



Options MD

Clear & Simple Options Strategies for Consistent Monthly Income

How to Create Regular Monthly Income by Being Wrong (The Iron Condor Primer)

By Doc Severson



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Foreword

If you've been trading Stocks, Options, or Futures for any length of time, you know how difficult it can be to be "right". You work hard at it; you read the newspapers, listen to business channels on the radio as you drive to work, subscribe to personal finance magazines, check your charts nightly, listen to Jim Cramer...and Stocks seem to do the exact opposite that you forecast them to do. You've even told your friends to trade contrary to your picks - if you're long, then go short! As soon as you buy a Stock or go long on an Option, it reverses. You have an uncanny knack for this.

You've devoted years of your life to learning how to invest, and you now have less money than when you started. You know more than you used to, but that knowledge has brought nothing but danger to your trading account.

The Market is out to get you.

As soon as those words start to bounce around your head, you're incapacitated as a trader. You will lack the confidence to pull the trigger when the signals are there to enter the trade, and "hope" will enter the equation when it's time to sell. You will trade "not to lose" instead of trading to win.

The problem here is that you have to be **RIGHT**.

If you forecast a stock to go up, and you buy the Stock, you have to be **right**.

If you forecast a Stock to go up and you buy a call Option, you have to be **right**, not only about the direction of the move, but also the magnitude and timing of the move!

If you forecast the Stock to go down and short the Stock or buy a put Option, you have to be **right**. Not close, not just partially correct.....but 100% right in every manner.

You're probably saying to yourself at this point, "*Isn't there a way for me to make money without being right?*"

Yes, there is!

I found a way that allows me to trade Options on major US stock indices to generate monthly income in a safe, consistent manner....without necessarily being right in my forecast.

And you can, too. Let's see how.....

The Concept - Directionless Income Trades

Hopefully you've had a chance to watch the free video, available on the page that you downloaded this paper from. If you haven't watched it yet, please do so because it'll give you a valuable visual reference so that this material makes a little more sense at first glance.

One of the great things about Options is that it's very simple to create bullish or bearish income positions, unlike Stocks where it can sometimes be awkward to create a short/bearish position....and you certainly can't go "short" and "long" on the same issue in the same account. Stocks and Funds just don't give you the flexibility of creating a non-directional income position that Options do.

The problem with Options is that....well, they're *complicated*. And I won't try to gloss over this fact. It has taken me years to learn to avoid all of the little mine fields that come with trading Options. I have made every possible mistake that there is to make with Options, and one of my favorite jobs is to help you avoid making the same ones.

And during this time I've learned what works, what doesn't work, and how to SIMPLIFY the process! Let's see if we can put this into practice by quickly showing how to use Options to create income.

[Creating Income](#)

Ready? To generate income with Options, we need at our disposal: a bearish income trade and a bullish income trade. That way, we're covered in both directions, as well as the "middle" if Stocks go sideways. Here are our income trades:

- **Bullish** - to create income with a bullish trade, we'll SELL A PUT OPTION.
- **Bearish** - to create income with a bearish trade, we'll SELL A CALL OPTION.
- **Neutral** - to create income with a neutral trade, we'll do both....sell Puts and Calls.

We sell the Option, immediately collect the cash into our account, and if we don't have any defensive actions required, then we keep the cash and sell another position in the NEXT cycle. Month after month like an assembly line....or an Insurance Company.

OK, now if you've ever traded an Option before you should be putting your hand up in protest right about now, yelling about something that sounds like "unlimited risk"! And you're right, so we're going to add an "Insurance Option" to these trades and turn them into an investment vehicle that is called a "Spread." Let's see how we build a spread by putting it into practice.....

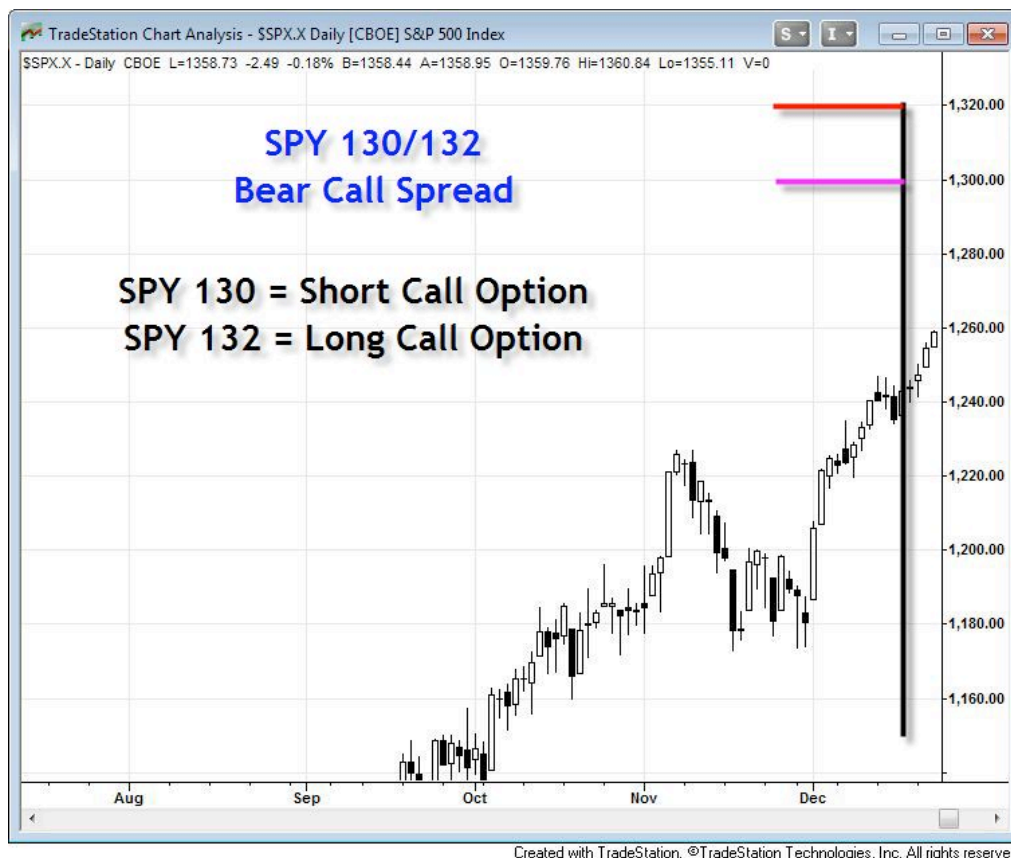
Options Spreads in Practice

Let's put these spreads in practice by showing some trades that we placed recently. At the end of 2010, we saw the S&P500 chart going into a possible consolidation pattern. These are sideways patterns where the charts takes a "breather" in the middle of a trend before resuming the prior trend. They happen all the time, and we look for these consolidation patterns as a higher-probability entry for a neutral trade like the Iron Condor.

