

# The Trader's Edge

Cashing In  
On the  
Winning  
Strategies of  
Floor Traders,  
Commercials  
& Market  
Insiders

Grant Noble

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*To my wonderful wife.*

*This book would have never been completed  
without your patience and love.*

# Introduction

There are three main reasons why I wrote this book:

1. *To tell the truth and nothing but the truth about futures trading.*

I've written articles for virtually every major futures-oriented publication, but it's become more and more difficult for me to find a publication that will print exactly what I want to say. There's a lot of institution pressure from brokers and vendors not to tell the average futures trader about the mathematics of investing, etc.

2. *To defend a lot of people in our industry (especially floor traders) who get a bum rap from the media and other financial professionals.*

It's true most people lose money trading futures, but as I will point out in the next chapter, most people don't make money (after inflation, taxes, fees, etc.) in such safe investments as bonds and stocks. The major difference is that in futures (thanks to the low margins), the bad habits of the average investor will just cause him to lose money faster than he would in "safe" investments.

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## **Chapter One**

# **Why Every Investor Should Learn How to Trade Futures**

### **Stocks and Return on Investment**

Stockbrokers like to trot out the fact that common stocks have been the best investment vehicle this century. Supposedly they have generated better total returns (capital appreciation plus dividends) than gold, bonds, or even the average real estate investment.

For the sake of argument, let's assume this fact is true. Let's assume stocks are the best way to go among common investment vehicles. Is this great return on common stocks all it's cracked up to be?

From February 1926 to February 1993 the S&P 500 averaged a 10.4 percent total return (capital gains plus dividends). After subtracting the 3.1 percent CPI inflation rate during this period, that's still a 7.3 percent return. A 7.3 percent real return will double your assets (even after inflation is factored out) in less than 10 years.

At this point the average investor might say, "Why should I worry about finding a successful trading method, especially in the ultrarisky futures market, when 'hold-and-sweat' in the stock market will give me such a good average return?"

In the first place, this return assumes you had enough money to buy all the stocks in the S&P 500. Round lots (100 shares) of just the 30 Dow stocks is a big hunk of change (over \$100,000 today at full margin). Index funds (which track a popular average like the S&P 500) are a phenomena of only the last few decades.

If you couldn't buy the entire S&P 500 (or even the Dow) all at once, then you would have had to buy odd lots (less than 100 shares), which would add greatly to your trading costs. Even if you had the unusual psychological stamina to avoid margin buying, ignore stock crashes, ride out many years of below-average yields, and be satisfied with only an average return from boring stock averages, a 7.3 percent return after inflation for hold-and-sweat is still deceptive.

As companies fell in and out of the S&P 500 (or the Dow), you would have to replace them, adding to your initial transaction costs. A 1 percent total for all these costs (commissions and the slippage of buying the asking price and selling the bid price) is very reasonable (especially when you consider the extra cost of odd-lot trading). This would lower your total return from 10.4 percent to 9.4 percent.

Estate taxes and income taxes have been high as 91 percent. About one-third of your 10.4 percent total return is in highly taxed dividends, not capital gains. But let's use the current 28 percent tax on capital gains as a very conservative estimate of taxes. Taxes would further lower your return from 9.4 percent to 6.77 percent. Subtracting the average inflation rate of 3.1 percent would leave you a true return of only 3.67 percent.

Actually, there's many more mice eating your investment cheese. Undoubtedly you invested more at market tops than at market bottoms, even if you were that one in a hundred that avoided selling out at bottoms and doubling up at tops. Your income would naturally fluctuate with the economy (which



roughly parallels the stock market).

At market bottoms, you would have less to invest. If you were unemployed or the victim of an emergency (such as an outbreak of war or a natural disaster), you may have had to sell your stocks along with everyone else—right at the bottom. Over time, this could cost you several percent points on your net total return (after taxes and inflation) of 3.67 percent from the S&P 500.

If you add a yearly fee (usually 1 to 2 percent) for a market adviser to administer this strategy (do you think the managers of all those mutual funds you own are working for free?), the most determined hold-and-sweat strategy would probably generate very small, or even negative, returns after taxes, inflation, commissions, financial emergencies, and fees!

In the 202 years of the New York Stock Exchange, we have at least five multiyear periods where owning the average common stock was a losing investment idea after inflation was factored out (1807–1813, 1837–1859, 1907–1921, 1929–1949, 1968–1982). In other words, about 43 percent of the time, stocks have been a long-term bear market where it was difficult if not impossible to make money buying common stocks.

