

Fade-Self... One Trader's Commentary

Strategy

25 August 2005

“Almost Certainly Uncertain In An Uncertain World”

*“I hate cameras. They are so much more sure about everything than I am.”
- John Steinbeck*

I don't mind being unsure, as a matter of fact anytime I'm completely certain of anything- I re-evaluate. What is the chance that Gold goes to \$600/oz tomorrow? What is the chance that Corn goes to 50 cents a bushel in a month? What is the probability that T-Bond rates go to 1% in the next year? The answer to all of these questions is.....negligible. Can I absolutely say they won't happen- well I could...but I won't. I like to think that for every trading scenario there is a corresponding probabilistic percentage. The other side of the equation is also important to examine. If the Euro is at 124.50 today- what are the chances it will be above 124.75 in the next two months? 98%? 99% If you were long with an objective at 124.75 would you go on vacation with no stop? I'd hope not. Because the one time you ASSUME any market scenario absolutely will or will not occur- IT DOES! Then, all your research, backtesting, all the books, the advisors, your moving averages, Fibonacci's, stochastics, they're all meaningless- because you put all your money on red- and black 20 comes up. Bye, bye profits, vacations in the Greek Isles, that 550 Maranello you've been dreaming of....all because you declined to take my advice about probabilities. Whenever you're approaching a trade- in your mind lay a bell curve over all the prices that have traded in the past 2 years. In fact, you should estimate the time you will be in the trade and lay the bell curve over that time period multiplied by 10. So, if you plan to be in a trade for 6 months- use 5 years of data. If you plan to be in a trade for 30 minutes use 1 day of data. But always use some sort of risk control because any scenario IS possible. Now, once you've set the curve on the values you can evaluate a probability that the market will move to your stop or objective.

For example:

Step 1: Trade Entry- September Euro is currently trading at 122.45. Long 10.

Step 2: Estimate Trade Duration- example 1 Month

Step 3: Multiply 6 Months * 10= 5 years

Step 4: Assign probabilities uniformly ranging from 99.9% for 122.46 and 122.44 to 0.01% for 86.00 (200 week low) and 159.00 (corresponding distance to the upside.)



Step 5: Assign a % trend bias to the trade based on whatever technical indicator you may use- that would skew the above curve (in this case momentum indicators would skew the probabilities to the upside)

This will now give you the framework for where to take profits and where to liquidate losers. If the Euro moves up to 80% on your curve you would take 20% of your profits. The same would be true on the downside. In our example that would mean you would sell 2 of your contracts. (perhaps sell 4 at the money calls with a delta of .5 each (Delta .5 * 4 at the money calls = 2 contracts of coverage.

The basic idea I'm trying to get across is that you should think about trading in probabilistic terms. If you are 20% sure that the Euro is going to keep going up-then you would liquidate all but 20% of your core position. If you're 65% sure that the Euro will keep going higher you would sell 35% (or hedge off using short options) of your position.

Equities- "Of Bears & Bulls"