The first thing that we did was to place a bearish trade as the price failed at a resistance level that we had identified; we placed an Options trade that's called a "Bear Call Spread" at SPY 130/132....where we sold the Call Option at the SPY 130 strike price and bought the insurance Option to form the "spread", at the SPY 132 strike price. We received a credit, or cash into our account when we placed the trade.

You can see this visually represented in Figure 1 with the horizontal pink line showing the SPY 130 short call, and the horizontal red line showing the SPY 132 long call Option.

Figure 1

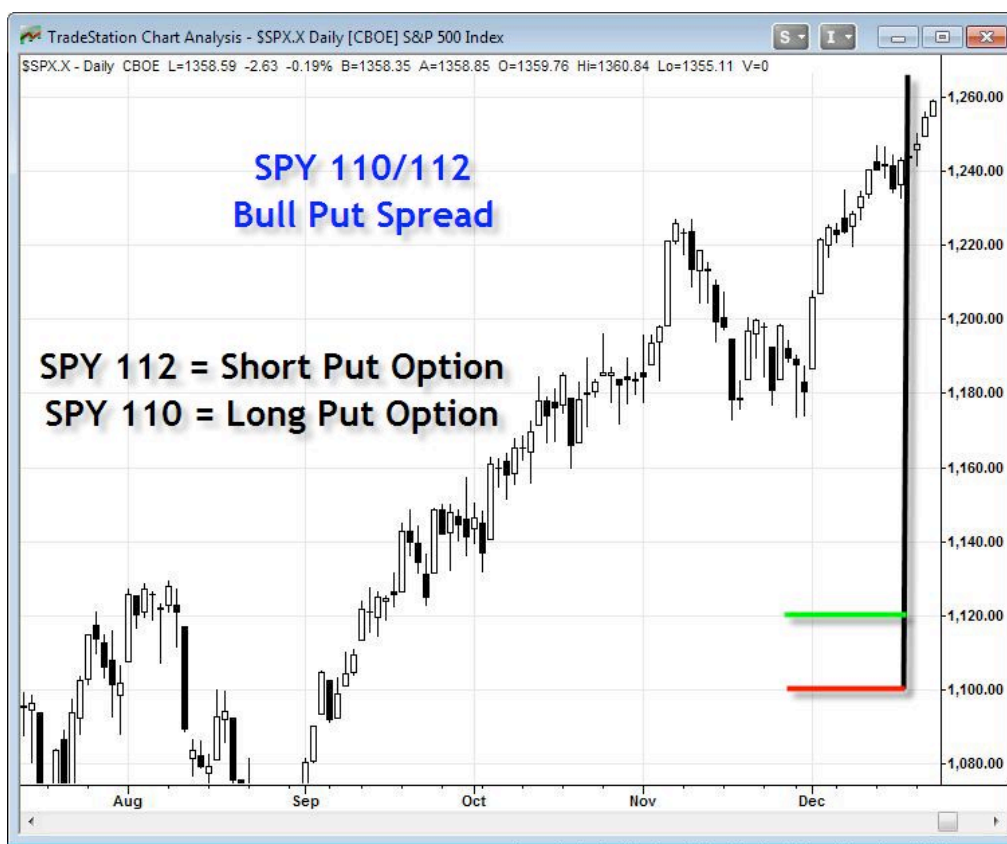


Note also that the black vertical line represents “expiration day” where those Options cease to exist; they “expire”. So the obligation that we hold only has a limited lifespan....and the point behind this position is that if the price gets to the black line - expiration day - and it has not “threatened” the pink line, then we just keep the income that we collected when we placed the trade, and move on to the next month.

If you’re like most traders, you probably want to know all about how the two Options interact with each other and why we placed them where we did. For now, keep focused on the bigger picture that we are creating income using these limited-risk, directional Options positions, and we’ll get to the details soon.

Now what about the “other” side of the trade, the bullish position? We’ve created one in Figure 2:

