Volume I Issue V

Fade-Self… One Trader's Commentary

Strategy ***10 August 2005***

"A Rolling Stone Gathers No Moss"

"Whatever side I take I know well I will be blamed"
-Keith Richards

Backseat traders often question why I sell options on winning positions and then allow them to go against me- rather than just exiting the futures position. Many traders focus too much on making the perfect trade. They want to buy the bottom of the market and sell the top. These traders believe that there is a perfect trading system out there that will allow them to accomplish this very egotistical objective. I believe that there is never a reason to pick a top or a bottom in a market. If you do- then you took too much risk. So, I like to say that I'm usually the last one in a developing trend. What this also means is that I like to enter trades when the volatility is the highest. The idea is that I would like to be in the market (at risk) for the shortest period of time relative to the move. For example, lets take the Eurocurrency's move from December 2004 (136.00) to July 2005 (119.00). This was a $21,250 move on one contract top to bottom over 8 months. On average that is a $2,656 move per month. However, more than half the move occurred in a one month period from May 5 to June 8 when the Euro dropped from 130.02 to 121.60. That was the best time to have your money at risk. So you didn't sell 136.00 and you didn't offset at 119.00, but if you had you would have tied up your margin for 8 months rather than just one. The other aspect is the psychological aspect of being in the market (especially on the winning side). If you would have sold 136 you would have had 6 months of opportunity to take profits. It takes a lot of discipline to sit by and allow the market to work for you over that long of a period. This is especially true when you consider that you would have had all your profits wiped away twice before you got the final big break.

Let's just say you did wait until 130.02 to get short. In that month the Euro made new lows 14 days out of 25. The lack of major retracement in that period would have made it much easier to hang on to your short position. For me, once the velocity begins to disappear I will sell options (in this case puts) on my positions to help round out the trade. If the market keeps falling- some of my position will be neutralized. If it retraces- the puts will lose value and I'll buy them back cheaper using the profits to hedge against money I give back on the futures side.

Equities- "Winning Ugly"

Well, we made it about 80% to my October objective in the stock markets. The pullback at the end of last week and beginning of this week was certainly a swift one. Last trade in the S&P 500 was 1228.50. This is why selling at the premium on winning positions is so important. I think we will surely make new highs in the stock market between now and October- in the meantime we're making money- but it's ugly. I never leave the table at the top of the market, but I usually hedge my bets once things go my way significantly. The Nasdaq is certainly leading the market right now and the Dow continues to underperform. For now I continue to be moderately long the S&P and short September near the money calls against. If we get some strong price action to the upside mid-week I could be adding Nasdaq positions to the mix. Any further pullback in stocks will easily be attributed to the rumors of more hawkish than expected Fed hikes in the next 8 months. This can easily be seen by looking at the VIX. As soon as the rumors that the Fed was interested in taking rates to 5% started circulating- the VIX started ticking up. Look for a weakening of the VIX to be your first signal to get more aggressively long small and mid cap stocks (Russell 2000, Mid-Cap S&P, Nas). I'd look for a late week rally to fill the gaps left last week. 1245 in the S&P, 1630 in the Nas.

Treasuries- "Flight 505"- to 5%

Last week I said, ***"The low of the move in the bonds has been 114.14. Once we hit 114 I would move towards delta neutrality by selling puts against short positions. I think a bond rally will coincide with the broad based currency rally versus the dollar that I've been calling for."*** Check your charts. Bonds bottomed just under 114.00 and have since rebounded above 114 half. There will be continued upward pressure on short-term interest rates as inflationary ideas move into the market. A recent rumor on Wall Street suggested that the Fed views 5% as neutral monetary policy. While this may be true- I would look for rate hikes to cease before next spring. Greenspan's exit may be a good time for the Fed to change its stance from accommodative "at a rate that is likely to be measured, to a more malleable stance.

Metals- “Coming Down Again”

Sure enough we’ve seen another failed rally in the precious metals. Long term bulls are certainly being tested as gold and silver continue to trade in monotonous ranges. Silver showed significant strength last week moving up from $7.00 to as high as $7.33 before selling back down to $6.96. Those of you who took my advice and sold $7.32 with a $7.42 buy stop and are sitting on $1700 a contract would be wise to sell November $7.00 puts and take in $1500. That way if silver moves back to your breakeven level at the top of this channel- (with a delta of .45) your option would lose about half its value. You could buy back your futures contract (at say $7.32) and the option (for $750) and make $750 on the transaction (less commissions).
Copper pulled back almost 4 cents earlier this week, but showed its resilience by bouncing back 3.5 cents the next day. Still long- but with 166 calls written against each position for $650 each. The velocity on copper has waned from a high of 3.9% last week to 2.3% at the close of business today. Remember a velocity below 2% signals a momentary pause in the trend. The velocity on silver is .6%- still not very attractive. Gold is at 1.7% and is looking like it may be a long term buy in the next two weeks.

Energies- “Hold on to Your Hat”

A good broker calls you and says:

7/14/05 – “In a long term bull market like crude there is no reason to be short. Don’t be hero.”

7/21/05- “I know, I know, if you would have shorted crude last week- you’d be up $4000 on one contract. Well, I still say- DON’T SHORT CRUDE.”

7/28/05- “If we breakout above $62 or below $55- then I’d consider taking a position.”

8/3/05- “I’m currently flat, but if we break $62.50 that could change.”

A good trader says:

8/10/05- “We’re long crude from $62.20- last trade was $65.10.”

Talk is cheap- trading isn’t about prognosticating- it’s about pulling the trigger.

I just don’t get tired of being long crude. I say- “If you’re long crude and not making money- wait 15 minutes.” This morning the crude inventories came out up 2.8 million barrels, which is a very bearish number. However, the gasoline inventories were sorely lacking. The market sold of 50 cents in 10 minutes- and proceeded to rally $2.00 slowly over the rest of the trading day. My clients got long last Friday around $62.20. The closing price today was $64.95. That's a three day gain of $2,795 per contract. My response to making that much money so quickly was to write Sept. $66 calls against the positions (bringing in $600-700 each.) These options effectively cap profits at $3,800- but only for the next 8 days- as they expire the 18th of August. In the meantime they will protect some of your profits if the crude retraces. Hey, even if you're only trading 1 contract on a 100K account and we pullback to $63.00- that's still a $1,450 profit on the trade. A 1.5% return in two weeks. Not bad.

Currencies- Satisfaction

A slow grind is the best kind. Of rally is that is. The high in the Euro today was 124.47. The Canada reached 82.78 and the Swiss, Pound, and Peso all made move highs as well. I'm looking for an increase in volatility in the next week. You will likely see 125.50 (my objective) and 121.60. If we hit 121.60 I would be aggressive in adding to longs in the Euro, Swiss, and Canada. I'm still long the Peso- the velocity there is .4%- but its waning a bit. Any profits on the table in the currencies at this point should be hedged tomorrow (Thursday). Wherever we stand. Sell calls or just scale back your positions. That's another reason I prefer not to work with accounts less than 50K- because it really constrains positions sizing and option selling. I'm never 100% sure of a move- so I'm never going to want to liquidate 100% of my position. So, if I'm long 20 Euro contracts – I'd take 30% of my profits – which means I'd sell 6 contracts. If I'm long 1 Euro contract – and I want to take 30% of profits. What can I do? Do you see what I mean? Risk control and positions sizing, along with trader discipline, are the most important aspects of making money in the futures markets.

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