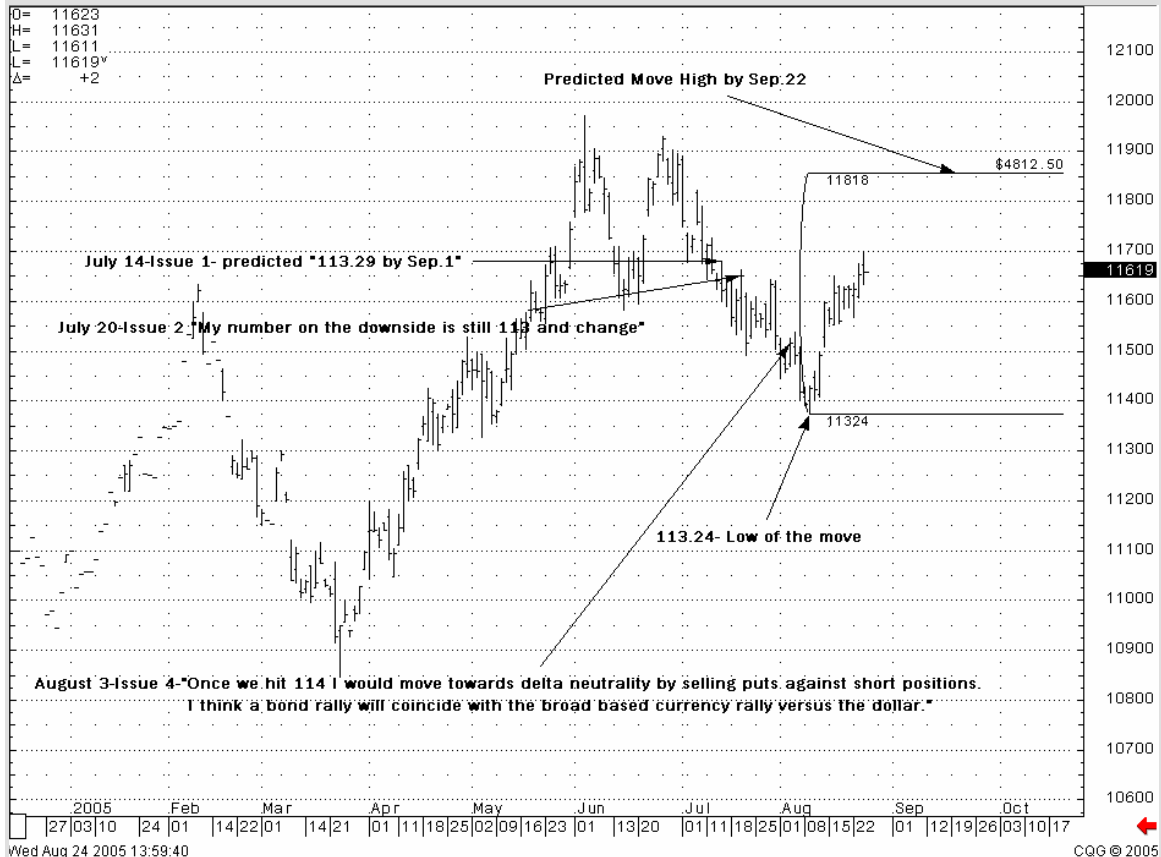
I have no position in equities today. Sorry. I have clients who call looking for trades in certain markets and expect me to always have a trade. That's crazy. This isn't a casino- sometimes probabilities aren't conducive to taking any risk whatsoever. Sometimes the doors just close. Most brokers believe that if the client is willing to take a risk- that it is the brokers job to find one for them to take. I don't get paid to deal cards- I get paid to advise you when to sit at the table and when to take your chips and cash out. So today- no trade.

I do expect the stocks to continue to sell-off. Last week I mentioned that I would be on the sideline until: the S&P 500 hits 1185.00, NAS 1567.00, Dow 10482, Russell 632. The last trade in the S&P is 1212.00, NAS 1567.00, Dow 10445, Russell 653. So, were almost there- just waiting for the S&P 500 and Russell to finish their drops. At that point I'm going to be looking for some bottoming action and then upward acceleration.

New highs in Crude today are reason enough to explain the current selloff. October Crude closed at \$67.40. There seems to be no end in sight for that trend and so the stocks will likely feel continued pressure until after Labor Day when the serious traders get back from vacation. The sideline is certainly the best place to be today.

Treasuries- "Tortilla Flat(ening)"

New contract highs today in the bonds- 116.31. I really think the bonds are going to make a BIG JUMP to the 118-119 level in the next month. I'll go out on a limb and say that when I write the September 22nd newsletter I'll be able to tell you I told you so ;) I do encourage you to read the last couple newsletter and match up what I've said with the following chart.



