November 25, 2005

Bill,

I told you I was working on some writings involving trading and Options that might be of interest to the readers. As it turned out it evolved far more than I expected and took a different form than I first imagined. As I read your daily Ask Fleck posts day by day I realized the knowledge level of readers was all over the spectrum. Any semi-advanced option stuff would appeal to only a very few and drown the rest. Slowly I came up with a question and answer format that fit right in with Ask Fleck. What I did was break it into a general Trading category and a general Option category. I also tried to answer the questions as if it was you answering.

Best,

Bob Ward

General Questions about Trading

Do you expect to make money trading? On balance and over time, yes.

Can you make some for me? (I just want to make enough for a new car / deposit on a house / to pay my rent / tuition) No, sorry, the world is not that simple and the market is never that generous. Making money by investing or trading is far more difficult than it looks. There is uncertainty in every decision and it is only over time and many decisions that good traders can have any hope of coming out ahead. I absolutely cannot guarantee that any trade I believe in will make $500 by next Tuesday or any other day for that matter. In general, you cannot borrow from a bank or brokerage and expect to earn it back from the markets -- if it was that easy we would all be fabulously wealthy. And banks and brokers would switch from being money lenders into speculative traders.

Do you make money every trade? Absolutely not. Nobody does. I certainly try to win more often than I lose, but there are plenty of losers to go around. If I ever get the losing part licked I'll be home free. The main objective is to not allow your losers to get bigger than your winners. An old adage when things aren't going right: "lose your opinion, not your money". It's in the nature of the business to have lots of losers; the key to successful trading is in dealing with them.

How much do you expect to make when you trade? There is no set amount. I have hopes and beliefs whenever a trade is entered, but the realities of the market soon set in and I may have to exit any trade or group of trades with a loss. This is part of the game. We can never know these things ahead of time. Trading is, after all, an adversarial game. Whatever we buy is being sold to us by someone with an opposing opinion … and they probably think the move is over. We can only make money if our opinion is slightly better than theirs on balance.

How much do you make a year? This varies a great deal from year to year and market situation to market situation. Some years are ripe with opportunities for my type of trading while other years are extremely difficult. Sometimes the market is generous and other times it is extremely stingy. Sometimes I get it right immediately and other times I should have headed for the hills instead. But these things are never knowable ahead of time. If I am leaning toward the Bear side, for example, then I'll likely do better when the market in general has a down year. If, however, the market goes opposite to my opinions then I feel lucky if I can escape unharmed.

As to actual yearly percentage returns, an investor in U.S. Bonds is looking to make 4% to 5% lately. A buy and hold Stock Market type is always hopeful of making 7% to 10% on average, but this can vary enormously and some huge downdrafts do occur. During the three years 2000/2001/2002 many buy and hold portfolios lost 20/30% a year and some, such as those heavy in Nasdaq high-fliers, were wiped out entirely. If you can make 10% a year on average with very few downdrafts you are doing well. If you can make 20% a year you are doing spectacularly. Two of the smartest, richest investors in the world, Warren Buffet and George Soros made their billions by compounding at 25% per year or so. The key for the rest of us, then, is to aim for 20% a year returns, but to be happy with 10-15%. And, no matter what, make sure you don't lose money. That is Buffet's rule number one. And it's much easier to say than do.

How long do you hold a position? I expect most of my positions will be held for a few months, but I'll occasionally do trades for a few days as well. I'm always hopeful that my positions will be held for a long time, as that signifies a winner that keeps on doing well, but the market is rarely that accommodating.

Where do ideas come from? I watch the markets day in and day out every day. Naturally this gets my mind working and churning out thoughts and opinions although most of the time I'm are merely thinking "this market is insane and these guys are really bonkers!" I read everything I can get my hands on and subscribe to several services. The work of a trader/investor is to read, read, read. I'm passionately interested in certain financial areas and the economies of the world. Occasionally I'll see political situations developing in the U.S. or elsewhere that might portend good or bad things. I try to develop trades for some of those. Tech/computer stocks are something I'm very interested in and have done well with. Currencies and precious metals are another specialty. There is no end to the number of things written about all these topics and when I disagree strongly with the way things are going I begin to think that a trade is developing. After all, as Mark Twain said, "it's difference of opinion that makes horseracing." This is true for markets as well.

