Credit Spreads and Iron Condors

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Disclosures

In order to simplify the computations, commissions have not been included in the examples used in these materials. Commission costs will impact the outcome of all stock and options transactions and must be considered prior to entering into any transactions. Multiple leg strategies involve multiple commission charges.

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Session Outline

Credit Spreads & Iron Condors – the Basics

Price Behavior

Managing Credit Spreads and Iron Condors

A Study by Larry McMillan

Bonus Strategy – The Split-Strike Butterfly

Credit Spread Defined

Sell one option (close to the money) and buy one option (out of the money). Both options have the same underlying and expiration.

The short option is covered by the long option.

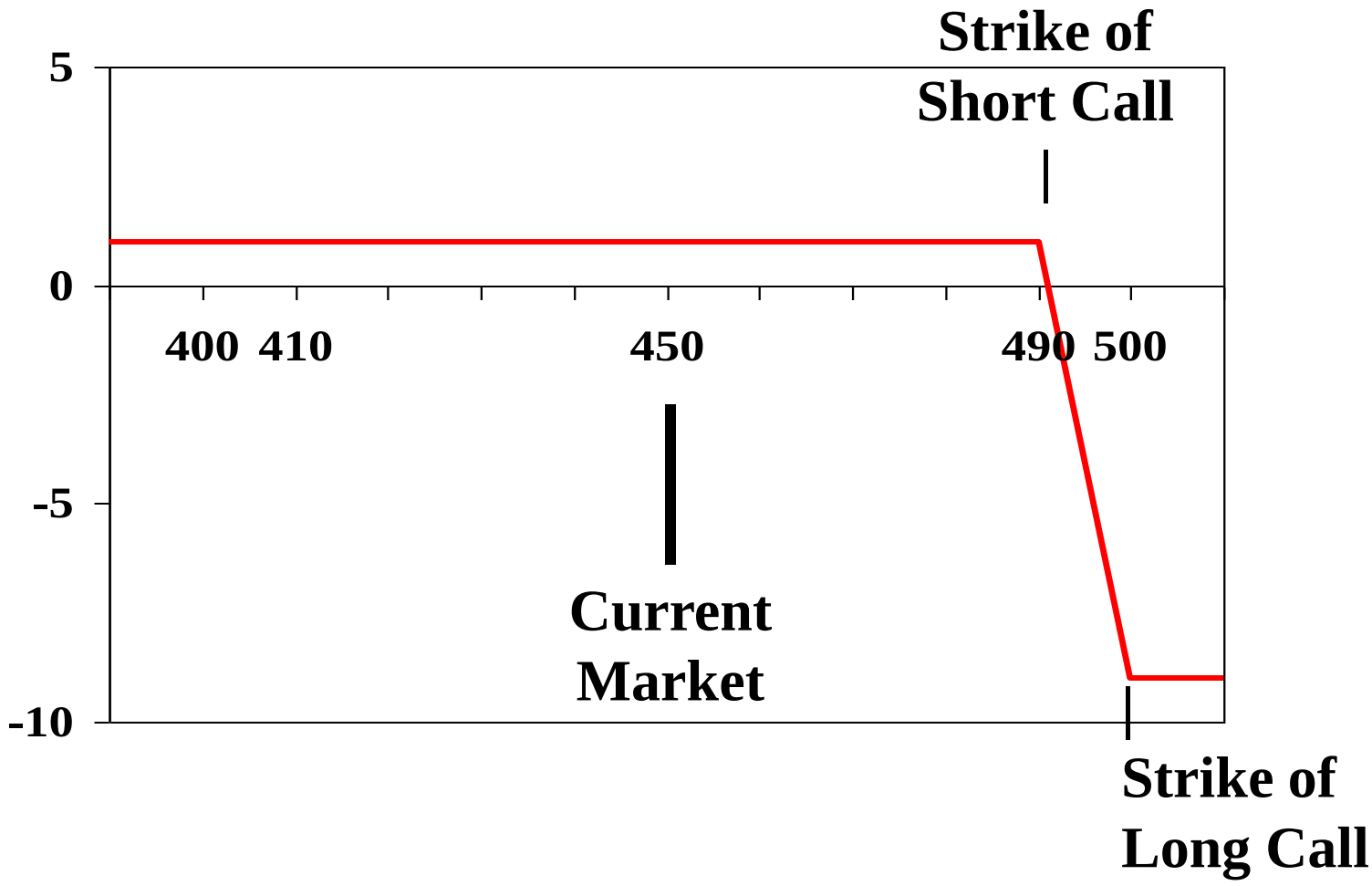
The margin requirement is the difference between the strike prices, less the net credit received.