Even during the bullish periods, we have had heart-stopping corrections, crashes, or panics that tried the courage of the most determined investor—the inflation-adjusted correction of 1862–1864, the panics of 1873, 1883, 1893, and 1903; the corrections of 1956–1957 and 1983–1984, and the crashes of 1962 and 1987. How many of you sold all your stocks at the low in 1987?

At this point, I can hear some saying “I have a balanced portfolio of stocks, bonds, and precious metals. I am diversified enough to ride out any investing scenario.”

Since 1920, we have had at least seven major periods where none of the usual investment vehicles—stocks, bonds, real estate, precious metals—rose in price (1920–1921, 1929–1932, 1941–1942, 1946–1949, 1968–1970, 1980–1981, 1983–1984). Over the last 75 years, about 15 percent of the time nothing conventional works (later on I will try to show why I feel we are on the verge of another no-win period).

### **Stocks & Options versus Futures**

The fact is, any investor who can't go short and take advantage of falling prices is really living in a fool's paradise of diversification. The unlimited risk of short-selling is only a problem for traders that refuse to limit their losses, violate the mathematics of investment (see the next chapter), and would end up a long-term loser any way. It's the futures market's unsurpassed ability to go both long and short that is the main (but not the only reason) why futures are the premier investment vehicle of the mid- to late 1990s.

I once worked with a gentleman I'll call "Sandy," who managed millions of dollars during the great stock bear market of 1973–1974. In a severe bear market, it's very hard to sell a lot of stock on an uptick, as required by stock exchange rules for anyone who isn't a specialist. Sandy described all the maneuvers he had to go through to get off a simple stock short sale. In essence, he had to buy enough stock so he could get an uptick to sell even more stock at a higher price.

During the go-go days of the 1980s, this uptick rule was waived for program traders that sold baskets of stocks against positions in the futures market. During the Crash of 1987, these traders dumped stocks without ceasing. Even sophisticated traders like Sandy could not find an uptick to go short!

This loophole has since been closed, but one fact still stands. It's very difficult for the average stock trader to go short in a bear market. In any market condition, a stock short-seller must keep a balance equivalent to the cost of the stock he is shorting, which is a heavy burden in interest or opportunity costs (unlike the futures market where he earns interest on the money he put up for margin).

Of course, investors can use options (puts) to go short. And the average investor is usually delighted to find out he can only lose what he puts up when he buys an option. Since the majority of options expire worthless, this is often a dubious advantage. I have read statistics that over 90 percent of options lose money from the time they are put on until the time they are offset (or

expire worthless). That's even worse than the 80–85 percent losing ratio shown by academic studies of futures traders.

Unlike futures, the option premium (the difference between the price of the option and the underlying security) usually increases with volatility. When a market becomes a bear market, the cost of buying a put option increases. In a bear market in futures, normally you have a negative carry charge market where the futures price is higher than the underlying cash market. You get paid to go short (i.e., if there is no change in the cash price, eventually the futures price will converge with the cash price by going lower).

In any case, any premium (the difference between futures and cash prices, known as *basis*) that exists in futures is only on one side of the trade. If the futures price is below that of cash (as in interest rate futures), this positive carry charge benefits the buyer just as much as it disadvantages the seller (the reverse of the example above). But whether you buy a put or a call, or whether you wish to go long or short a market in options, you will pay a premium on either side of the transaction. You lose either way you go.

Unlike a stock, you don't get dividends (or interest on your margin money as in futures) on an option. Option commissions tend to be much higher proportionally than futures. (Discount commissions of \$35 are normal on a 100-share option of a security worth \$3,000–\$5,000. Contrast that with the normal \$25 discount commission on a futures contract, which can control up to \$250,000 in equivalent cash assets.)

Perhaps the only advantage of options over futures is the ability to make money if there is no change in the market. Professionals often put on strangles (simultaneous selling of an out-of-the-money call and put) and collect the premium on both sides if the underlying market doesn't make a major move. (The majority of time markets are in easily defined trading range markets.)

But even this option advantage is better used with options on futures rather than options on individual stocks. The dirty little secret of the stock market is that it is far more volatile and

far less predictable than soybeans, cattle, copper, and other traditional futures contracts.