Why don't you have positions in every industry? Although I follow as many industries as I can, I don't feel I know many of them deeply enough to bet my money on. That is what separates the professional from the amateur and the trader from the gambler. As my banner says: "Often wrong, but never in doubt". While this is clearly a tongue-in-cheek joke it is also meant to show I'm opinionated and not bashful about it. You cannot trade successfully without strong convictions on the markets. The thing is, however, that I feel strongly about lots and lots of topics. So what? You can't trade everything or you will soon be broke. All opinions are not well formulated enough or advantageous enough vis-à-vis the market's pricing to give a trading edge. I have to pick my battles and so I try to focus on what I believe I know best.

While there are no doubt some great Sri Lankan Bonds, or frozen wasteland Canadian Tar Sands projects, or imminent collapses in mortgage-backs or housing markets, I just can't clearly see what they are. And if you invest in things that you can't see clearly, you will soon find that someone who does see clearly in those areas will have an edge on you and take your money – that's the real way markets work. And don't let anyone tell you different.

Why do you play commodities? And which ones? I have a soft spot in my heart for the commodities markets, but it is nonetheless a wild and wooly area which is probably best not introduced to casual traders. I do dabble a bit here and there aside from the major positions I take in Precious Metals and Forex, but I don't think discussing such dabblings makes sense unless I develop a real strong longterm opinion on some market.

Why do you think you are able to win in the markets when others do not?

Apparently I have the knack for translating my opinions, over time, into winning market strategies. That is to say that in certain cases my opinions seem to work out better than the prevailing opinions in the market at that time. You cannot learn this knack in school and you cannot take a test to find out if you have the knack. You can, however, learn a thousand tricks through the hard knocks of experience and from listening to other traders, but in the end it's all on-the-job training. You must be able to process lots of market related information to arrive at opinions that can then be compared with the market's opinions. You must be able to translate your opinions into tradeable strategies and learn how to pull the trigger. Learning to pull the trigger to enter and exit the market is a major complication all its own. And some people have greater difficulties exiting the market, especially with taking a loss. But taking early losses is key to surviving.

These are not skills that are easily defined. The whole topic is nebulous and vague. It's like asking a major league batter how he gets a hit. As one player said, "it's simple - - I just keep my eye on the ball, lean back, and take a whack!" Except that 99% of us would never be able to hit the ball at that level of competition. The major leaguer is a professional with extraordinary native abilities and has developed competitive skills through years of tough, tough practice.

In general, the answer as to why anyone has won in the markets is that they either had an edge or they were lucky. If they can do it for more than a few years it becomes less and less likely that it was pure luck and more likely that they have some sort of an edge.

What does it mean to have an edge in trading? It means you have a slight advantage in your manner of understanding the market and in your way of trading it. To be a winning trader you have to know something that the other players do not. Let's say you become expert in reading how the market reacts to news events -- that would be an edge. If properly utilized such an advantage can lead to profitable trading results over time. But if used improperly, such as jumping in and out when you are impatient or when you are emotional about the market's roller coaster ups and downs, any small advantage can quickly disappear. Trading losses will most likely result. Finding an edge is simply the starting point of any successful trading method, but it can easily be squandered and lost -- as many, many people have learned the hard way.

How do you expect to keep getting the edge? The more things change, the more they remain the same. The markets keep changing, yet they also retain an enormous number of similarities to their old ways. The key is to identify what is working now and likely to work in the future. I'll keep on reading and watching and processing information related to markets and corporations and economies. If for some reason it fails to generate successful trading ideas for me then after a year or so I'll take a step back, try to clean up all my positions, and clear my mind to recognize and accept a different point of view. When I find my footing again and begin to understand what is going on then I'll know it's time to start up again.

If you want to be different than you already are, you have to be prepared to reinvent yourself. Because markets are always changing traders must adjust again and again; it's an ongoing process.