Credit Spread with Calls

Sell 1 35-day 490 OEX Call	@	2.65
Buy 1 35-day 500 OEX Call	@	(1.50)
Net Premium Received:		1.15
Maximum Risk:		
Break-even point at exp.		

OEX at 450.00

Credit Spread with Calls at Exp

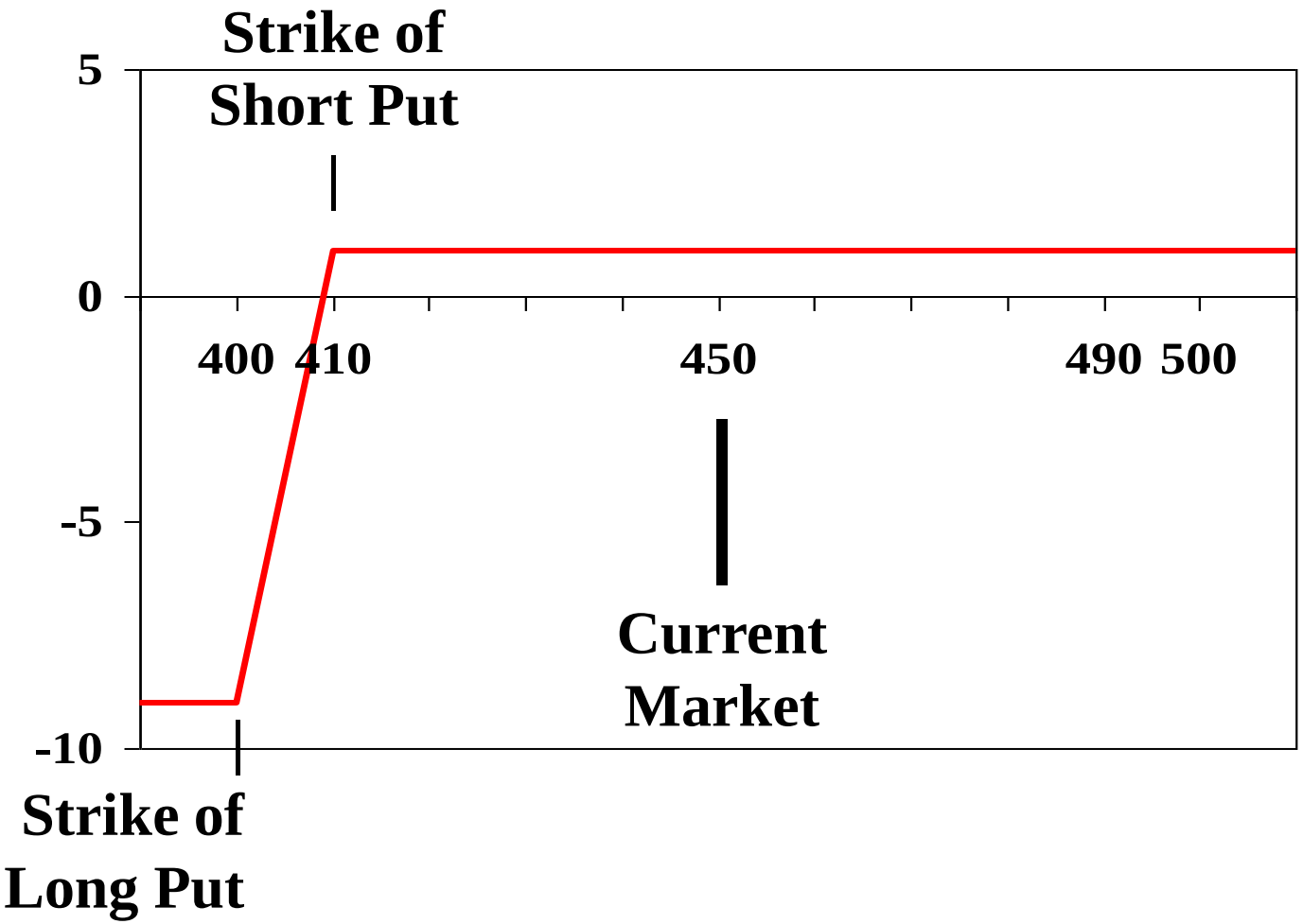


Credit Spread with Puts

Buy 1 35-day 400 OEX Put	@	(1.45)
Sell 1 35-day 410 OEX Put	@	2.50
Net Premium Received:		1.05
Maximum Risk:		
Break-even point at exp.		

