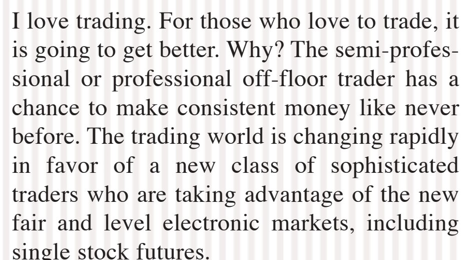
SFO Stocks Futures & Options

Provided by permission of SFO Magazine October 2003. © 2003 Wasendorf & Associates, Inc. • 3812 Cedar Heights Drive • Cedar Falls, IA 50613



Odds Tilting in Favor of a

New Class of Traders

Apply “CORCO” to Single Stock Futures

By Richard W. Friesen

I love trading. For those who love to trade, it is going to get better. Why? The semi-professional or professional off-floor trader has a chance to make consistent money like never before. The trading world is changing rapidly in favor of a new class of sophisticated traders who are taking advantage of the new fair and level electronic markets, including single stock futures.

Looking Back

I was a futures broker for a major retail brokerage firm in the 1980s. It was obvious from “inside the machine” that the retail futures customers generally did not stand a good chance. By the time the customer paid $75 round turn for a futures contract, he was already in a deep hole even before the order hit the floor.

I have watched the seat prices on numerous financial exchange drop precipitously over the last five years with pressure from new electronic markets, decimalization and competition for diminishing retail order flow. Market makers' income has collapsed, forcing most independents out of business and fostering the consolidation of market making firms.

The process of change will continue across all markets. Eurex (the all-electronic German exchange) will be opening a U.S. futures exchange with competing products. The Chicago Board Options Exchange, part owner of OneChicago futures exchange, has received its own futures exchange permit. The futures industry, which for the last 100 years has enjoyed a product-by-product monopoly, may now face the same pressure as the stock options industry with the same impact on the floor locals and benefits to off-floor traders.

As the exchange world continues the transformation to electronic trading, the advantage will move from the market *maker* to the market *taker* who can trade from home or office. With electronic trading as the key, off-floor traders can reach for and grab the Holy Grail – for potentially more consistent trading profits. They'll be able to refine and define trading behaviors and “map” these personal behaviors to the marketplace by creating personal, custom futures derivatives. And new products like single stock futures also open the door for sophisticated players to achieve consistent trading profits from off the floor as never before.

But before diving into the unique attributes offered by single stock futures, let's take a look at the behaviors that are needed to take a trader from amateur to expert.

Refining Trading Behaviors

One “word” sums it up. The skills of a sophisticated trader will blossom as the result of disciplined refinement of personal “CORCO.” What is that? CORCO is a coined acronym used in Magic Carpet Trading™, a derivatives training package we've developed to give a single name to a set of mutually dependent trading behaviors. CORCO stands for “**C**hoosing **O**pportunity and **R**isk **Co**nstantly.”

How does CORCO elevate a novice trader to the level of sophisticated trading and keep the sophisticated trader on target with fewer costly errors? Here's a quick summary:

C: Traders are in *Charge* and *Choose* their positions every moment.
O: Traders choose the precise *Option* that gives them the most *Opportunity* and edge over the rest of the trading world.
R: The *Risk* traders choose will be the risk they are familiar with and are good at managing in a *Range* that will never compromise trading capital.
Co: Traders will *Constantly* look for new ways to create and organize positions that hold just the *Components* that best focus on the greatest opportunity and include only the risks they like.

C = Take Charge and Choose
Every trader is in charge of his position. Any position a trader has at any moment exists because he chooses to have it. Period. The trader needs to constantly ask, "If I wasn't in this position, would I put it on knowing what I now know?" If the answer is "no," the trader should get out – immediately.

But, getting out of a trade is often difficult because of a well-studied phenomenon known as "status-quo bias." Psychological studies of this behavior reveal that the value placed on a trading position by the trader grows with ownership. Here is an example:

I hired an experienced trader to trade IBM options on the CBOE. He had blown out twice but convinced me that he had learned his lesson and would follow the Magic Carpet Trading System. He went through our training program, nodding vigorously throughout each lesson like he had seen the light. Oh, was I wrong! He still thought he was smarter than the system.

The value placed on a trading position by the trader grows with ownership.

After a short period on the floor, his positions exceeded his risk limits. He would get out under pressure, bust limits again and finally refuse to get out. Not willing to tolerate his lack of discipline, I terminated him. But, and this is the amazing part, he began searching for a new financial backer so he could take the offending position with him. He was so attached to his position that he wanted to keep it in spite of the fact that it had caused him to blow out for the third time!

When a trader discovers that he has a personal relationship with a position, I recommend getting rid of it immediately, just for practice if nothing else.