Could you give us explicit details of what you are trading step by step so we can follow you exactly? No, sorry I can't do that. Not only would that overwhelm me timewise, but secondhand trading tips, especially when quick decisions are important, often lead to frustrations and problems for everyone involved. My original purpose in sharing my trading views had a twofold rationale: I could help others by spreading valid strategies and I could encourage a sort of informational feedback loop where knowledgeable readers would let me know their insights as well. As a byproduct of these and by thinking out loud about my strategy on a daily basis I forced myself into the good discipline of "facing reality" a little bit each day. So far it has worked out well, but I just don't have any extra time left to expound any further in print than I already have.

You are constantly going "short" various Stocks, yet you advise against "shorting" for casual traders. Why is that?

Shorting Stocks can get dangerous and messy at times. There are many drawbacks to going short and it is best left to experienced traders and professionals who know how to deal with the technical difficulties that can arise with short positions. On top of this there are at least a half dozen subtle biases working against you when you go short -- too many to go into here.

Many smart people point out that short-selling is like trying to sail against the wind, so it is not something I openly advocate for others. But shorting works for me. It is the only strategy that makes sense to me when the market's cheery prospects for future earnings are far above reality (as I see it). To win at trading you must interpret the facts better than the market does, so given my bearish earnings outlook shorting is the right path for me to follow. Over the years I have been able to make money on my shorts despite the many disadvantages that others cite and so I will continue to trade this way. Only time will tell if fighting the entire dead fish community was worthwhile.

One way that the aggravation of shorting can be lessened is by buying Put Options instead of going short. This adds a new layer of complexity to your portfolio, but it also adds protection. We'll discuss Options in another section.

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General Questions about Options Trading

Your positions often say "Short Intel and Long Intel Puts". Why do you need Put Options if you are already short?

When I believe in a scenario strongly I like to take as big a position as I can. The Put Options are a limited risk way to get extra bang for the buck. They add leverage to my position. Options also have the interestingly beneficial property of increasing exposure when the market goes your way and decreasing exposure when you are wrong. This is related to an Option's Delta. This concept is discussed more thoroughly under Delta if you are interested.

Why do you say buying Put Options is preferred to "going short" for most readers?

When you short-sell Stocks there are lots of potential aggravations to be dealt with. Buying Puts gives the same expected payoffs, but many of the potential complications are reduced.

For example, the most painful scenarios when shorting Stocks are the violent short-covering rallies and the rare takeover or merger at above-market levels. Just imagine being short GM shares before Captain Kirk Kerkorian stepped up to the plate a few months ago. When these things happen the market gaps up and often never looks back. Since a good trader should control risk he would be buying the shares back as it rallied in order to lower exposure. But in a gap-up situation the price moves higher instantaneously and any buyer would be forced to pay such higher prices. Also, many traders would hesitate to pay the gapped-up prices, leaving them further exposed as the rally fueled itself higher. With Options, however, while you would still be hurt your position is magically lessened every tick up, even though you don't act at all. The Option does all the adding and subtracting of positions for you automatically.

What is the best Option to buy? Unless you can predict precisely how a Stock price will move, there is no "best Option" to buy. Most traders try to imagine how a scenario will play out in the future and choose their Option position accordingly. Key pieces to this puzzle are time, price, and volatility. If you know there will be a big price move next week then buying a two month Option is overkill. Likewise, if you know market volatility will quiet down (which tends to shrink Option values) you would benefit more by selling Options rather than buying them. The more closely you can pinpoint future price and volatility and the timeframe of occurrence the more clearly you can select the Option that will net the highest return and will thus be the "best Option". Unfortunately this requires a crystal ball as well as a deep understanding of Option mechanics.

Since no one can really predict such things with accuracy any selection of “best Option” is merely a guess. A helpful tidbit from Option theory: all Options, regardless of maturity or Strike Price, have an equal expected return – and that expected return is the cost of money, say 5%. We can discuss more on expected returns at another time if there is interest.

My own preference in Options is to buy long dated Puts slightly out-of-the-money, especially now that Options are cheap due to low implied volatilities. Long dated Options give my ideas plenty of time to play out and insure that I’ll participate when and if my predictions come to pass. It’s just another way that Options can be used as insurance. If I develop any specific Option ideas that I like better I’ll let you know as it happens.