OEX at 450.00

Credit Spread with Puts at Exp



Why Credit Spreads?

Every option strategy is unique.

Unique profit/loss graph

Unique price behavior

Unique tradeoffs

Some option sellers prefer credit spreads. Why?

Psychology: "The market won't go there!"

Also, consider the "Greeks"

The "Greeks"

Delta – change in an option's theoretical value for a one-unit change in price of the underlying

Gamma – change in delta for a one-unit change in price of the underlying

Theta - change in an option's theoretical value for a one-unit change in time to expiration.

Vega - change in an option's theoretical value for a one-percent change in the volatility assumption.

The Greeks of a Credit Spread

		Δ	ϑ	υ	τ*
–1 460 Call	13.50	–.48	–.01	–.55	+1.87
+1 470 Call	9.00	+.32	+.01	+.51	–1.70
Net Debit	4.50	–.16	–0–	–.04	+.17

OEX, 450; Days, 35; Volatility 32%

* 7-day theta

Credit Spread Offer Tradeoffs

Positives: Collect premium

Risk limited to a known maximum

Low delta (for adverse price moves)

Near zero exposure to volatility

Negatives: Less premium for the same time

Low delta (for positive price moves)

Credit spreads can be part of a monthly, premium-selling program seeking income.

The Iron Condor Defined

An iron condor consists of
two credit spreads

an out-of-the-money bear call spread
and
an out-of-the-money bull put spread

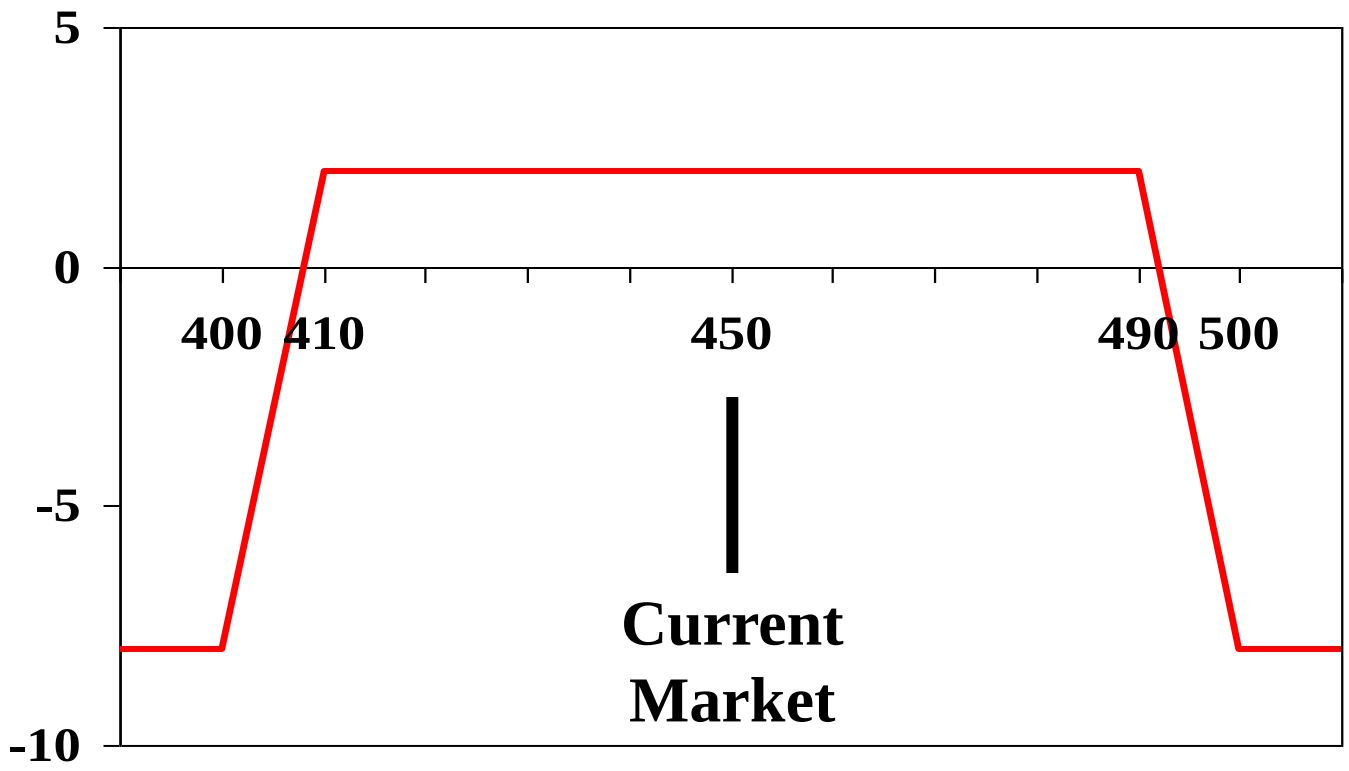
Note: multiple commissions are involved
must be done in a margin account