Figure 2

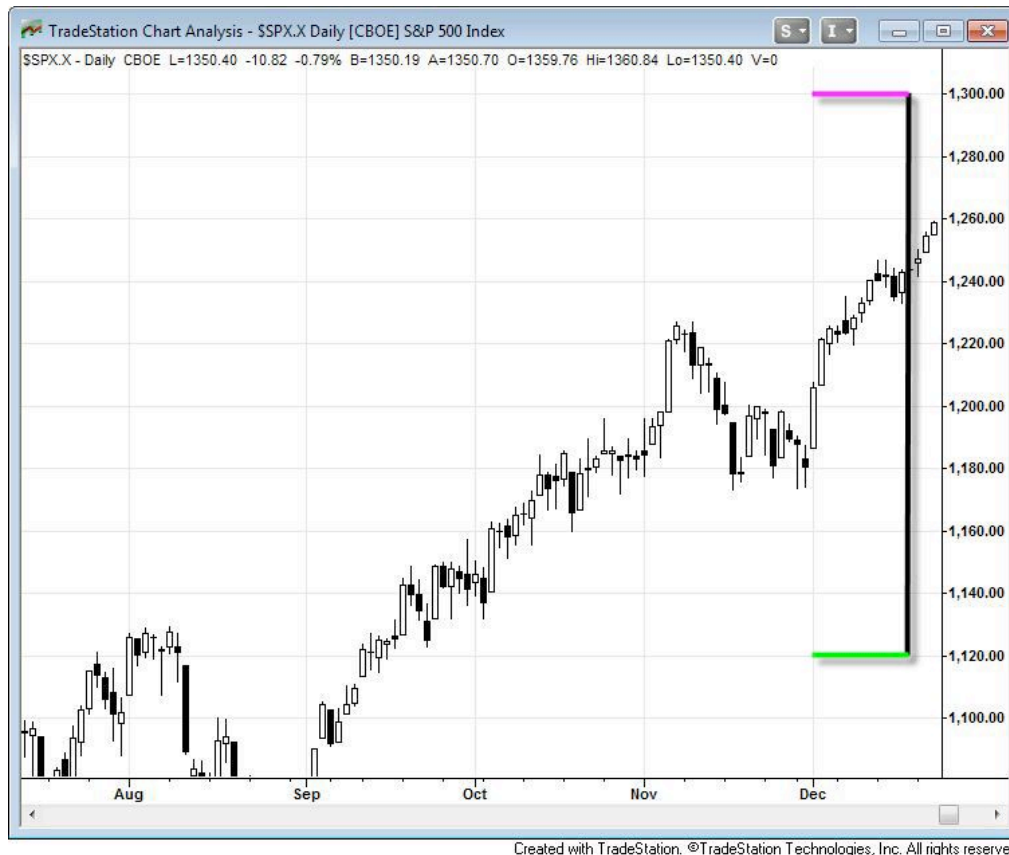


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Now we have a short put creating income at SPY 112 (green line) and the “insurance” Option at SPY 110 helping to limit the risk. As long as the price gets to expiration day without having “threatened” the green line at SPY 112 (we’re using the \$SPX chart here so just divide the price scale by 10) then we keep the income that we collected a month ago and carry on to the next cycle.

Now let's put both bullish (bull put spread) and bearish (bear call spread) positions together to form the Iron Condor in Figure 3:

Figure 3



In this diagram, I skipped adding the “insurance” Options from the spreads as we’re mostly focused on where our short strikes are located anyway. I think of these spreads as just one “position” anyway.

Returns

So what can a trade like this bring in? Let’s say that I would dedicate \$10,000 of capital to this position. That means that I could play 50 contracts on each “side” of this trade....50 contracts of bear call spreads and 50 contracts of bull put spreads. Each spread should pull in a credit of at least \$.15 per contract....which is Options terms is \$15....so we should bring in \$750 of credit for the call spreads and \$750 of credit for the put spreads. Depending on the broker that you use, commissions for the entire trade could be as low as \$40 for the entire trade.

- **Income:** $(\$750 + \$750) = \$1500 - \$40 \text{ commissions} = \1460
- **Maximum Risk:** $(\$10,000 - \$1460) = \$8540$
- **Return on Risk:** $(\$1460/\$8540) = 17.1\% \text{ return on max risk}$

Notice that I only used the \$10,000 figure as max loss; since we cannot “lose” both the bullish and bearish positions on the same month, most savvy Options brokers do not require you to hold these “maintenance” funds on both sides of the Iron Condor....just the larger of the two positions, if there is any difference.

Flexibility

Notice the flexibility of this trade. We could have made it a bullish trade alone with the put spreads if we had a bullish forecast, or we could have made it a bearish trade alone with the call spreads if we had a bearish forecast. Either trade alone would have made us roughly \$750 income or $(\$750/\$9250) = 8.1\%$ return on risk which is still not a bad return at all.....and all without the requirement of being 100% correct. We don't even need to be half correct on the forecasted direction to win the trade.

The Missing Pieces

So if this trade is so great, why isn't everyone and their uncle trading it? If you weren't thinking this question, you should be. There are no “silver bullets” in trading and you should be skeptical of any perceived edge that someone claims to have. Edges are only earned with application of sound fundamentals, and practice.

The most common reasons that I believe that most traders aren't using investing vehicles like this are:

- **Unfamiliarity** - there is an initially steep learning curve to Options, which is a barrier to entry for most traders that are comfortable with Stocks, regardless of their current performance. You must be motivated to stretch your boundaries.
- **Risk Management** - The majority of all Options Education programs focus on what they think that customers want, which is an alphabet soup of Options Strategies. There's a new one to try every week! Unfortunately what most Options traders don't learn is the basic skill of Risk Management. It is truly the professional's main edge over the Retail trader. Most professionals just use a small subset of simple strategies, over and over again.

So let's get busy fixing those gaps! In the rest of this guide, I'll show you techniques for how to improve your spread trades entries, as well as the “basic” risk management techniques for a “high probability” Iron Condor. We'll even cover some advanced material to show how professionals manage their risk. Let's get cracking!

The Mission

As Stephen Covey would say, let's begin with the end in mind. The purpose of this guide is to show you how to build a consistent income-producing system that can pay you approximately 10% a month on your risk capital.

At first glance, that might not sound like a lot. But if you bring in consistent income, you'll see that even a lowly 3% monthly account return compounded monthly turns into a 43% annualized gain! Not many fund managers can produce that kind of return. Executed correctly, there is incredible power in this strategy as these seemingly small returns start to pile up and compound monthly.

And winning trades on a consistent basis does wonders for your account and your outlook!

So our mission is starting to take shape:

- **Build a trading system that produces consistent monthly returns, regardless of the direction of the Market.**

Since we're on a roll, let's throw a couple more requirements onto our mission:

- **We don't have to be right**
- **We don't want to "lose" a trade**

Sound good? A system that consistently makes monthly income, doesn't require us to be right about the direction of the Market, and allows us to "win" every trade that we want. It's possible, so keep reading.

Now that we have a mission on the table, let's discuss some Strategies at a high level.

Strategies - Offense and Defense

A strategy is a very high level plan, using vision to imagine the end result that you want to accomplish. Before we dive into the details, let's take a minute to outline some of the strategies that we will use to produce our system.

What we've found is that our Options trading strategies are very analogous to the strategies that you see during a football game. Before we put on a trade, we're on offense and we have the ball. We dictate the flow of the trade, and we're in control since we're in cash on the sideline. Once we actually enter the trade, we're essentially kicking off the ball to the overall Market. We are now on defense for the remainder of the trade, playing "prevent defense" so we can keep the credit that we received at the beginning of the trade. When we're on defense, we don't control the action of the Market. We can, however, draw up some defensive plays to anticipate how we'll respond to whatever the Market can throw at us.

So through the rest of this guide, I'll refer to "Offense" as the act of actually entering a trade. "Defense" is where we learn to protect and risk-manage our trades.

Offensive Strategies

What Trading Vehicle Will We Use?

What kind of trade are we going to use to produce this monthly income?

Recall what we said above about trading directionally - we have to be right about a lot of things. Your odds of winning are somewhere less than 33%; the stock must go up, not sideways nor down. So if options buyers are only winning 33% of the time, who is winning the other 67% of the time?

Options Sellers!