O = Option for Opportunity
Every trade, be it equity, fixed income, commodity or derivative, is a container for a number of opportunity/risk components (O/R). Like two sides of a coin, opportunity and risk are the flip sides of a trading profit. Trading is really about the O/Rs. The individual stock, option or futures is simply the container for the O/R.

As a serious amateur gains skill in trading, he will discover where his strengths lie. Each trader must discover that at which he is really good. What opportunity does he see before others? What risk is he good at managing? Once this edge is identified, the successful trader sticks with that opportunity and gets rid of all other risks embedded in a particular trade that do not contribute to that opportunity.

Some traders are good at spotting and managing trends. Others are "mean reverters" who buy dips and sell rallies. Some traders are avid contrarians who buy when even they themselves don't want to (a true contrarian!). Some traders understand the fundamentals of particular stocks, industries or the market as a whole. Some traders have their own technical indicators.

When a trader knows precisely where his opportunity lies, he will know what his risk is and manage the risk he is good at managing. Just because he buys an option on a future does not mean he needs to hold all the risk embedded in that product or any other product.

R = Range of Risk
Once the trader has a handle on the risk he likes, no matter how comfortable he is with it, he needs to calculate what happens to the position if the unlikely or impossible event associated with that risk occurs. Remember, the more people that have a vested interest in a risk and ignore that risk, the greater the likelihood that the market will surprise the naïve.

My trading firm had a 15/30 day rule of thumb for risk. Simply put, we multiplied our daily average profits by 15 to arrive at the 15-day risk. If any position created a risk greater than that, it was hedged. Period. Occasionally, when the market was in a state of turmoil and there was blood in the streets, we increased the risk calculation to 30 days. When blood is in the streets, opportunity is greatest and, in some cases, risk is less!

CO = Constantly Check the Opportunity and Risk Components
The volatility of the market can shift as the players move from greed to fear. A position that was low risk when it was put on may be a high-risk position under current market conditions. If the market shows the slightest indication that it may be departing the expected behavior routine, a nimble trader not attached to his position will get out of the risk immediately. I cannot stress this enough. Speed counts. If the trader is a few seconds too late, the cost of closing the risk may get very expensive. If the trader reacts prematurely, as is the case nine out of ten

times, it will cost a little embarrassment (enjoy the sheepish feeling) and a little money, but the trader will survive and be back in the game to play another day.

In simple positions, risk checking is easy. If the trader is long or short, the risk per dollar move in the market is easy to calculate. If the trader has more complex spreads, the risk analysis will require separating the risks into "buckets" and measuring the potential losses individually and as a group. If the trader has complex options positions, the risk analysis becomes very complex, but the process is the same. Solving this analysis gets the trader closer to the holy grail of consistent profits. Do the position's opportunities and risks still match the trader's personal skills? He should keep checking…constantly.

A trader can buy a sector but sell one problematic stock, literally creating his own custom index.

New Opportunities with New Products

The second part of a well-honed trading plan is to integrate CORCO trading behavior with products that are created to leverage what the trader does best. Because of restricted access, cost and capital requirements, the freedom to choose risk has, up until now, only been available to the floor members and trading firms. Now, a trader can improve his behavioral CORCO and execute it with single stock futures and narrow-based indices. For the first time, an average equity investor can put away the shotgun and get out the rifle with scope to target his market opinion on a bull's-eye opportunity.

Think about it. Whenever a trader buys a stock, he buys a mixed bag of opportunity and risk. For example, a banking company may have excellent prospects, but it also includes sector risk in the banking industry. Much of this risk is out of the control of the company and *certainly* is out of the trader's control. In addition to sector risk, a trader also must consider overall market risk. Even if he picks a good company in a sector with excellent long-term potential, the overall market can pull down every sector and every stock. These variables can place even a judicious trader on the altar of randomness.

Parsing Opportunity and Risk into Components

By parsing the components of all trades into O/R, a trader can look at each O/R independently and understand what is really on both sides of this coin. By adding up each bucket across all trades, the trader can see how much risk he has accumulated in total for each O/R.

For example, a trader who is short calls in a number of stocks with long stock to hedge the deltas (directional risk) can separate the gamma O/R (change in delta at differing underlying values) from each individual equity position and put them in a single bucket called the "gamma bucket." The trader will have a better idea of his total aggregated gamma O/R. He can do this for all the risks inherent in options by both looking at the O/Rs in each issue and in the aggregate.

At this point, the trader can measure, risk by risk, what would happen in case of an "unlikely" event and reduce that particular risk with the precision of a surgeon's knife by hedging the undesirable O/R and keeping the desirable O/R.

