"Sharpening Your Trading Skills:" Hedging Profits and Howe's Limit Rule

By Jim Wyckoff
http://www.futurespartners.com/

My mission is to help you become a more successful trader--by analyzing markets and pointing out to you potentially profitable trades, and (importantly) by providing unique educational features that will move you farther up the ladder of trading success.

One of the most important tenets of successful futures trading is survival. In order to enjoy those winning trades that will make you successful, you must survive the losing trades that all traders encounter. It's not unusual for successful futures traders to have more losing trades than winning trades in any given year. The key is the successful traders' losing trades result in much smaller losses than their winning trades' profit gains.

Surviving the more numerous losing trades in order to catch the fewer big-winner trades requires the use of prudent buy and sell stop placement. However, there are some home-run-type trades (which we all dream about) that may require even more protection for you than stops. If you are in the middle of a potential "home-run" trade and are accruing very nice profits, you may not want to exit the trade because of even more profit potential by staying in the trade. However, you also have a substantial profit in place and don't want to lose it if the market becomes highly volatile--which is many times the case in big "home-run-type" market moves. It is situations like this where the purchase of options on futures can "lock in" trading profits for you--yet allow you to remain in a trade that could result in even more profits.

I'll provide a "hedging with options" example, but first I want to discuss the market conditions that can lead to the use of options to hedge futures trading profits.

I've said the placement of buy and sell stops in your trading plan is very important. However, when market movements become extreme, stops can be far less effective. The gap between bid and ask prices can get so large that a stop level gets bypassed by a large degree. When a market locks limit up or limit down, stops are virtually ineffective.

Indeed, limit price moves in futures markets can be the best and the worst of times for a futures trader. At this time I'd like to share an interesting futures market theory with you.

My good friend, Steve Moore, of Moore Research Center (MRCI) in Eugene, Oregon, pointed out to me many years ago "Howe's Limit Rule," and I want to share it with you.

Robert Howe, a market and technical analyst, suggests that a futures price at the limit of a tradable daily range, once reached, becomes an objective which the market will again test and ultimately exceed, at least briefly, and usually sooner rather than later. Why? A primary function of any market is to explore and discover value. A

market artificially interrupted in its pursuit of current value is unsatisfied and leaves critical questions, such as how far and how urgently the market would continue searching for fair "value."

Unlike objectives derived from chart formations and mathematical formulas, which approximate a target range, Howe's Limit Rule identifies precise price targets which can be valuable to both short-term and position traders.

For instance, if a market trades at a "limit up" price: 1. Short-term traders may more confidently buy into any pullback (whether intraday or during subsequent trading days).

2. Traders already long may be encouraged to maintain their positions. 3. Prospective short-sellers may be discouraged from taking immediate action.

Understanding the principles of Howe's Limit Rule, each of the above would expect a

decline, if any, to be minor unless and until that limit price is exceeded by at least one tick.

However, if after a prolonged trend a limit price is exceeded only briefly and tentatively, a failure that ultimately constitutes a reversal may be imminent (as the market exhibits

exhaustion). As a corollary, an unexpected limit move in the direction opposite the prevailing trend can be an early warning of a trend reversal (as everyone changes their minds at the same time).

Finally, an abrupt limit move from out of accumulative or distributive congestion can signal the beginning of a powerful new trend (as everyone tries to go through the same door at the same time).

On the rare occasion when a lead futures contract leaves a traded limit price "hanging" (not exceeded prior to its expiration), that limit price is carried over as a future objective for subsequent lead contracts. As such, it can become a target for intermediate- or long-term trend exhaustion. In other words, the prevailing trend may be maintained and/or a new trend suppressed until that "hanging" limit is exceeded, often creating a double top or double bottom. The lead contract is most cash-connected, and those prices later become significant support/resistance points on weekly/monthly charts. Limits left hanging in deferred contracts are specific to them only and become irrelevant at expiration.

Okay, let's get back to an example of hedging some decent futures profits with options. Let's say a trader established a long position at 7.00 cents in one contract of March 2001 N.Y. sugar futures back in April--just after prices broke out above a resistance area. The trader then sees a nice uptrend that takes prices up to 8.50 cents, but then the market pauses. The trader already has a profit of $1,680 (150 points), but thinks the bull run may not be over. He purchases a put option on March sugar with a strike price of 8.50 cents, for a cost of 45 points, or $504. He has just locked in a profit of $1,176, and he is still in the market and long sugar. If the trader then stayed in the market for the rally that took prices to a high of 10.81 cents in

early August, and exited his long position at, say, 10.50 cents, that's another 200 points of gain, or $2,240 more in profit. Thus, the trader pockets a total profit of $3416.

Another point I want to make is that when markets move toward price extremes, you have a double-edge sword. The profit potential is likely the highest during these big price moves, but the high volatility means the market can very quickly turn against you--and your protective stop may not be effective. If you have purchased an option to hedge your profits, you have also limited your potential losses if the market makes a sudden and violent turn against you.

Here are some important caveats about hedging your futures profits with options: Make sure the market you are trading has a "liquid" options market. Some markets, such as lumber or the U.S. dollar index, have adequate enough open interest to trade straight futures, but their futures options are "thin" and not a good candidate for hedging profits. Also, you want to make sure you have a substantial profit accrued before hedging your winning position. You probably don't want to take a bigger bite out of your trading profits by purchasing an option than you have profit left after purchasing that option.