



Risky business?

Is day-trading less risky than position trading? We take a look at this basic assumption and offer some tips to help you manage both your day-trading price and transaction risks.

By Rick Thachuk

Day-trading has become more popular among retail traders the past few years for several reasons. Primarily, the affordability of real-time quotes (many online trading accounts now provide free real-time quotes), the availability of free intraday graphs via the Internet, and the emotional and financial appeal of finishing every day and starting every weekend with no market exposure. Moreover, because margin requirements for day-trading are reduced, in some cases effectively close to zero, traders with small-sized accounts can afford to day-trade some of the expensive contracts such as the 30-year Treasury bond and even the S&P 500.

The assumption made by most retail traders is day-trading is less risky than traditional position trading, where contracts may be held for several days or weeks.

While it is true that day-trading eliminates overnight price risk (because positions are closed or offset at the end of every day), there are other factors that when considered collectively, can make day-trading a riskier proposition. Traders contemplating starting a day-trading program should be aware of these risks and how to manage them, where possible.

Price risk The price risk of day-traders, by definition, exists only during the day. The position trader, on the other hand, assumes in addition the price risk overnight and often over the weekend. However, this does not necessarily mean that the day-trader can more



easily manage price risk than the position trader can. One reason is that position traders can use options to manage price risk effectively. Maximum risk is known and fixed for every debit option trade regardless of price movements during the day or overnight. When day-trading, however, option-related strategies are undesirable for price risk management for several reasons. (Floor traders in the trading pits of an exchange may be able to use options to manage the risk of their day-trading activity. See "Day-trading on the floor," right.)

Option markets typically are less liquid than the corresponding futures market; meaning prices may not reflect market value,

orders may take longer to fill and to be reported back to you, and the cost in terms of the bid-ask spread is higher. Moreover, except for deep in-the-money options, options will not move as much as the corresponding futures contract. This eliminates the motivation for day-trading options from a potential profit perspective. From a risk management perspective, the impracticability of incorporating option strategies into a day-trading program requires that the trader rely solely upon a less-effective risk management tool: stop orders. The risk of slippage associated with stop orders is well known to all traders, but becomes more acute for the day-trader.

Stop orders are notorious for being filled at a less desirable price than specified in the order. This slippage usually amounts to a tick or two, but can be significantly greater under inordinately volatile conditions. Neither the day-

trader nor the position trader has direct control over the slippage of a stop order and so both must equally bear this risk. During some instances, the better the executing broker in the pit, the less the slippage will be. However, the retail trader — whether day- or position trading — cannot realistically expect to have any control over who is the executing floor broker. ("Daytime stops," page 38, further details stop placement for day-traders.) Even though both must bear the risk, the relative cost of this risk is not the same. For position traders, the dollar value of the slippage relative to the open equity loss on the trade is typically small because the position trader initially

Day-trading on the floor

Floor traders with immediate access to a futures market and its corresponding options trading pit are best positioned to execute day trades quickly and effectively. They are the first to receive any information originating from the pit. Of course, floor traders pay for this privilege: To stand in the trading pit requires that you buy or lease a membership. Memberships range from \$50,000 to over \$1 million depending upon the exchange.

Floor traders who accumulate large positions day-trading can use options to manage (hedge) their price risk. They do this by buying or selling options so that the net delta of their portfolios at the end of the day is zero. The delta of a position refers to the dollar change in its price for every dollar change in the price of the underlying futures. Consider the prices of the June 30-year T-bond options.

30-Year U.S. Treasury bonds

June futures contract last trade price: 94-15

Call Options			Put Options		
Strike	Price	Delta	Strike	Price	Delta
96	1-17	+0.38	96	2-49	-0.60
94	2-11	+0.50	94	1-46	-0.45
92	3-28	+0.69	92	1-00	-0.30

Say, for example, that the end of the trading day is approaching and a trader is long three June bond futures contracts that were purchased throughout the day. A long position of three futures generates a net portfolio delta of +3.0. To square the position until the next morning, the trader could sell the three futures contracts, which returns the net delta to zero.