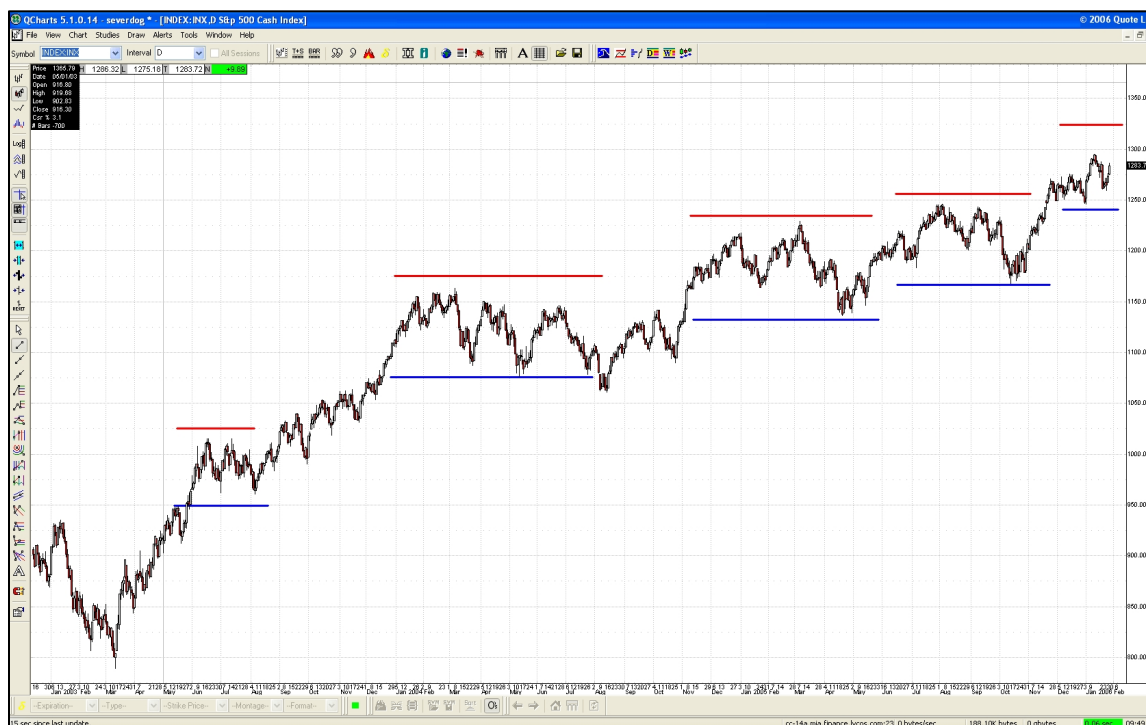
Done correctly, options sellers can make money if the Market goes in their favor, if the Market goes sideways, and even if the Market goes against their position! The trading instrument that we use (and was discussed earlier) is an Options Credit Spread, known as either a Bull Put Spread (Put Vertical Credit Spread), or a Bear Call Spread (Call Vertical Credit Spread). The combination of these two credit spreads used in the same month is what we call an **Iron Condor**.

How do we play an Iron Condor on a price chart? Refer to Figure 4; the red lines would be your Bear Call Spread positions. If the price settles **below** those positions by Expiration day, you keep the credit that you received when you placed the trade. The blue lines would be your Bull Put Spread positions; if the price settles **above** those

positions by expiration day, you keep the credit that you received when you placed the trade.

The **Iron Condor** is formed when you have both Bull Put and Bear Call Spread positions placed in the same month, meaning that you expect the price to trade within a range. As you can see from the chart in Figure 4, trading ranges are interspersed with occasional trends:

Figure 4



Another advantage of the Iron Condor is that it only requires “maintenance” for one side of the trade. (whichever “side” is larger) This means that for the same amount of risk maintenance in your account, you can potentially double your returns! Check with your broker to confirm that they handle it in this manner.

[Trading What Stock?](#)

Some requirements that we’re looking for in a tradable equity are:

- A great chart that obeys support and resistance lines
- An options chain with enough premium throughout the strike prices to provide the possibility of placing distant, out-of-the-money trades
- Reduction in Event Risk (earnings announcements, downgrades, etc)

The instruments that I've found to meet these requirements are the ETFs of the S&P 500 (SPY) and the Russell 2000 (IWM). I generally use spreads that are 2 strike prices wide, such as a SPY 145/147 Bear Call Spread, or an IWM 61/63 Bull Put spread. The S&P500 generally charts better than the Russell 2000, so it is my primary instrument with the Russell being secondary. I'll discuss my thoughts on these instruments, and others, in Appendix A.

[Over What Timeframe?](#)

We have found that the 6 to 7 week timeframe prior to options expiration is just about right for placing the first "cornerstone" trade for each expiration month. This provides a good compromise between getting enough premium to make the trade worth it, vs. minimizing your time exposure with a short option, which is an obligation.

Our offensive strategy: we will use either a Bear Call Spread or a Bull Put Spread (depending on Market conditions) to receive a credit and cash in our account, using the SPY or IWM options, and we will place this trade approximately 6 to 7 weeks prior to Expiration. Once we have entered our first trade for the month, we will look for opportunities that the Market provides to place a trade on the other side of the Trading Range, creating an Iron Condor by having both Bull Put and Bear Call spreads in play during the same month. We will not "force" these trades, only putting them in play as the Market reveals its direction.

[How Many Contracts?](#)

This is a very important concept, that you not overtrade the size of your account. If this is a new strategy to you, start with very small trades, maybe one or two contracts. When you get experience with the strategy and are really planning out your trades in a professional manner, you can increase your position size. I keep my maximum monthly position for all my Income Pyramid strategies (covered in the next video!) to no more than 40% of my account, for reasons that we will see below. Regarding position size, rule #1 is to make sure that it does not put more than 2% of my trading capital at risk. In addition, I never place all of my position at one time; we'll discuss Pyramiding in the Tactics section. **Most months I am only playing 5 to 10% of my capital; you must not over-trade your account.**

[How Much Credit do we Ask for?](#)

The very least that you should ask for on a \$2 credit spread would be \$.15 per share of credit. This means a \$150 credit for a 10 contract trade, minus commissions. This will generally equate to a trade that has about a 90% **Probability of Success** for expiring out of the money. We'll talk more about this concept in the "Tactics" section, and at the end of this guide we'll share with you a different type of Iron Condor that mostly professionals use.