The Iron Condor

B 35-day 400 Put	(1.45)	Put Spread
S 35-day 410 Put	2.50	1.05
S 35-day 490 Call	2.65	Call Spread
B 35-day 500 Call	(1.50)	1.15
Net Credit for Iron Condor:		2.20

OEX at 450.00

The Iron Condor at Exp



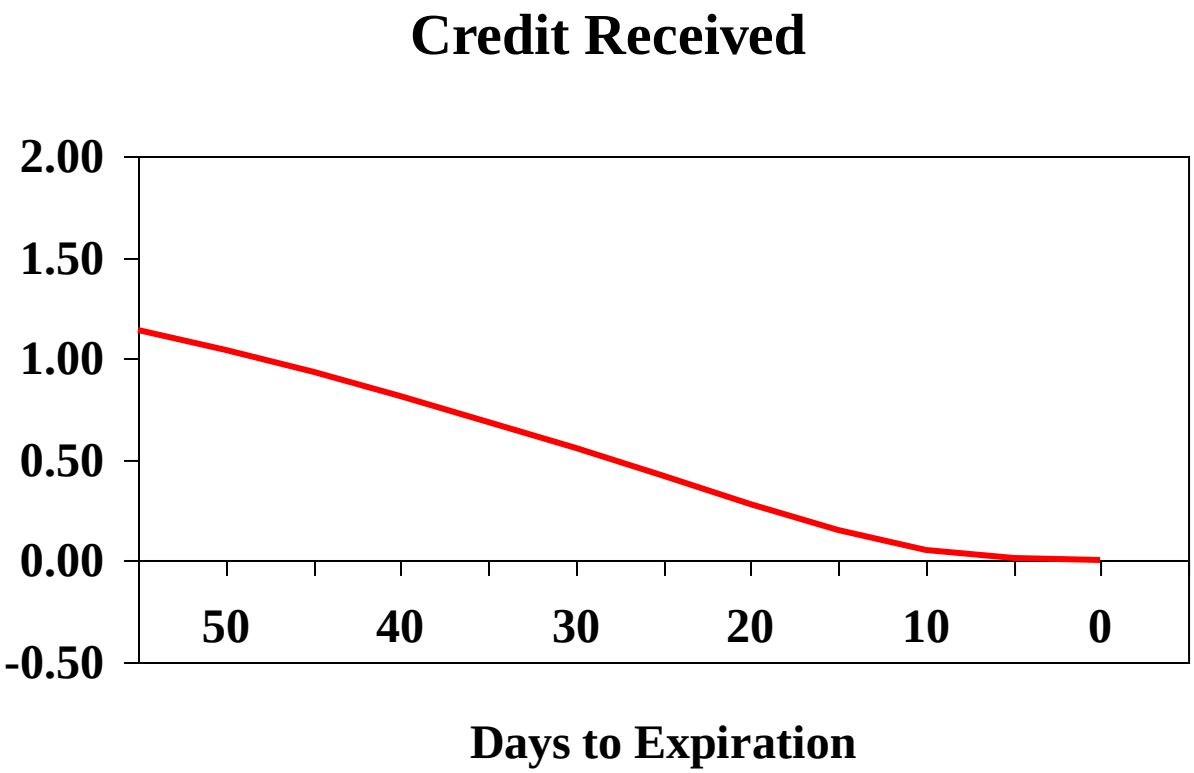
Reasonable Questions

How many days prior to expiration is the "best time" to establish an iron condor?