As an alternative, the trader can use options to reduce the net delta to zero. Specifically, he can buy put options or sell-

ing call options. Based on the option prices shown in the table, the trader can keep the three bond futures and hedge the price risk by buying five of the 96 put options. Because each put option has a delta of -0.60, five put options have a combined delta of -3.0 and thus will exactly offset the delta of the futures and bring the net portfolio delta to zero.

Similarly, the trader could instead purchase 10 of the 92 puts, or sell six of the 94 calls. (Buying a call option generates a positive delta and selling a call option generates a negative delta.) Determining what options to buy or sell depends upon relative prices at the time. That is, the floor trader will buy options that are undervalued in price or sell options that are overvalued in price. Such mispricings are short-lived, making this strategy tenable only to the floor trader.

sets a higher permitted loss than the day-trader.

For example, the position trader may set an acceptable loss of \$800 on a bond trade (and has allocated even more cash in margin to cover possible further loss), while the day-trader may accept a loss of only \$200. A one-tick slippage in the bond market (\$31.25) increases the cost to the position trader of 4% and to the day-trader, a much higher 16%. The relative cost of slippage can cause some day-trading programs to become unprofitable in certain markets (such as those that are less liquid and have wider bid-ask spreads). Moreover, in those unusually volatile periods, unexpectedly high slippage has the potential to damage the long-term return performance of a day-trader and even can wipe out a significant percentage of trading capital. An all too common track record of a retail day-trader is a series of alternating small-sized winning and losing trades culminating in one unexpectedly large losing trade — after which the trading typically stops altogether.

Although price risk exists for a shorter period of time for the day-trader, the inability to use options and the higher cost of slippage on stop orders relative to open equity loss of a trade can make this price risk more difficult to manage. But the story does not end here. Transaction risks also become more significant for the day-trader.

Transaction risk With every transaction to buy or sell, there are risks involved. These risks are faced by both the day-trader and the position trader and include:

- Mistakes made by the trader in entering the order. The consequences are fully borne by the trader.

- Mistakes made by the broker in filling the order. This includes lost orders. In some cases the consequences are borne by the broker, but more commonly, the consequences are borne by both the broker and the trader. The latter may be true, for instance, if after the trader places his order, he verbally confirms that order when read back by the broker, even if it was recorded and read back incorrectly.

- Trades that were correctly filled but placed in the wrong account. This is corrected easily by the broker without cost. However, it will become a problem if the trader acts on this information. That is, if the trader makes another trade believing that the previous one was lost, then he will bear the consequences of that trade, even after the lost trade is correctly replaced in his account.

- Change in price or quantity of reported fills. Sometimes reported fills are later adjusted in price or quantity. This is a result of mismatched order correction among the executing floor brokers at the end of the day. The consequences are fully borne by the trader.

- Delays in reporting fills. Imagine that you have a long position in the

market and you are not sure if your protective stop has been filled. The market closes in five minutes. It has been a volatile day with high volume in the pit. You call the desk for an order check on your stop and they tell you, "Nothing back." This means that your stop order may or may not have been filled. What do you do? In short, there is little you can do. This uncertainty causes much more anxiety and has higher potential cost to the day-trader than the position trader. Included in this category is the risk associated with canceling an order, subsequently transacting as if it was canceled and then later discovering that the order was filled because it was too late to cancel.

- Inability to transact. The transaction may not be able to be executed at the desired price because of market illiquidity, because trading is suspended by the exchange (during especially volatile conditions) or because the market is locked limit.

- Failure to transact. The day-trader must offset positions prior to the closing bell or be prepared to carry positions overnight. Because price risk is much more difficult to manage overnight, the trader can lose a considerable amount of money during an adverse price movement. Moreover, the trader may not have sufficient capital to meet overnight margin requirements. Failing to transact can be costly to the day-trader and can occur for several reasons. There is always a ➤

➔ risk that the trader will become distracted during the day and forget to offset positions before the close. Communication-related problems also can prevent executing a necessary transaction. In addition, there may be early market closings (prior to an official holiday) — a trader unaware of an early closing may fail to transact in time to offset positions.