Timing the Trade

It is possible to get to a point in the month where you feel that you're in the middle of the trading range, and you can enter the entire Iron Condor position at once. Doing so certainly saves time but sometimes doesn't give you the *edge* necessary to consistently win trades.

Our strategy for these trades is relatively simple; we will look for the dominant trend when the Market is seven weeks out from expiration, and allow that Market to become completely oversold or overbought and stall at support or resistance. Our first position is then entered. The opposite position is entered as it "breathes" or pulls back to the other side of the trading range.

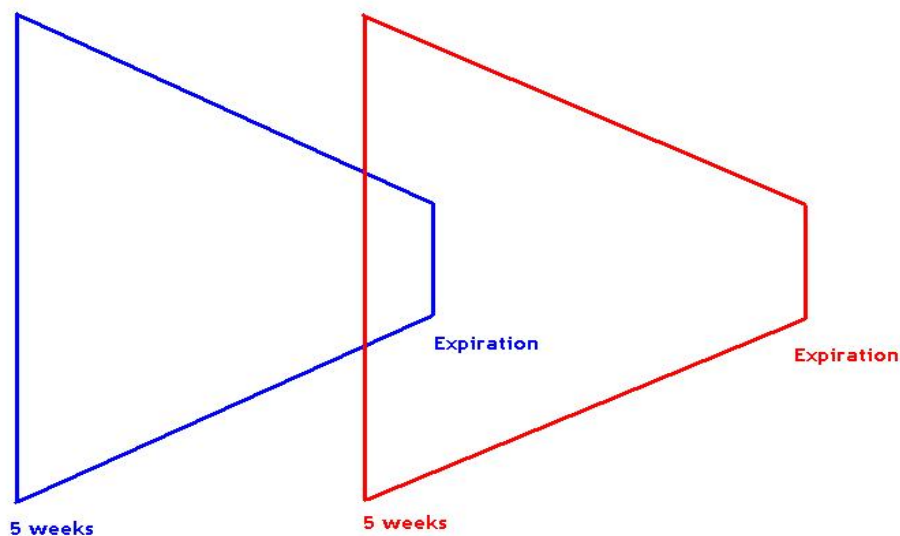
We normally use technical tools and charting to help identify those "oversold" and "overbought" peaks and valleys in the charts, as well as support and resistance zones.

Setting up for Next Month

We talked above about initiating trades 6 - 7 weeks prior to expiration. If that happens, won't trades over two monthly cycles overlap? *Yes!*

Figure 5 shows the relationship between the two months; shrinking premium forces front month trades closer to "the money" as expiration day approaches, and the back month trades are just being initiated:

Figure 5



To play each month, you have to make sure that you have an adequate balance in your account to play two months at once and still have a reserve to defend the front month's trade should you need to. If you are only playing 5-10% of your account as we indicated before, then this should not be a problem. Please understand that this diagram is only approximate, and is not meant to accurately reflect the exponential time decay that increases much more rapidly in the last few days of the month.

Earning regular monthly income means that you're not done when you're in the middle of the current month. You're proactively looking out to the *next* month, preparing yourself for that month's trades. It's very common to be managing "front month" positions during the last week prior to expiration day, while establishing new positions for next month. It's a little like playing defense in two games at once, which underscores the need for good tactics in terms of money management and position management, which we'll discuss in the next section.

Defensive Strategies

Once we put on our trades for the month, we're on defense. Let's discuss our Defensive Strategies:

Lines of Defense

Even before you place your trade, you will have identified your **lines of defense** between the ball (current stock price) and the goal line. (the sold strike of your credit spread) Think of the first line of support or resistance between the current price and your sold strike as your "defensive line". Think of the second line of support or resistance as your "linebackers", and the last line of defense against your position as your "defensive backs".

By identifying at least three lines of support or resistance between the current price of the stock and your sold strike, the Market has to smash through your defensive line, vault over your linebackers, and then finally get past your defensive backs in the open field to "score" against your position. By ensuring that you have adequate lines of defense, you're building an additional **edge** for your position, above and beyond that which options sellers employ.

Refer to the chart in Figure 6. The red lines at the top of the chart represent lines of **Resistance** or your Lines of Defense for a Bear Call Spread. The blue lines at the bottom of the chart represent **Support** or your Lines of Defense for a Bull Put Spread.

Figure 6



In this chart of the SPX, we would identify lines of defense on the top as 1) the red horizontal resistance line at 1440, 2) the red descending trend line that marks all of the previous highs since October, and 3) the red horizontal resistance line at 1500.

Lines of defense on the bottom would be formed by 1) the descending blue trend line that previously marked intermediate highs (*former resistance becomes new support*), 2) the blue horizontal support line at 1325, and 3) the blue horizontal support line at 1270.

Exits

Just like a street game, you can decide when you've had enough of the Market moving against your position. You can take your ball and go home. When you trade like this, you will know what your exits are well in advance so that you can make an objective, rational decision about when and how you will exit.

Overtime

If you exit a position that's being attacked by the Market, do you lose that trade? *Only if you quit the game.* Like Judo where you use your opponent's weight and strength against them, you can use the power of the move against your position to execute what's called a "roll out", which means that you establish a new position a good distance out of the money (further away from your original position) using enough contracts to profit on the overall combination of your original position, plus the rolled-out position.

We'll discuss this technique in detail in the next section.

Tactics - Offense and Defense

We've defined our Strategies for how we intend to play these positions on a monthly basis. We know what we're going to use to trade, and what kind of trade to use. We know that we're going to define our exits and learn to defend them. In this chapter we'll dive down a level and define how we actually do these trades and talk **Tactics**, by defining how we:

- Time the trade
- Enter the trade
- Monitor the trade
- Defend the trade
- Exit the trade

Timing the Trade

The first thing we need to do on any given month is to understand the flow of the current Market. Think of the Market as an ocean, with money flowing in and out of the Market. Note in the chart in Figure 7 how the price tends to move back and forth, all the time under the influence of a larger, slower trend:

Figure 7



Observe how the shorter trends typically last a few weeks heading in one direction, only to reverse/retrace in the opposite direction for a few weeks. This is normal Market action, akin to “breathing”. Stocks do not trend straight up nor straight down; they pause to consolidate, and retrace to attract new buyers. This is all part of Elliott Wave theory.

Deciding when to enter the first trade in a month comes down to several variables, and can be a combination of science, art, and experience in terms of when and how to enter. Let’s discuss some of the variables and how to use them:

Days to Expiration

All of our trades are placed between four to seven calendar weeks prior to expiration. This gives us the best balance of harvesting premium while keeping as much distance as possible between our sold strikes and the current price.