There are many academic studies that prove this fact, but you really don't need to be an academic to figure this out. Individual stocks that double in price or lose 50 percent of their value in a day are a relatively common occurrence. This type of action is a once-in-a-lifetime occurrence in futures (I can't think of a single example off the top of my head).

In October 1987, the S&P 500 future lost 45 percent of its value in 13 days of trading. The most spectacular commodity crashes—soybeans in June 1973, cattle in August 1973, sugar in November 1974, silver in January 1980, and crude oil in January 1986—all took about three times as long to travel the same distance (a 45 percent collapse).

The reputation for volatility in futures is strictly a function of its low margin requirements. A 5 percent move in a stock from 20 to 21 would only draw a yawn. A 5 percent move in corn (from \$2.00 to \$2.10 a bushel) is a \$500 move approximately equal to the usual margin on corn.

Not only is the stock market more volatile, it's volatility is less predictable than futures. Mergers (or the sudden failure of a merger), preliminary earnings reports, the comments of corporate officials and politicians—all these bolts from the blue can cause a stock to double or lose half its value. Totally unexpected events in futures (like the Russian coup, Chernobyl, etc.) are far more rare and, in any case, hardly ever have the same impact of stock shocks.

A freeze in Brazil can cause coffee prices to triple, but we know that will only occur in "our summertime." An orange juice freeze or soybean drought can cause prices to explode, but these events can only come at regular intervals, which can be easily anticipated.

Even regular reports are not so regular in the stock market. Earnings reports can be shifted around in an unexpected manner. Highly touted announcements or press conferences can mysteriously disappear or be rescheduled. Over the last decade, we have seen key reports shift around with the latest investment fad.

In the 1960s, it was earnings. In the 1970s, it was the money supply. In the 1980s, it was the trade deficit. In the 1990s, it's the unemployment report. I don't know what the next critical government report will be in the next decade, but I do know the Pig Crop Report, the USDA crop conditions as of July 1, etc., will basically have the same influence over futures prices tomorrow as they do now. If you are going to use options, it makes sense to use them in the (relatively) regular world of futures rather than the wacky world of individual stocks.

There is a slight tax advantage (thanks to the latest Clinton tax increase) in holding cash assets (such as stocks and precious metals) for a capital gain, which you can't do in futures or other derivatives like options. But capital gains tax breaks can be taken away at any time (as they were in the 1986 tax "reform"). And in order to take advantage of a lower capital gains rate, you need a bull market—which as we've seen only occurs about half the time in stocks. Many investors have seen a winning investment turn into a loser while waiting for the proper time to take a capital gain.

Virtually every investment vehicle outside of futures depends on a market maker or specialist. A market maker or specialist has tremendous advantages over those media demons, futures floor traders, who supposedly make sure no investor can possibly win trading futures.

A market maker can declare an order imbalance and simply shut down trading in an option or a stock. No single pit trader can do that to a future. A floor trader only knows the bid/asks he sees in open outcry in the pit. An order filler may have 1,000 contracts to sell, but he doesn't have to show them all by open outcry in the pit. He can sell them off 50 or 100 contracts at a time until he has sold them all.

By contrast, anyone who wants to sell stock at a specified price must register his order in the specialist's book. In other words, unless a stock trader wants to play "hot potato" by constantly juggling his order size, he gives up any chance of keeping his order size a secret.

As Sandy explained it to me, the specialist (or his friends)

are not above stepping in front of a large order by selling a tick or two below this large order. This is supposed to be against the rules; however, wherever you have insider monopolies (rather than the free market of an open outcry auction), you are going to have these eternal problems of human nature.

Did you know that no futures trader has ever lost money due to the failure of a clearing member of the Board of Trade or the Chicago Mercantile Exchange? The New York Stock Exchange can't say that—which is why there is now stock insurance to protect against bankruptcy in stock firms. The clearing system of futures is inherently safer than the system in place for stocks.

Much has been made of the zero sum game of futures, i.e., for every short there is a long, for every winner there is an equal and opposite loser. (Often the loser is a perfectly content hedger who has already locked up a profitable price.) However, this zero sum game aspect of futures has an unexpected bonus in a financial crisis.

Let's use the latest shock in futures as an example. Over the weekend of June 28–29, 1994, a freeze struck Brazil's coffee fields. Coffee opened almost 40 cents higher on Monday's opening from Friday's close—a price move of over 30 percent, or \$15,000 per futures contract.