A day-trader will execute more transactions than a position trader over the same time period and therefore will face these risks more often. In addition, the day-trader usually is constrained by time when problems do arise; errors must be identified and corrected before the trading day ends. Any resulting loss is likely to be significant to the day-trader who operates with less financial flexibility than the position trader.

Tips to manage risk Because some of the risks mentioned above cannot be readily managed, their expected cost must be factored into a day-trading program. Following these simple steps, however, can reduce other risks:

1. Trade liquid markets only. Prices will be current; fills will be executed quickly and are more likely to be reported back in a timely manner.
2. Acquire a real-time price data feed to monitor the market accurately.
3. Enter transactions online to reduce recording errors and increase

Daytime stops

Day-traders must rely on stop orders to protect their capital, as best as is possible, from price risk. As with stop orders in general, the day-trade stop order must accommodate short-term random fluctuations, yet close out a trade when prices have moved too far in an adverse direction. Setting the proper stop depends upon the win-to-loss ratio of the trading system, the average profit of a winning trade and the cost of transaction and other fees. For instance, if the program generates a profitable trade two out of five times, and if the average profit is \$500 per contract with \$25 in commission and fees per contract, then the average loss must be less than \$292 per contract for the program to be profitable overall.

These factors are interdependent. For

the speed in which fills are reported, but only if you are comfortable doing so. Some traders feel more confident transacting over the telephone. If trading by computer, make sure you have the trading desk's phone number in the event that the computer or Internet link goes down.

4. Enter transactions well before the market closes so as to provide sufficient time to resolve any problems that may arise.

5. Secure access to the overnight market for use in an emergency to close a position.

6. Avoid trading near the time of important news or numbers' releases. For instance, the bond market can react violently immediately following the release of the employment numbers. Here, the trader risks significant slippage on stop orders if the price movement is adverse.

7. Avoid markets with price limits. A day-trader caught on the wrong side of a limit move can purchase an option to provide some price protection. Option markets will continue to trade even when the futures market is locked limit. The trader should be aware that implied volatilities will be high in this case and option premiums will be costly.

8. Make sure you have the time to devote to your day-trading. Day-trading often requires constant supervision of the markets.

Moreover, with constant monitoring, any transaction errors can be identified and resolved quickly.

9. Secure direct access to the floor so that current bids and offers can be relayed to you and acted upon immediately. Realistically, the day-trader cannot receive this level of service unless trading volume is very large.

10. Maintain sufficient cash so as to limit your trading activity. You may want to maintain half to full margin in cash for every contract that is day-traded. This will help prevent you from overtrading. Don't day-trade if you are not well capitalized.

11. Do not overtrade. The more you trade, the higher the risk. Even when day-trading, there may be many days when no trading occurs. You may not need to trade every day.

Day-trading does eliminate overnight price risk and therefore may seem to be less risky than position trading. However, the difficulty of managing price risk during the day coupled with the transaction risks that are more significant for the day-trader are often overlooked by retail traders and should be seriously considered before embarking on a day-trading program. **FM**

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example, when the average loss is lowered, a greater percentage of the trades will be stopped out at a loss, thus affecting overall profitability. Several months of paper trading should be sufficient to determine the stop price that results in the greatest expected profit of a trading system. One of the mistakes made by retail day-traders is thinking that price risk can be minimized by using tight stops (that is, stop orders with a price that is very close to the trade entry price) that risk, for instance, less than \$100 per contract. For most of the major liquid markets, this represents only a few ticks and in some cases, is barely sufficient to cover the cost of the bid-ask spread.

In the 30-year Treasury bond market, the spread is usually one or two ticks val-

ued at \$31.25 to \$62.50, respectively, per contract. With the S&P 500, the bid-ask spread can fall between one-tenth and one-half of a point valued at \$25 to \$125, respectively, per contract. A stop order that accommodates an adverse price movement of just three ticks in the bond market, for example, requires that the trader buy within three ticks of the low (going forward) or sell within three ticks of the high (going forward). It is unrealistic to expect this caliber of trading performance systematically. The result is that stops will be elected almost continuously, and the trading capital slowly but surely will dwindle. In addition, the stop order will incur slippage making it even more unlikely that risk can be constrained to under \$100 per contract, especially during volatile periods.