If you initiate a trade around the seven week level, you will receive a higher premium relative to the shorter timeframes; however you are “exposed” to a greater time risk. If you initiate trades in timeframes shorter than four weeks, you may have to set up the trade too close to the current price to provide enough safety. Like everything else in life, it’s a compromise.

Types of Entries - Cornerstone & Confirmation

Our first trade of the expiration month, known as the “**Cornerstone**” trade, usually occurs somewhere between six to seven weeks to trade before expiration. We call this a “Cornerstone” since it is the first trade of the month, and everything else depends on us laying this trade down at the right time, in the same manner that the Cornerstone for a building sets the direction for everything else built on top of it.

Cornerstone trades start with a relatively small position, using about 5% of our account equity as maintenance. For a \$20k account, this is a 5 contract trade on the SPY or IWM using a \$2 difference between the short and long strike prices.

Since we never place our entire order at one position, additional “pyramiding” trades (called **Confirmation** trades) occur if we can place positions out *further* than the original Cornerstone positions.

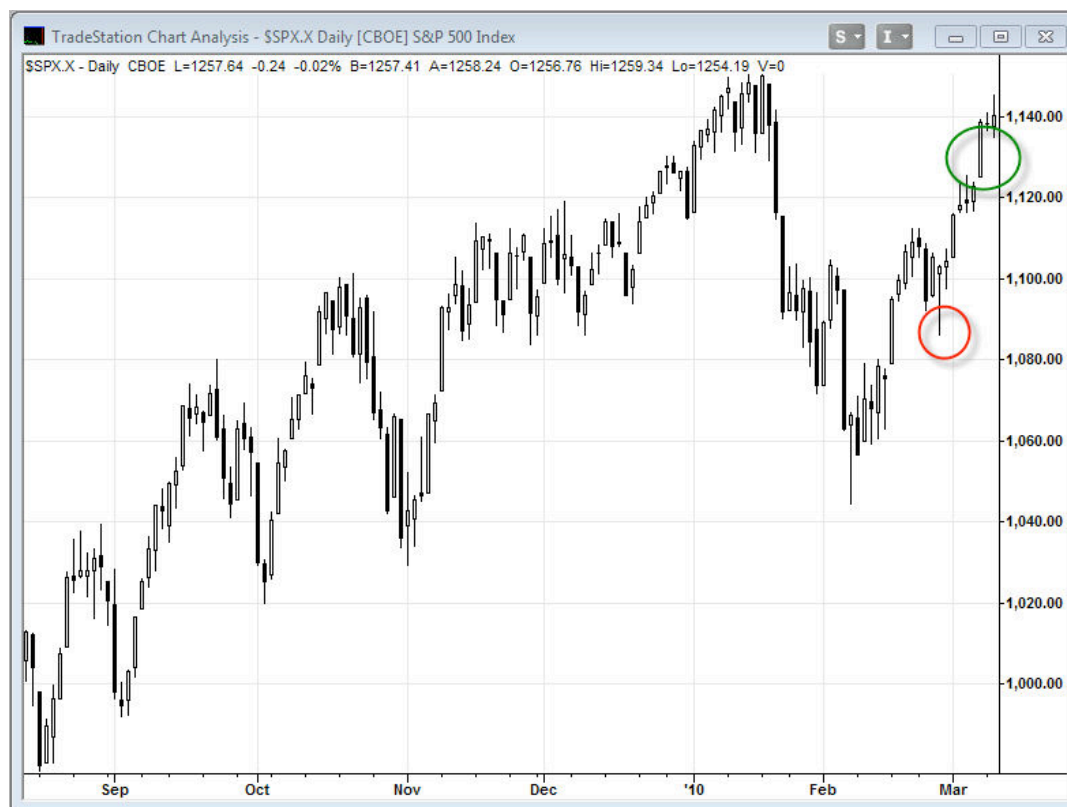
This pyramiding technique goes back to the early 1900’s, and it was how legendary trader Jesse Livermore would scale into a position. The point is to never place your entire position for the month on the first trade; make sure your forecast is correct first. If we were wrong in our forecast, then we only have a small position to adjust.

If the chart reacts as expected, after we place our “Confirmation” trades we will then look for an opportunity to complete the Iron Condor by placing the opposite spread. As we confirm a position by adding to it, we would never exceed the 40% account

equity limit. We frequently only use about 5-10% of our account every month. Don't overtrade your account.

For example, in Figure 8 you can see how the price was under the influence of a larger uptrend. When the price “committed” to re-establishing the uptrend in late February, we scaled into two bullish credit spread positions and waited for the price to rally up near resistance before we established a single bearish position.

Figure 8



On these dates, we entered the following positions:

- **February 25** - Cornerstone SPY April 96/98 Bull Put Spread
- **February 25** - (later) Confirming SPY April 95/97 Bull Put Spread
- **March 2** - Completion of the Iron Condor with the SPY April 119/121 Bear Call Spread

The trade initiated on February 25 (red circle in Figure 5) was a “Cornerstone” trade which anchored the rest of the month. A trade placed later that morning as the price continued to drop lower allowed us to enter an “extrapolation trade” (discussed below) which allowed us to establish additional position size further out of the money as a “Confirmation Trade”. We then waited until the price rallied up to resistance (Figure 5 green circle) to establish our Bear Call spreads and “complete” the full Iron

Condor. In this case we established this Iron Condor with a Bullish bias since the chart had an overall uptrend in place.

Many months it will be impossible to “confirm” a side of the Iron Condor because the price has either run away from that side, too much time has gone by, or implied volatility has decreased. (or all three) That’s when I will use another instrument to enter my confirmation trade.

For example, if I use the SPY as my primary instrument, then I will use the IWM to enter additional trades if I cannot get the confirmation trade further out of the money than the Cornerstone trade. And there is no shame in just playing Cornerstone trades! Many months I will just trade Cornerstone trades if I feel that the Market is just too volatile, and the additional positions in play via Confirmation trades....are just not worth the additional risk.

[Types of Entries - Extrapolation Trade](#)

Since we often cannot wait for the price to become totally overbought/oversold in the opposite direction, the second trade of the month is what we call the “Extrapolation Trade”; we use the momentum of the Market as it runs away from our Cornerstone trade to catapult the next trade far out of the money in the opposite direction. We are trying to extrapolate where we could get a fill if the price runs up/down to a known support or resistance target. Once we calculate this target, it’s a matter of using our Probability analysis (explained shortly) to calculate where we could get a fill.