Is "high" or "low" volatility better?

Is the iron condor a "good monthly strategy"?

The Iron Condor and Time

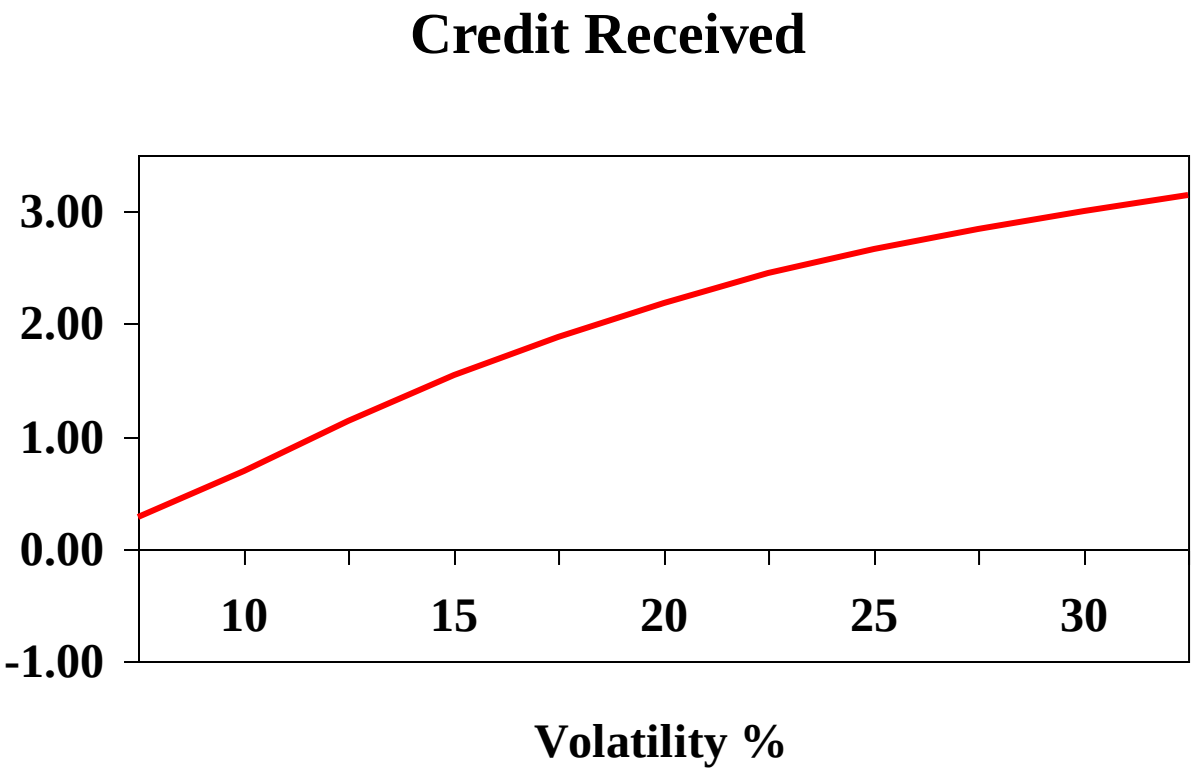


The Iron Condor and Time

Observations:

- Time decay is nearly linear until 10 days
- To “make money” requires time
- More time increases the risk
  - Risk of a “big market move”
  - Risk that the market will start to trend

The Iron Condor and Volatility



The Iron Condor and Volatility

Observations:

- Changing volatility has a “big impact”
- Volatility changes frequently

  There is a “normal range” of volatility

  What is “normal” changes in different market environments

The Delta of an Iron Condor

	Delta	
B 35-day 400 Put	–.03	Put Spd Δ
S 55-day 410 Put	+.16	+.13
S 35-day 490 Call	–.23	Call Spd Δ
B 35-day 500 Call	+.06	–.17
Net Delta:	–.04	

OEX at 450

The Delta Changes - 1

	Delta	
B 35-day 400 Put	–.01	Put Spd Δ
S 55-day 410 Put	+.09	+.08
S 35-day 490 Call	–.35	Call Spd Δ
B 35-day 500 Call	+.11	–.24
Net Delta:	–.16	

OEX at 475

The Delta Changes - 2

	Delta	
B 35-day 400 Put	–.00	Put Spd Δ
S 55-day 410 Put	+.05	+.05
S 35-day 490 Call	–.48	Call Spd Δ
B 35-day 500 Call	+.19	–.29
Net Delta:	–.25	