By parsing O/R into separate components, the trader also can start pricing and trading the O/R by mapping that behavior and making money from trading the different buckets of O/R. It is important to understand that it is the component O/Rs in each position that are being traded, not the stock, option or futures contract themselves. For example, an option trader charts implied volatility, a big O/R of most options, while a single stock futures arbitrageur may chart the cash to futures basis.

O/Rs can be traded by creating custom derivatives by buying and selling combinations of futures contracts. These buy/sell combinations generate a new derivative. In the past, this has been called "spread trading" by the industry, but I like to think of it as "customer-created products." This is one of the most exciting tools for the average trader to come along in years. Customer-created products can provide significant profit opportunities because they have unique patterns that can be charted and traded. During times of market chaos, these derivatives can experience temporary extremes that may provide for a quick trade with excellent risk/reward profiles.

Trader-Created Products Using Single Stock Futures and Indices

Is an analyst over-hyping a stock? Is it overbought? Sell it and buy a solid, competing company whose P/E ratios and other fundamental factors are favorable in a process called "pairs trading." The market can go anywhere – up, down, sideways – but with this strategy the trader has selected the exact risk on which he wants to bet. If he is right, the "spread" between the two stocks will "come in," and the trader can unwind them profitably.

Because futures allow much more leverage, and the risk of outright movement has been mitigated, average traders now are able to put on larger positions than they would if they were placing a bet on a stock outright. Since the risk of a spread is lower (*most* of the time) than an outright long or short, a larger position can conceivably be put on. Of course, there is absolutely no law that states that a short stock can't go up and a long stock down, making both positions very risky, but the odds are lower. Again, this possibility has to be filtered through the trader's money management rules.

Also remember when creating spreads to pay attention to the total dollar value on both the long and short sides of the spread to overcome either a bullish or bearish bias in the spread.

In addition to giving a stamp of approval for trading in single stock futures a year ago, the Commodity Futures Modernization Act (CFMA) also approved the listing of narrow-based index futures. This means that entire stock sectors can be traded with the same futures product as single stocks. OneChicago lists 15 Dow Jones MicroSector Indexes. NQLX lists futures on Exchange Traded Shares (ETFs): an equity that trades just like a stock but represents an entire index. NQLX lists ETFs, called iShares, on the Russell family of indexes, along with the NASDAQ 100 Index. Check both exchanges' web pages for updates. These indices add yet another piece to the puzzle of precision risk-taking.

Anyone wanting to trade broad market movements can trade futures on the indices. If, on the other hand, a trader wants to narrow his O/R to match particular skills, he can combine single stock futures and index futures to map his skill set to the exact O/R he wants.

If, for example, a trader believes a stock is going to out perform the S&P averages, he can buy single stock futures and sell a futures index against it. By doing this, the trader is saying that he doesn't have an opinion about how the market as a whole will move, but he *does* have an opinion about how his stock of choice will perform in relationship to the averages. If the market goes down and his stock does not drop as far, the trader has won his "bet."

A trader may not want to predict market direction, but he *can* become an expert in a sector of stocks and how they interplay. The trader can watch and chart spreads over time and get a sense of whether they are trending or trading in a range and trade accordingly.

When a trader has studied and identified an opportunity, he has many options. He can trade an individual stock against its own sector or against a broad market index. He can trade a market sector against another market sector or against a broad market index. A trader can buy a sector but sell one problematic stock, literally creating his own custom index. By buying and selling baskets of single stock futures, narrow-based indexes and broad stock indexes, a trader can narrow his risk and focus on opportunities where he has an "edge" over the rest of the market.

Any technical trading techniques the trader has used for analyzing generic exchange products can be applied to his own custom-created derivatives. Some of these new products will tend to behave like oscillators and stay within a band. Others will be trending, e.g., one buys uptrends and sells downtrends. Because a trader can make customer-created products that match his "edge," he can take advantage of opportunities that are not immediately neutralized by larger market forces.

Computers have moved from mainframes owned by large corporations to your desktop. Exchanges are moving from closely guarded clubs to publicly traded companies competing for your business. Direct exchange access is becoming available to all. Derivatives products that used to take a year from idea to listing because of regulatory bureaucracy now can be created by the off-floor trader in minutes. It is time to consider a world of new possibilities.

Richard W. Friesen is founder of Friesen Consulting, a specialist to exchanges, brokerage firms, banks and trading companies. He is the author of an e-book, ***Single Stock Futures, How to Increase Profits and Reduce Risk****, and expects to release his derivatives training package,"Magic Carpet Trading," early next year. Friesen can be reached at rich@friesenconsulting.com or his web site, www.friesenconsulting.com.*

SFO

Provided by permission of SFO Magazine October 2003. © 2003 Wasendorf & Associates, Inc. • 3812 Cedar Heights Drive • Cedar Falls, IA 50613