Volume I Issue XIV

Fade-Self… One Trader's Commentary

Strategy **8 November 2005**

"Jackson Boulevard Chronicles"

"When men are pure, laws are useless; when men are corrupt, laws are broken."
- Benjamin Disraeli

"My grandfather once told me that there are two kinds of people: those who work and those who take the credit. He told me to try to be in the first group; there was less competition there."
- Indira Gandhi

Jackson Boulevard runs east/west near the center of the loop here in Chicago. More futures business occurs within 5 blocks of Jackson Blvd. than anywhere in the world. Needless to say, Jackson Blvd. has been ABUZZ the last three weeks. I thought the timing might be right to comment on the state of the futures industry in light of the REFCO debacle. (In my humble opinion) The futures industry has gotten a bad rap for a long time and for many years this was for good reason. Since the industry fell under the auspices of governmental regulation in the 1970's it has been evolving. Slowly. From pork bellies and frozen concentrate orange juice to interest rate swaps and bobl's- we've come a long way. Obviously, when the biggest, most reputable kid on the block gets caught (allegedly) with his hand in the cookie jar- everyone loses. REFCO helped move the industry forward light years beyond where it would be without. The technology, talent, and legitimacy that REFCO brought to investors and markets around the world were unparalleled. Were. Past tense. Hey, even Rome fell. Rather than cry over spilled milk- it's time move on. A changing of the guards. So, with that in mind- this issue of Fade Self is dedicated to moving forward. With my regular analysis of the market sectors- I will also dedicate a few moments to explain some of the most cliché trades I've seen in futures. Trades that represent the old way of doing things. I'll also suggest a new way to trade each particular sector.

Equities- “E-Mini S&P Daytrading”

This is a perfect example of a trade that made so much sense that it didn’t make sense anymore. In the 90’s and even into the ought’s you could make a good living on very short term trading in the S&P (scalping.) As the market matured, however, and more and more institutional players and black box operations (program trading) entered the fray- the choppiness increased. Now, trading the S&P mini is essentially a shell game. Play at your own risk.

The reason the E-mini S&P 500 daytrade has lost its profit potential is because of its widespread use for so many different applications. The market can’t trend for very long before its weighed on by an institutional player hedging or a black box operation scalping on a different time horizon. I suggest instead, that you try trading the E-mini Russell 2000. First, because the Russell is not as traded as the S&P- which does decrease the liquidity- but it’s a like the difference between a fish swimming in the Mississippi River instead of the Amazon River. A single fish isn’t going to be able to tell the difference. As far liquidity goes neither will you. What you will notice is that you will get a lot more bang relative to your trading buck. For instance, if you’re a short term trader you might ride a trade for say 10 minutes. In the E-Mini S&P you’d be fortunate to get 3.5 points on a good 10 minute bar. That comes out to just $175 per contract. Initial margin on a contract being $3938. However, with the E-Russell a commensurate move would be worth 2.5-3.5 points. That works out to $250-350 per trade. The margin on an E-mini Russell is just $3025 or 76% of an E-mini S&P. When you take the average winning trade as a percentage of initial margin for the SP you get $175/3938 or 4.4%. The Russ comes out to $300/3025 or 9.9%. Now, if all you do is daytrade- and you’re good enough to win more than you lose- the Russell is going to give you a 125% better returns over the long run. So, if you are a pretty good trader and you make 9% trading the SP- by my estimations and experience- you’d be looking at 20.25% over the same period.

I’m still very bearish the stock market. The last trade in the S&P was 1222.50- I think you’ll see 1162 in the next three months. I think there is a good chance you’ll see 1080.00 by February.

Treasuries- "Deep out of the money Eurodollar Puts"

This is an example of a trade that not only never made any sense, but also never made anyone any money. Except for your broker that is. This trade played on the idea that when interest rates are low- they must go higher. Timing is everything on that one. A lot of intelligent people KNEW that rates had to go up 3+ years ago, but lost a lot of money along the way. When and how much rates rise was the real question. Now, if you're broker called you in Summer 2002 and said that he wanted to buy March 04 97.00 Eurodollar Puts because they would make money if interest rates went above 3%- you might have asked, "how much?" When your broker answered that they were just $200 a piece- you might have asked, "how many?" Wrong question. You're broker probably said something like, "Well, lets play it conservatively and just buy 25." Ok, so now you're in for $5000 on a position that "makes sense." At the time of the trade interest rates were actually- STILL FALLING. The Fed was still lowering rates at that point. There doesn't seem like a huge difference between 1.5% and 3%, but it amounted to a difference in your bottom line of $6250. That's the $5000 that some local on the floor of the CME made from writing you your 25 Eurodollar lottery tickets and the $1250 that went towards dinner and drinks for your broker and his cronies. Nice trade.

Now, you can probably tell the theme of this issue is – TELL ALL THE BROKERS SECRETS!! Haha…So, as far as interest rate futures go- if you only trade technicals and are looking for a liquid market to daytrade- shh- come around the corner with me ------------------→ (Whispering) Ok, here's the deal- European futures markets are dirt cheap and are in most cases more liquid than US futures. The Schatz (2 yr-note), Bund (~5yr), Bobl (~10yr), and Buxl (~30yr) cost as little as 30 cents a contract to trade. 30 CENTS! AND you can trade them with any major futures house in Chicago. You thought $4.80/RT for e-mini S&P's was cheap...But remember- you didn't hear it from me….