Since the minimum margin for one coffee contract was around \$3,000 at the time, it would appear the clearing firm guaranteeing this trade and hundreds of others might be in trouble if the losers reneged and refused to post extra margin or pay their losses. But even if we assume there was no extra money in the losers' accounts (very unlikely) and they refused to send any more money to cover their losses (another unlikely event), the clearing firm is still far from getting into trouble.

Say the clearing firm has a total of 250 short coffee contracts and 200 long coffee contracts on its books before the freeze, or net short 50 contracts. Fifty times \$15,000 is \$750,000, which is far less than the \$1.25 million ( $450 \times \$3,000$ ) it has on account for customer margin.

You can see it is very difficult for a futures clearing firm that is clearing accounts from a wide variety of customers to go broke. Only gross overspeculation by its principals could cause such a problem.

(If a clearing firm's owners were net short hundreds of contracts of coffee before the freeze, and if that position represented the overwhelming majority of their assets, then conceivably that clearing firm could go broke. In that case, the commodity clearing corporation of that exchange would guarantee the trades and seize whatever assets the firm and its principals had left. All customer positions and money then would be transferred to solvent clearing firms. This has happened only once in Chicago during the two decades of my experience.)

By contrast, even a "prudent" stock firm could go broke in a meltdown similar to the 1987 crash. A stock investor only has to put up 50 percent margin to purchase a stock, 35 percent to maintain that position. A 45 percent collapse in two weeks (like that which occurred in 1987) could bring a client's balance to negative territory. If that firm's investors were speculating in bonds and other securities that can be purchased for 10 percent margin or less, it could be only a matter of hours before they are in the firm's pocket, so to speak.

The billions in losses racked up banks and brokerage house during the bear market in bonds in 1994 is just the tip of the iceberg of what could happen in a crisis. Through October 1994, the bond market had dropped 15 percent for the year. In a crisis atmosphere, where bonds could go down 50 percent in a few months, there could be trillions in losses.

Yes, stock options are cleared basically the same way as futures in that both the seller and buyer of the option (and their respective clearing firms) guarantee that trade. But the clearing of stock options is far more concentrated in a handful of firms than is futures. It's far more likely the whole stock option clearing system will fail in a 1987-type meltdown than hundreds of clearing firms, which specialize in clearing futures as unconnected as cattle and bonds.

Finally, the futures clearing corporations (to which all futures clearing firms belong) have been in existence for up to 150 years (versus the 20+ years of the option clearing corporations). They have had a far longer time to accumulate assets (through clearing fees charged on every futures trade). These assets are far in excess of the miniscule amount of assets that backs the insurance that “guarantees” stock trading.

As Will Rogers used to say, “I am more concerned about the return of my money than the return on my money.” In terms of a potential financial crisis, I think we can safely say the federal government is more likely to renege on its debt than the clearing corporations of the futures market fail to make good on transferring money from futures losers to futures winners.

For smaller investors, the low cost of entry and the ease of true diversification may be a great advantage. For \$10,000, you can have a balanced portfolio among the six trillion-dollar markets—metals, currencies, interest rates, agriculturals, crude complex, and stocks (through options on index stock futures), while \$10,000 won’t buy you even a round lot (100 shares) of a Dow stock like Caterpillar at today’s prices.

The price of individual stocks are far more correlated than the futures prices, i.e., the price of IBM, GM, and Disney are far more likely to rise and fall together than the price of cattle, silver, and T-bonds. Even the price of gold stocks are far more tied to the rise and fall of the overall valuation of the stock market than the rise and fall of the Consumer Price Index!

True, to achieve diversification among the six trillion-dollar markets with a \$10,000 futures account you may have to control the futures equivalent of \$150,000 in cash assets. But because of the more negative correlation of futures markets, plus less volatility and chance of negative surprises, the real risk may not be all that much greater than an equivalent amount of margined stocks ... and you don’t have to put up \$75,000 (50 percent)!

From every rational perspective, the futures market is a better deal, especially for small investors. As I have stated before, all the low margins of the futures market do is speed up the



losing investment process of the average investor. The next chapter will discuss the real reasons why 85 percent of futures traders lose. They are the same reasons why 85 percent of stock investors underperform the market averages (which, as we have seen, barely keep up with inflation after expenses and taxes).