OEX at 485

The Iron Condor and Underlying Price

Observations

- Initial delta is “small” – but it changes
- Losses occur before the underlying price reaches a short strike

Alternatives for Managing

If market rises "too much:"

1. Close the call spread – have a "stop-loss" price that is less than the initial credit for the iron condor.
2. Roll up the call spread:

   Example: Buy the 490-500 Call Spread
   Sell the 510-520 Call Spread

Managing Iron Condors

Observations:

- No managing alternative is “good.”
- Managing must be done early.
- Should remember the initial credit.
- Sometimes closing a position and taking a loss is the best action!

“Trouble” or “Worth the Trouble”

Larry McMillan studied 10 years of data on iron condors in April, 2007

Conclusion of study:

Iron condors cannot be used “automatically.” They must be used and managed subjectively.

For a Copy of Larry's Report

E-mail: info@optionstrategist.com

Phone: 800-724- 1817

"Condor Document" (Cost is $10)

http://www.optionstrategist.com/cmd.asp?productid=5067154

An Alternative to the Credit Spread

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Skip-Strike Butterfly

Skip-Strike Butterfly

Skip-Strike Butterfly Defined:

Long 1 call strike A

Short 2 calls strike B

Skip strike C and

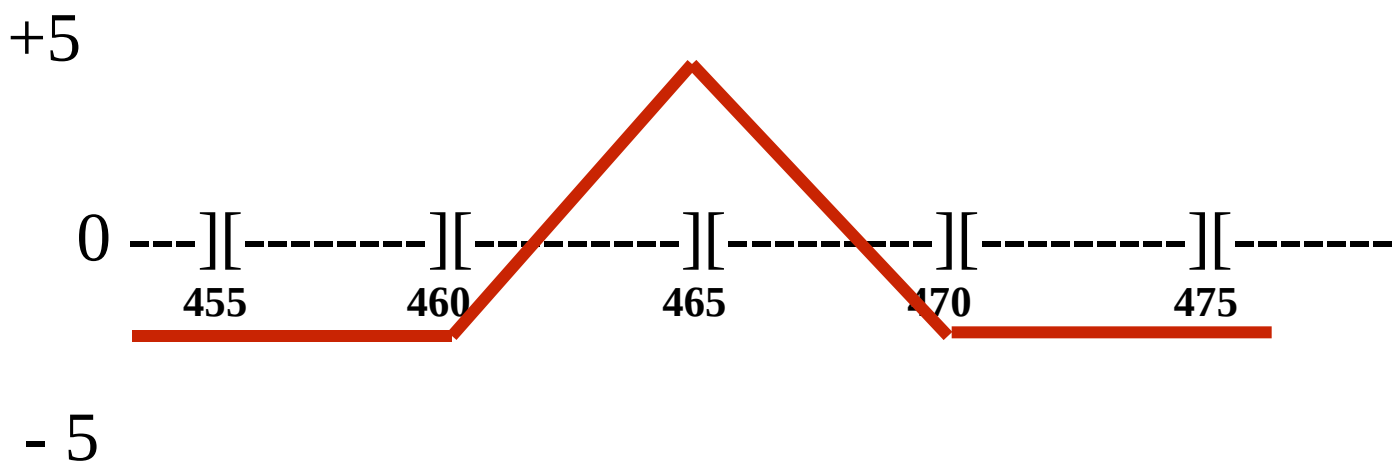
Long 1 call strike D

The strikes are equidistant, and the options have the same expiration date. The position is typically established for a net credit.

Must be done in a margin account!

First: Review a Standard Butterfly

OEX	+1 460 Call	11.60	(11.60)
450	-2 465 Call	9.50 ea.	19.00
	+1 470 Call	7.70	(7.70)
		Net Cost	(0.30)



Market Forecast?

The standard butterfly is established for a net debit and is appropriate for a neutral forecast. The ideal is for the underlying to settle at the center strike at expiration (or close).