In the example above, the confirming trade on the Bull Put spread side was obtained by placing lower targets than the Cornerstone trade, and letting the Market come down to fill the order.

[Timing Entries - Conclusion](#)

In summary, we will look to place our first trade of the month about 6 to 7 weeks out from expiration, for a minimum \$.15 credit on a \$2 wide credit spread, just as the SPY/IWM is topping or bottoming. If our Market analysis proves us correct, we may use a Confirming trade at more distant strike prices or on a different instrument to maximize our gains.

As the Market continues to run away from our Cornerstone trade, we’ll seek to “extrapolate” our next trade, on the other side of the chart. This trade as well can have a “confirming trade” to maximize your returns, once you confirm that the trade is safe.

So now that we’ve determined our timing for the trade, what strike prices should we choose?

Entering the Trade

To enter a credit spread, we ***Sell to Open*** the short strike, which is the strike price closest to the money...and ***Buy to Open*** the long strike, furthest from the money. I always let the broker handle this transaction as one complex trade. If your broker does not allow this entry as one single trade.....run, do not walk away from them.

Choosing the Strikes

In quiet markets such as those found from 2003 - 2006, we could get away with static price targets to choose our strike prices. This is an arbitrary way to select a price target, and I needed a method that would adjust to the current volatility of the market, and accurately place trades to reflect that range.

How can you objectively evaluate present Market conditions? How can you accurately and objectively select the proper strike prices?

Let the current Market conditions (reflected via Implied Volatility) help you understand how far out to place your positions!

The current Implied Volatility figures can actually be reverse-derived from the Black-Scholes Theorem to determine the probability of the price closing at a certain strike price by expiration day!

All good Options brokers now offer these measurements via online tools & calculators. Using Probability Analysis, we can implement a trading rule concerning choosing strike prices for Cornerstone or Confirmation plays:

We will seek a “Probability of Success” of about 90%, or a “sold strike” delta of roughly .10 on any trade that we enter.

Let’s look at how we can determine what strikes to use by examining the options chain. Figure 9 shows a thinkorswim chain of the SPY July 2011 puts; what strike prices should we use to establish a Bull Put Spread?

First of all, note that I have configured my options chain to display Probability of Expiring as well as Delta. If my goal is to find a spread that has about a .10 delta or a 90% probability of expiring OTM at expiration, my first candidate appears to be the July 117 strike. Note that the ***Probability of Expiring*** field relates to the probability that this option will expire \$.01 in the money at Expiration. For our purposes, we will use the inverse of this value, or $(100 - 12.14\%) = 87.86\%$ Probability of Success.

Now let’s determine how much credit that this spread is offering; remember, I’d like to receive a minimum of \$.15 credit for a \$2 wide spread.

If we place a Bull Put Spread that is \$2-wide, then we need to use the Option \$2 further out of the money for our “insurance” Option, so our Spread would be the SPY 115/117 bull put spread. For these strike prices, the spread is showing a Natural Credit of (.71-.64) or \$.07, and a Natural Debit of (.76-.58) or \$.18. The “Midprice” of this spread is halfway between \$.07 and \$.18, or about \$.12. That’s not going to get us a \$.15 fill unless the price drops.

Figure 9

Strikes: ALL		PUTS					
Exp	Strike	Bid X	Ask X	Impl Vol	Prob.Exp	Delta	
JUL 11	115	.58 X	.64 W	26.33%	10.22%	-.08	
JUL 11	116	.64 W	.70 X	25.82%	11.14%	-.09	
JUL 11	117	.71 X	.76 W	25.30%	12.14%	-.10	
JUL 11	118	.78 B	.84 W	24.81%	13.26%	-.11	
JUL 11	119	.87 N	.92 W	24.38%	14.53%	-.12	
JUL 11	120	.96 X	1.01 W	23.84%	15.82%	-.13	
JUL 11	121	1.06 X	1.12 X	23.38%	17.31%	-.15	
JUL 11	122	1.17 W	1.23 C	22.87%	18.87%	-.16	
JUL 11	123	1.30 W	1.36 C	22.41%	20.65%	-.18	
JUL 11	124	1.44 X	1.50 C	21.93%	22.54%	-.20	
JUL 11	125	1.59 X	1.65 B	21.42%	24.58%	-.22	
JUL 11	126	1.77 X	1.83 A	20.98%	26.87%	-.24	
JUL 11	127	1.97 X	2.03 A	20.54%	29.35%	-.26	
JUL 11	128	2.18 W	2.25 X	20.07%	31.98%	-.29	
JUL 11	129	2.42 X	2.49 W	19.61%	34.83%	-.32	
JUL 11	130	2.69 X	2.76 N	19.17%	37.89%	-.35	
JUL 11	131	3.00 X	3.07 X	18.78%	41.20%	-.38	
JUL 11	132	3.33 X	3.40 W	18.34%	44.66%	-.41	
JUL 11	133	3.69 C	3.77 X	17.90%	48.30%	-.45	
JUL 11	134	4.10 C	4.18 X	17.50%	52.12%	-.49	
JUL 11	135	4.55 X	4.64 X	17.14%	56.06%	-.53	
JUL 11	136	5.04 W	5.15 X	16.80%	60.07%	-.57	
JUL 11	137	5.56 B	5.71 W	16.43%	64.13%	-.61	
JUL 11	138	6.18 W	6.35 A	16.29%	67.98%	-.65	
JUL 11	139	6.84 X	7.03 X	16.16%	71.67%	-.69	
JUL 11	140	7.42 N	7.74 X	15.70%	75.58%	-.73	
JUL 11	141	8.25 W	8.51 X	15.87%	78.51%	-.76	

Moving up a couple of strikes to the SPY 117/119 bull put spread, we can see that for these strike prices, the spread is showing a Natural Credit of (.87-.76) or \$.11, and a Natural Debit of (.92-.71) or \$.21. The “Midprice” of this spread is halfway between

\$.11 and \$.21, or about \$.16. This trade has a very good probability of receiving a minimum \$.15 credit fill.