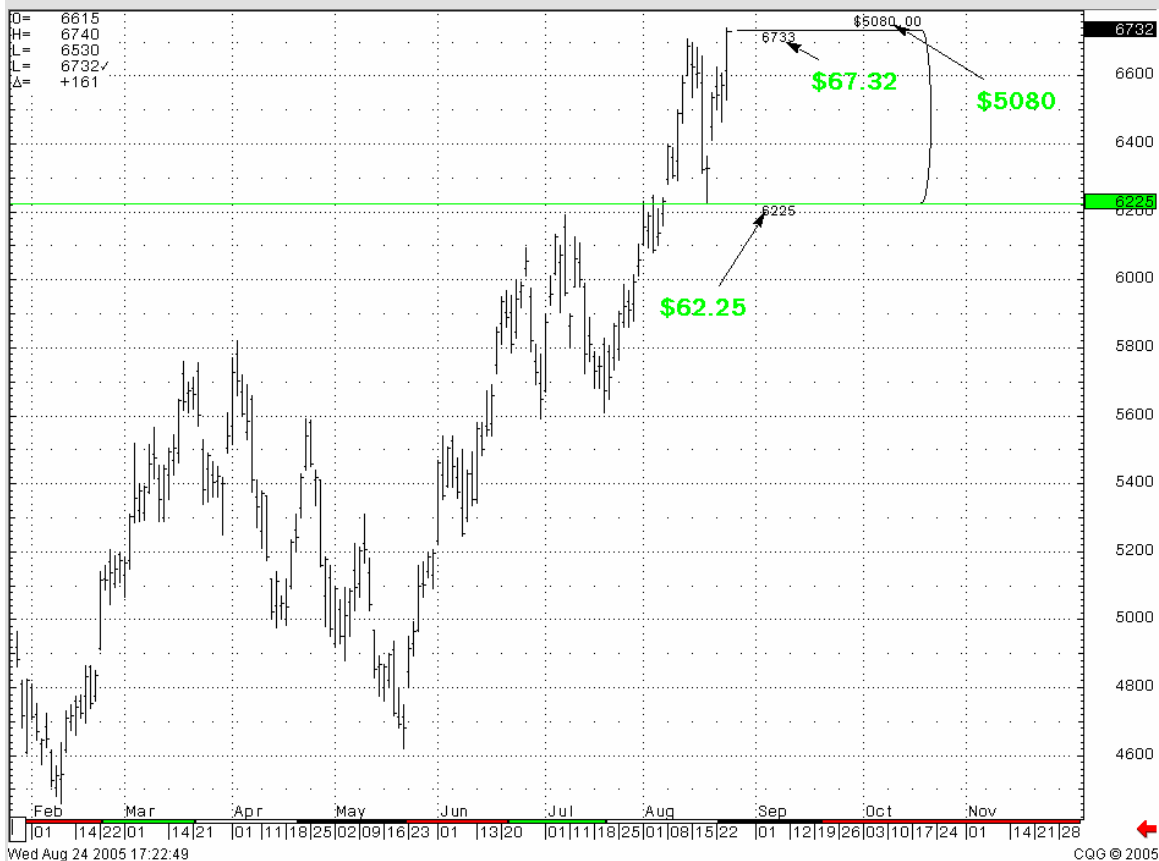
Metals- "The Wrath of Copper"

Not really a wrath per se, but it has been volatile. I was stopped out of my newest position last week- but bought it right back Monday of this week. Taking a few hundred dollars heat on those positions today- but not sweating it. I'll be selling calls against the newest positions if we hit 170.50. Last trade was 166.70.

Silver and Gold are much more interesting right now. I'm actually bearish silver and bullish gold. Strange. I'm flat right now, but I wouldn't be surprised if I had a short silver/long gold spread on in the next week. Technically silver is very weak and could be prone to fall hard to \$6.60/oz. Gold is less likely to fall as far- probably not past \$430.00/oz. Once Gold begins making its move I think it will be a straight shot to \$470.00/oz. If we got long at say \$440 that move would be worth \$30,000 on 10 contracts. The margin on one contract in December Gold right now is \$2,025. Either significant dollar depreciation or an inflationary scare (\$70 Crude?) could spark a rally in gold to these levels. This will be the move that all the gold bugs have been waiting for the last two years (since the last move from \$370 to \$450. If we were to continue through \$470.00/oz it is possible that the hedgies could jump in full force and push it up to \$500/oz. A move like that would drag silver along for the ride with silver running up to \$8.50/oz.

Energies- "The Summer of Content"

