur the investor would have had to consider removing his hedge by buying back the short futures contracts so he/she could participate in any further upside action.

Strategy II: Using E-mini Nasdaq-100 Futures to Gain Market Exposure—The Long Hedge

You are expecting a large cash infusion due to the sale of a business. Since you believe that technology stocks are at attractive levels, the cash proceeds (about \$100,000) will be invested primarily in high-tech stocks at close of deal in four to five months.

Problem:

You are very bullish near-term, especially on technology stocks. You lack sufficient cash to construct portfolio immediately.

Strategy:

Execute Long Hedge by buying 3 E-mini Nasdaq 100 futures contracts (3 contracts were worth approximately \$100,000 in August 2001).

Advantages:

- Easy to execute
- Less costly and more efficient than buying a basket of stocks
- Initial cash outlay or performance bond would be much less than \$100,000 (in fact it would be less than 17% of that amount—about \$5,240 per contract x 3 or \$15,720)

If the market rose before you received the \$100,000 in proceeds, the futures would also tend to rise, allowing you to participate in the advance. Four to five months later, you could purchase the stocks. The higher price that you would pay would be offset by the profits in the futures contracts. If the prices of stocks (and therefore the Nasdaq-100) declined, your futures contracts would lose money. However, the cost to purchase your portfolio would also be reduced. This "anticipatory long hedge," as it is sometimes called, allows you to enter the market immediately at a fraction of the cost.

declined twice as much as the index. Hence, if this investor hedged using the E-mini S&P 500 he would have made some profits on the hedge, but not enough to cover the severe decline the portfolio experienced. In summary, I had to confess that the tracking error and concentrated nature of the portfolio could be a problem.

The next caller had \$52,000 in the T-Rowe Price Blue Chip fund. Again, this fund correlated well with the overall market, had a high R-squared. S&P futures would have been useful as a hedge in this case too. But, unfortunately, this investor had too small a portfolio. Even one mini S&P 500 contract is too large for the amount of assets to be hedged. The person then asked if these new "Spider stocks" might be useful. I smiled and replied yes and sent her to the AMEX (trying to be a good samaritan!).

The last caller had almost a million dollars in the Mutual Qualified fund. Since I had some of my own money in this fund I knew it well. Although the investor did have a large enough asset base, there were some items that made this fund a less attractive candidate for hedging with S&P futures. The Mutual Qualified fund is loaded with stocks that many other fund managers would never touch. Michael Price, who ran it for most of its operating history (before he sold his fund company to Franklin Templeton), had an interesting collection of investments. The portfolio had a huge value tilt, including many bankruptcy candidates, companies reorganizing out of bankruptcy, junk debt and a whole collection of

investments that much of the Street avoided. Too bad for them, as this and other Mutual Series portfolios had amassed a superb track record (except for during the dot.com mania, where many value investors were left in the dust by technology). Indeed, as 2000 unfolded and much of the technology space become toxic waste, Mutual Qualified did what it usually does in adverse markets—it went up. If this investor had hedged, he would have made money on the hedge as the market slid and would have profited on the investment being hedged since the fund was up 2.9 percent during this time frame. It is nearly impossible to profit on both sides of a hedge! All things considered, the low correlation means that S&P 500 futures would not provide a good reliable hedge in this case. (Note: During the 73-74 bear market, when the S&P was down nearly 50 percent, Price's flagship fund, now run by the great team he left behind, was down less than two percent—an amazing but little known accomplishment in the investing world.) To reiterate, the investor must closely consider the size of the portfolio to be hedged, the construction and the correlation to the futures contract. If an investor had investments primarily in small cap issues, then the Russell 2000 futures might be more appropriate than the S&P 500 in this case.

We will now provide details on how such hedges might be constructed. Remember, hedging is insuring against an adverse price move. An

R-squared very close to 100 since they invest in the index itself. A low R-squared means that very few of the fund's movements are explained by movements in its benchmark index. Put another way, funds with lower R-squared values move to the beat of a different drummer and will not mimic the moves of the S&P as well over the long run. In very general terms, high R-squared values mean a portfolio has a good correlation with its benchmark—S&P 500.

The first investor had a \$400,000 balance in the Vanguard 500 Index fund. I told him he had an adequate balance and that his correlation to the S&P 500 is perfect. It should be as the fund perfectly replicates the index. That fund was down about 9.4 percent. The S&P 500 futures (and the mini S&P 500) were down about

9.88 percent. Basically the fund was a very good candidate for hedging—if he chose to do so. He had a large enough portfolio and a good correlation with the futures—so it would have been a good hedge. It doesn't get any more simple.

The second investor had \$110,000 in the Janus Fund. The amount invested was not adequate for the regular S&P 500 futures but could be hedged using two mini S&P futures. However, two minis would have a value of \$140,000. He would be hedging a \$110,000 investment with a \$140,000 "insurance policy"—he would be overhedged. Not a bad thing in a bear market but a bit risky should stocks move upward. I also conveyed that the fund was a bit concentrated and had a large tilt toward technology. This explains why it

See **E-MINIS**

Continued on page 24

Book Review

***Bear Market Game Plan:
Strategies for Success in
Choppy Markets***
by Ross Jardine

By Jaye Abbate

Timing is everything—and Ross Jardine has timed the release of his powerful new book, *The Bear Market Game Plan*, with dead-on precision.

The severe downturn and choppi-ness in the markets has ushered in

one of the toughest investment mar-kets in recent history. Newer invest-ors have never encountered this type of trading environment—and even experienced traders need to brush up on bear market methods they haven't used in a long while. Jardine's timely new work, *Bear Market Game Plan*, puts it all in per-



spective and provides solid strategies that investors can apply immediately to survive—or prosper—even in the most brutal, bear market conditions.