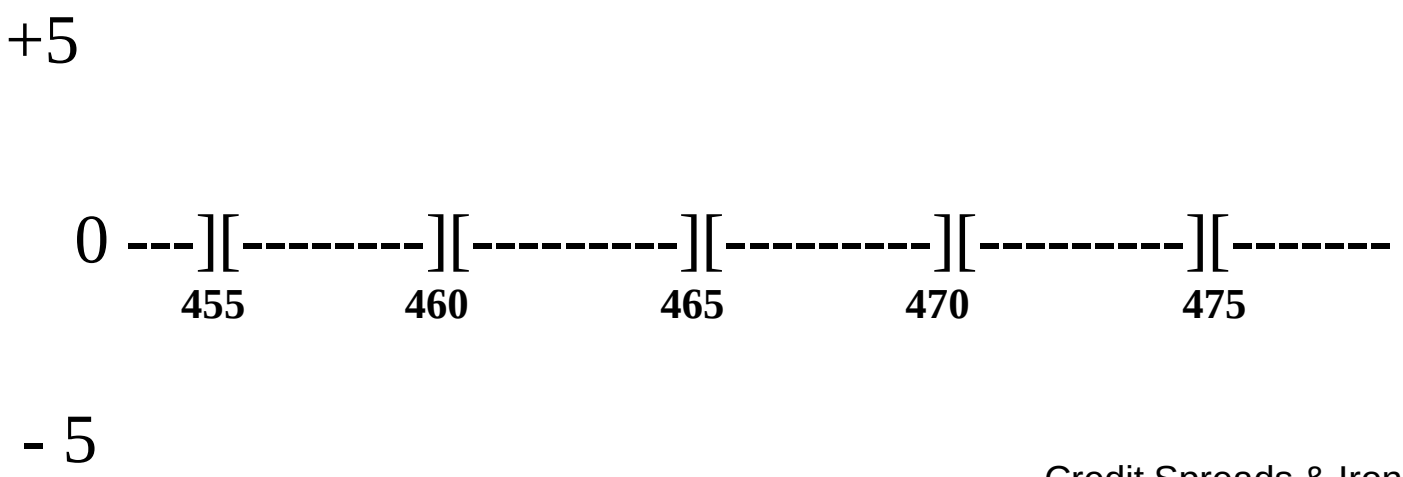
What if you want a net credit and a you have a slight directional forecast?

Consider the skip-strike butterfly.

Skip-Strike Butterfly

Moderately bullish – market near 465 @ exp.

OEX	+1 460 Call	11.60	(11.60)
450	-2 465 Call	9.50 ea.	19.00
	+1 475 Call	6.20	(6.20)
		Net Credit	1.20



Skip-Strike Butterfly - Summary

A strategy that “collects premium”

An alternative to the iron condor

Use calls when neutral to bearish

Use puts when neutral to bullish

Risk is limited

The maximum risk exceeds the credit

Summary

Credit spreads collect premium and limit risk.

The tradeoff is lower premium.

Psychology: “The market won’t go there.”

Iron condors collect two premiums, but the market must stay between the short strikes.

The skip-strike butterfly is an alternative.

Credit Spreads and Iron Condors

THANK YOU FOR ATTENDING.

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Credit Spread with Calls

Sell 1 35-day 490 OEX Call	@	2.65
Buy 1 35-day 500 OEX Call	@	(1.50)
Net Premium Received:		1.15

Maximum Risk: = **10.00 – 1.15 = 8.85**

Break-even point at exp. **491.15**

490.00 + 1.15 = 491.15

OEX at 450.00

The margin requirement equals the maximum risk.

Credit Spread with Puts

Buy 1 35-day 400 OEX Put	@	(1.45)
Sell 1 35-day 410 OEX Put	@	2.50
Net Premium Received:		1.05

Maximum Risk: = **10.00 – 1.05 = 8.95**

Break-even point at exp. **408.95**

410.00 – 1.05 = 408.95

OEX at 450.00

The margin requirement equals the maximum risk.

The Greeks of a Credit Spread

		Δ	ϑ	υ	τ*
–1 460 Call	13.50	–.48	–.01	–.55	+1.87
+1 470 Call	9.00	+.32	+.01	+.51	–1.70
Net Debit	4.50	–.16	–0–	–.04	+.17

Plus: Near -0- exposure to price and volatility

Minus: Reduced benefit from time decay

OEX, 450; Days, 35; Volatility 32%

* 7-day theta

Skip-Strike Butterfly

Moderately bullish – market near 465 @ exp.

OEX	+1 460 Call	11.60	(11.60)
450	-2 465 Call	9.50 ea.	19.00
Skip 470	+1 475 Call	6.20	(6.20)
		Net Credit	1.20