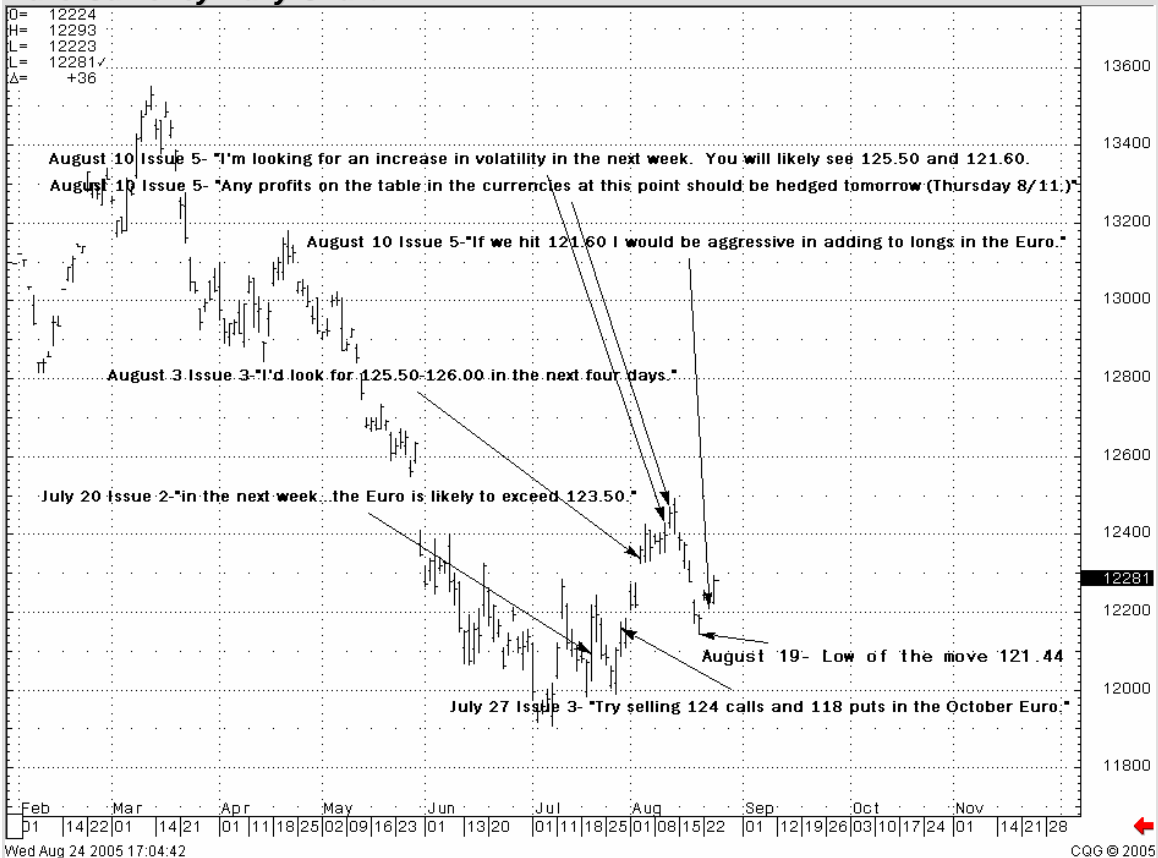
It seems like whenever Crude drops with reckless abandon \$3 or \$4 dollars that everyone panics and wants to believe that the top is in. Well, last week when our favorite commodity cascaded down from \$67.10 to \$63.20 in three days we didn't panic. As a matter of fact we wrote, "I'm looking for Crude to drop another dollar, but to rebound over the next few weeks." So, in the face of a complete free fall we chose to side with the level heads- predict we would drop to (lets do the math $\$63.20 - \1.00) \$62.20 and then head back up. Check the chart.....



Currencies- "Travels With Euro: In Search of the EU"

Well, those of you that speak with us daily know how close I've been to buying the Canadian so many times over the last month- well I finally got the requisite signals to jump in Monday on the close and has it paid off. Our entries averaged around 83.23 and the last trade was 84.02. I hedged up by selling 84 Sep. and 85 Oct. calls on half the futures positions. The rest of the currency move- specifically the Euro has traded in a surprising predicable manner the last few weeks. I'll summarize my projections in the Euro graphically in the following chart. It seems that when you see the chart and the dates of the projection that its far more convincing than just reading the words here in the newsletter.

Euro-Currency Daily Chart



We've had quite a few inquiries lately from prospective clients that have been reading the newsletters, followed along, and are convinced that they are ready to start trading but want to start with less than the minimum \$50K. Our solution for them is to suggest that they work with one of our brokers and formulate a strategy that incorporates my strategies on a trade by trade (non-discretionary) basis. So, one of our brokers would call you with our trade and explain it on a case by case basis. You would have the final call as to whether to make the trade. Basically, you would open the account and work one on one with one of our brokers in instituting a strategy that would largely mirror the trade rec's you read in the newsletters. If you have an interest in this type of relationship give our brokers a call at 866-629-9054.

Fade-Self (fād-sēlf) verb.

1. In trading- to take objective conscious action that is directly in opposition to the trader's gut instinct.

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