Savvy investors know that come bull, bear or rapidly changing market environment—significant money can be made by applying the right methods, during the right market conditions, if you have a solid “Game Plan” in place. Jardine's step-by-step “Game Plan” approach will coach you on which strategies to use, and when to implement them for consistently superior results. Ross also reveals a number of critical points, including:

- Key option strategies that are ideal for brutal, bear market circum-stances;

- Ways to protect your investments during up, down, or choppy mar-kets; and
- Tools for determining the mar-ket's trend—and powerful risk management methods for turbu-lent markets.

Plus, he covers why not to let the Bear scare you, how to overcome the emotions created by choppy, unpre-dictable market conditions, tactics for using the trend to your advan-tage—and many more explicit steps to follow in the face of an emerging bear. You'll even find ways to ride a “bull” to even greater profits.

Now, more than ever, investors need a step-by-step “Game Plan” to survive the tough trading climate, and “Online Investor Toolbox” founder Ross Jardine's new book provides just that. It's an excellent place for all investors to start—as they try to figure out how to play by the rules in an ever-changing invest-ment arena.

So, get over the Bear Market blues, be poised to prosper when the bull comes raging back and, most importantly, get your “Game Plan” in place today.

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S&P 500 INDEX*Continued from page 14*

month before expiration, a loss of about \$695 will be registered. At 16 days into the trade, a 10 percent move lower of the S&P futures would produce a loss of \$1,300. Based on experience, a stop out will most often occur during the second half of the cycle, since it takes some time for the S&P futures to trade lower by 10 percent. In other words, it is less likely for the futures to plunge 10 percent in two weeks.

Assuming an average of all of these possible losses at different time intervals for our loss management amount, we would come up with a stop-out loss amount of approximately \$650 to \$700. Obviously, this is an average. Sometimes it may be \$1,300, other times breakeven, or even a partial winner. The point here is to be disciplined so that average losses are manageable. Based on past performance, and past performance does not guarantee future results, given that 10 percent of the trading periods hit the 10 percent mark dur-

ing a quarterly cycle, this leaves an excellent performance profile. Average losses are kept low while the high probability of winning each trade is retained at 90 percent.

Based on this approach, it is possible to produce an annualized return of over 100 percent on margin if all goes according to plan. Based on a \$10,000 account, simple (non-compounded) annual returns would be between 30 percent and 40 percent. Aggressive money management techniques can push this annual return substantially higher. While there are other ways to plan your trade management and placement of spreads (I like to use the monthly cycles, too), the art of the exit is the key.

Other approaches may work better, but the simple mechanical method presented above is a good place to start.

John F. Summa is a NFA registered Commodity Trading Advisor. He is also the founder of *OptionsNerd.com*, a free options trading advisory/educational Web site.

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FULL TIME TRADING

Continued from page 13

self to the screen in his effort to catch the next "big one."

... To Protect Themselves from Possible Losses that Could Occur

Albert was in the habit of watching his stops very closely. Often, he would lower his stop, thinking that it would get hit and the market would immediately bounce back. It was not okay for him to be wrong and lose money on a position. He forced himself to watch the screen for most of his waking day and sometimes through the night. Albert was exhausted and a nervous wreck. I pointed out the obvious when he told

me his problem. In order for him to trust himself, he was going to have to commit to his stops and feel that he could walk away from the screen. I suggested that he go back to his trading plan. He needed to work on contingencies for his rules and backtest all of the positions that he had taken to see what the results would have been if he had kept to his original stops. What he found was that he would have made more money if he had consistently stayed with his original stops. We worked on his issues of the fear of being wrong. We also worked on mentally rehearsing feeling comfortable trading his rules and staying with his initial stop loss. Now, he is able to leave the screen with confidence that his rules for

stop placement are the best for his method. Albert works a four-hour day and is well rested for making better choices.

... "It's Time to Call it a Day"

Here are some questions for you to coach yourself. They will help you recognize if you are using the right amount of time to produce the best results.

- Why do you work the hours that you work?
- What would happen if you worked fewer hours?
- When do you make most of your money?
- How much of your day do you waste?
- What part of the day do you make

most of your money?

- What part of the day do you make the least amount of money?
- Who expects you to put in a certain amount of hours to be considered full-time?
- Would you make more money if you worked less or more hours?

Conclusion

Successful trading initially demands many hours of studying and planning. One of the difficulties and/or benefits of being a professional trader is that the traditional eight hour work day is not necessarily the rule for getting the most in monetary reward. While some traders need those extra hours to produce great profits in the markets, I have found that many traders who lessen the hours that they spend in the markets produce better results.

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adverse price move to a fund holder is a down market. Thus hedges of this sort are also called short hedges, since the investor would have to sell short a futures contract to protect against an adverse price move. If the market did slide, the profits on the short hedge would hopefully offset the losses on the portfolio of stocks.

Conclusion

Over the last 15 years, CME's stock index futures product line has seen tremendous growth. Much of the success in these products is because of their advantages to large institutions such as banks, pension funds and mutual funds. Used properly, these products provide superb risk management and trading opportunities. Their usefulness, however, is not limited to billion-dollar institutions. Suitable individual investors with adequate risk capital and the appropriate type of portfolios can successfully employ these vehicles too.

David Lerman is the senior director of equity index products marketing at the Chicago Mercantile Exchange and the author of *Exchange Traded Funds and E-mini Stock Index Futures*. He has traveled around the globe on behalf of the CME, giving seminars and workshops to retail and institutional audiences, including pension funds, corporations, banks and brokers on risk management/trading using equity index futures and options.

For information on ordering his book, please see the *CRB Trader's Bookshelf* found on page 18 of this issue.