Everyone trades Options expecting to get rich, but no one seems to do so. What’s going on?

Since most traders try to use Options for the “big score” there is an inherent problem they must deal with. The problem is that when you bet on a true 99 to 1 shot you will have 99 wipe-outs for every winner. So those dreams of making millions in Options when you risk only a few thousand dollars in premiums are very far fetched. It’s right up there with winning the lottery or playing in the Super Bowl. But we all dream anyway.

A far more likely win with Options would be doubling or tripling your premium investment. In the extremely rare case where you earn as much as ten or twenty times your investment you have to predict a real longshot scenario with pinpoint accuracy -- and have it happen very fast. Every January we read stories of how traders saved their year by pulling off this longshot coup or that, but what you are actually hearing about is the classic “survivor’s bias”. A thousand guys tried it and only two are still around because they got it right. Betting your whole bankroll on longshots leads to a very high probability of ruin. After a while most of these gunslingers will end up managing the local fast food restaurant instead of other people’s money.

To have a high likelihood of collecting some money at Option expiry, and remaining solvent, you must limit yourself to buying at-the-money or in-the-money Options. These will give you a better than fifty-fifty chance, but, of course, they seem very expensive at the time. There are many cheaper Options to buy if you have money to burn and feel really lucky, but the market is telling you in big neon letters: these are lottery tickets with little chance and no intrinsic value. Just remember: you get what you pay for.

How do traders use Options?

Experienced traders tend to use Options to augment their outright Stock positions. That is, they will take an outright Stock position that reflects their opinion and also buy Options which will add more exposure if things go well. They have learned that adding onto winning positions and exiting losers is the best way to play the game. Options suit this strategy perfectly. This is discussed further under Delta.

What is Delta?

Delta tells us how much of a move we can expect in the Option for every dollar move in the Stock. For example, if an IBM Option moves up $0.30 while IBM Stock moves up $1.00, then the rate is 30/100 which we would call a .30 Delta. The Delta is not fixed for any Option -- it keeps readjusting to price, time, and volatility changes. If IBM shares move higher and higher then the .30 Delta Option would slowly rise to .35 then .40 and so on until it reached a top of 1.00 (at which point the Option would move 100% as fast as IBM). Likewise if IBM should fall then the Delta would fall as well until it reached a low of 0.00 . You can see that the Option picks up relative speed when it's winning and slows down when losing. (We used Call Options for this example.)

How does Delta show us our equivalent risk position?

Using the Delta as a multiplier we can easily tell how large an IBM risk position we have. The .30 Delta Option we discussed above would give us the equivalent of 30 shares of IBM risk for each 100 share Option. Thus the end-of-day profit or loss on a .30 Option would look similar to having owned only 30 shares of IBM for the day. As the Delta rose to .40 we would have 40 shares of IBM equivalent risk and so on.

If IBM shares rise strongly and the Delta nears 1.00 we would be long an equivalent of 100 IBM shares having started with just 30 shares. In this way we will have added to our winning position. If the opposite occurs and IBM prices fall, as time passes and expiry closes in the Option Delta would near 0.00 and all our IBM exposure and risk would be removed.

Can Delta indicate Probability?

The Delta can be considered a ballpark probability of how often the Option will finish in the money. Although this is not strictly correct from a mathematical point of view it is, nevertheless, a pretty good rule of thumb. For example, at-the-money Options have a Delta of about .50 and also a fifty-fifty chance of winning. A Delta of .80 implies an 80% likelihood and .30 means 30% likelihood. It pays to take note of this when choosing which Option to buy; when we buy apparently inexpensive Options with Deltas of .10 or lower it becomes highly unlikely (just a 10% chance) that we will ever collect.

Does Delta indicate an Option's relative cost?

Yes. If we compare all the January Options, for example, a Delta of .80 is much more expensive to buy than a Delta of .50 or .30 and so on. The higher the Delta the more in-the-money the Option is, and you always have to pay more to be further in-the-money.