As far as trading US interest rates goes- last month this is what I wrote- and it still holds true, "Following is a chart of the Dec. Ten-Year Note- I'm selling it. I think you'll see 110.00 soon and over the next 3 months you'll see 102.00." The chart is on the next page- if you would have sold 10 contracts the day I sent you issue 10- you'd be up $21,200 on the trade. Think about it.

Metals- “$600 Gold Calls”

This trade is one that has many variations. Most bad. The idea is that your broker takes your ideas that gold is likely to go higher and basically hypes them up. Gold is historically a slow mover. The volatility is very low relative to many other commodities- especially the other metals. The broker usually will convince the client to buy deep out of the money calls with at least a year to expiration. That way you’re “buying a lot of time.” It sounds like a good idea, but in reality it’s a very bad one. For you to make money gold would have to make a pretty vigorous move. When I say vigorous- we’re talking about Hunt Brothers like moves on silver. Gold calls should only be used near or at the money, because of the high propensity for gold to move in a channel. This phenomenon is due to the high public awareness of the market- lots of weak hands need to be run out of the market on an almost monthly basis.

As far as trading goes. I would stay neutral gold. I’m still long with calls written. The same is true for silver and copper. I actually bought some more copper this morning and wrote slightly in the money calls on the position.

Energies- “Heating Oil Call Spreads”

So, here’s the trade. Buy a $2.00 December Heating Oil Call and Sell a $2.50 December Heating Oil Call. You may pay $500 for the $2 call and sell the $2.5 call for $250. So you’re total cost is JUST $250! Well, don’t forget commissions and fees. If you’re trading at California or Florida broker you’re probably paying at least $80 PER OPTION commission. Don’t forget about the small print fee game either. I mean- have you ever tried to decipher a futures brokerage account statement. I’ve seen hundreds- there are so many ways for sneaky brokerages to hide your costs from you. Next week- I’ll show you ours and go through it item by item so you can compare it to yours. Deal?

Getting back to the trade. The old adage is that Heating Oil goes up in price in the winter months because it gets cold out- an intelligent statement and a very stupid one at the same time. The price of heating oil is based on expectations for the future- not the temperature outside- come on. You’re telling me that it comes as a surprise that it gets cold out in October? Besides, just because heating oil does go up (a self fulfilling prophecy) doesn’t mean you’ll make money on your spreads. Timing is infinitely important- especially with options. Decision making is also big. If the market does go in your favor- when are you going to take profits? It’s hard to let a profit run- especially when you may have been waiting for it for weeks or months.

Most people (who do make money on energy options spreads) make very little relative to the full profit potential of the trade. They get out too early or get out too late- timing is everything.

Currencies- "FOREX Trading"

There is no such thing as a free lunch. When a company tells you you're going to pay ZERO COMMISSIONS- read the fine print. **Here's how it works- when you place your trade in the forex market there are two ways that the trade is executed. The first and the traditional way of making a forex transaction goes like this: You place your order and its routed directly to the bank you have a line of credit with and flows side by side with actual banking transactions. The market you're trading is so liquid that it is likely that it is locked (which means that there are bids and offers at the same price. Ex. Euro is locked when a market is 118.95-118.95. When this occurs there is essentially no friction. For people make large transactions in banking- that is essentially the case. If you wire 3,000,000 USD and your bank tries to charge you even a $20 wire fee- you'd laugh right. Right. So that's no friction trading. And it's possible. BUT that's not what 95% of FOREX shops are selling you when they promise you NO COMMISSION. They don't make money just from the interest that a bank makes- so they don't have an incentive to give you a no friction trade. So, the way that most shops do business is by way of a "dealing desk." Essentially what this means is that they act as intermediary between you and the real market. This also means that they can give you whatever quote they want. If you're trading the Euro they might give you a 118.93-118.97 market. Not bad you think. 3 pips (ticks) wide. That means that if you simply must buy- you'll pay 118.97. The true value of the market is still 118.95 but you can't trade at that price. Instead you pay 118.97 which is 2 pips away from the real market. Since they have access to the real market which is trading at 118.95 they will simultaneously sell 118.97 with you and buy the 118.95 which is offered by the bank. They make 2 pips or $20 per lot (each lot is $100,000 of actual cash moving) So, if you're trading $3,000,000 USD at a time that's 30 lots. 30 x $20 = $600. That's like paying a $600 fee to wire $3,000,000. That's crazy. But, if you're trading through 95% of the forex shops out there- that's just what you're doing. However, traders know where they can go and not get screwed. Every prop trader I know clears through a firm called EFX Group. Check out their website www.efxgroup.com. Download their platform and see for yourself how tight their markets are.**

I switched back to normal font to give you the "catch." Here's the catch instead of paying no commission- you give them a chance to pick off a few points from each trade. That's a big catch- it will certainly add up if you trade enough. It's definitely better to pay the $7 "commission" to a group that allows you to trade a truly liquid market- rather than pay $0 "commission" and leave yourself open to a couple pips every trade.

As far as the currencies go, I'm still very long the dollar. More specifically short Euro with puts written and short Yen big with puts on those positions as well. I'll reiterate that we could see 115.00 in the next month. Watch for it.

Fade-Self (fād-sĕlf') ***verb.***
1. In trading- to take objective conscious action that is directly in opposition to the trader's gut instinct.