The numbers that I want to deal with now are between the Natural Credit and the Midprice:

SPY July 117/119 Bull Put Spread = \$.11 Natural x \$.16 Midprice

When we all begin trading options, we're taught to sell options at the Natural Credit, and Market Makers and off-floor professionals are all too willing to accommodate you. Here's where you can gain an edge in your trading - ***never submit an order at the Natural Credit!*** It's a good idea to start to enter an order by trying to get a fill at the Midprice (\$.16 for this example). If you're not being filled on the position after having that limit order out there for a few hours, then back the limit order down to your minimum of \$.15 and resubmit the order for that credit. Never accept wholesale pricing when you sell a spread (Natural Credit) nor pay retail pricing when you buy a spread. (Natural Debit)

Your job is to get the spread that's as far out of the money as possible, while still obtaining a minimum \$.15 credit. Whenever I'm faced with a choice between two spreads, I usually pick the one further out of the money and wait for the price to move enough to fill my order.

Higher potential monthly returns can be yours by placing trades with a winning probability closer to 80%; however you are trading a higher rate of return for more risk and a more active defense. We prefer the ~90% figure for traders new to the Iron Condor, as it provides a nice balance between consistent returns, and lack of worry about our positions. In our experience, a trade with a ~90% Probability of Success, or a .10 Delta, usually equates to about a \$.15 credit, pretty consistently. This figure diminishes once the trade gets within 4 weeks to expiration.

As you gain more experience, you'll want to work your way up to trading "Low Probability" Iron Condors, which are discussed at the end of this report. In the meantime, the key behind long term success with High Probability spreads is to never, ever take a max loss by letting the price get near your spread. We'll talk more about that in the "Defending the Trade" section.

Entering the Order

Once you determine your target strike prices, the next task is to actually enter the trade. In Figure 10 we show the July 117/119 spread being entered by right clicking on the 119 strike price, and selecting the “Vertical” spread option:

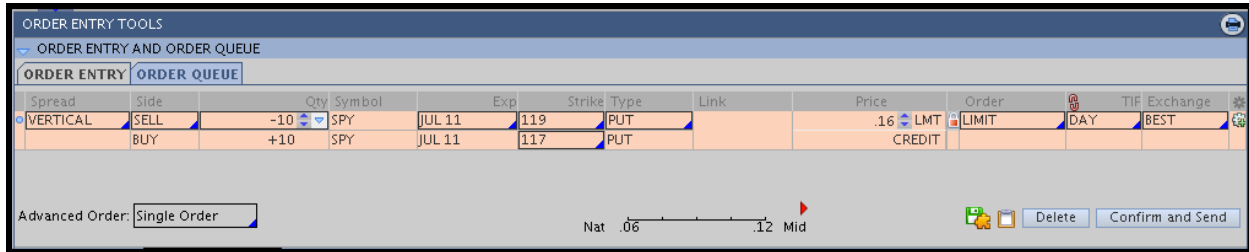
Figure 10

Strikes: ALL		PUTS					
Exp	Strike	Bid X	Ask X	Impl Vol	Prob.Exp	Delta	
JUL 11	115	.58 X	.64 W	26.33%	10.22%	-.08	
JUL 11	116	.64 W	.70 X	25.82%	11.14%	-.09	
JUL 11	117	.71 X	.76 W	25.30%	12.14%	-.10	
JUL 11	118	.78 B	.84 W	24.81%	13.26%	-.11	
JUL 11	119	.87 W	.93 W	24.38%	14.53%	-.12	
JUL 11	120			23.84%	15.82%	-.13	
JUL 11	121					-.15	
JUL 11	122					-.16	
JUL 11	123					-.18	
JUL 11	124					-.20	
JUL 11	125					-.22	
JUL 11	126					-.24	
JUL 11	127					-.26	
JUL 11	128					-.29	
JUL 11	129					-.32	
JUL 11	130					-.35	
JUL 11	131					-.38	
JUL 11	132					-.41	
JUL 11	133					-.45	
JUL 11	134					-.49	
JUL 11	135					-.53	
JUL 11	136					-.57	
JUL 11	137					-.61	
JUL 11	138	6.18 W	6.35 A			-.65	
JUL 11	139	6.84 X	7.03 X			-.69	
JUL 11	140	7.42 N	7.74 X			-.73	
JUL 11	141	8.25 W	8.51 X	15.87%	78.51%	-.76	

BUY	▶
SELL	▶ Single
BUY Custom	▶ Vertical
SELL Custom	▶ Back/Ratio
Copy	Calendar
Quick Quote	Diagonal
Add To Watch List	▶ Straddle
Market Depth	Strangle
Trade Grid	▶ Covered Stock
Quick Chart	Collar/Synthetic (Combo)
TOS Charts	▶ Butterfly
Prophet	Condor
Send To	▶ Iron Condor
Create New Note	Vertical Roll
thinkLog search	Collar with Stock
	▶ Double Diagonal
	▶ Unbalanced
	▶ Deep and Wide

Once you select this option, the order entry dialog will show at the bottom of the screen as shown in Figure 11, which is where you will specify your minimum credit, the strike pair, quantity, and terms of the order:

Figure 11



This example is shown for the broker thinkorswim but the process is essentially the same for most option-savvy online brokers.

Monitoring the Trade

Once this order has been entered, it may not be filled for a few minutes, a few days, or maybe not at all. You've hung a carrot in front of the Market, and you've asked to be paid more than wholesale for your transaction. Your order will typically be filled by a burst of volatility during the day. (this is why I love entering orders right as the Market opens in the morning) Normally you would be emailed by your broker to inform you of a successful fill.

Remember, once you place the trade and are filled, you are no longer on offense....the Market has the ball and you're on Defense now, protecting your sold strike or "goal line".

Defending the Trade

If you've played a credit spread trade before, you know that as soon as you put the trade on you're in a hole. It costs you more to exit the trade (a debit) than you made at the onset of the trade, as a credit. Two things come to your aid: **Time and Distance**.

As the weeks go by, time bleeds off both your short and long positions in the spread, and if your spread expires out of the money, both options will expire worthless. It's not until those last few days that the premium really bleeds off quickly in your favor. This is the option greek **Theta** working on your side.

Distance will also help; as the price runs away from your position (if you played it right!) the spread will climb out of the hole and start to go profitable.

So in an ideal world, everything works perfectly and the price runs away from your position and everything expires out of the money. But this isn't a perfect world, so we need to study some defensive tactics.

Defending the trade means that you're going to take a proactive approach to how you handle this trade. You're not going to shut down the trade because of a big intraday spike that amounts to nothing, nor are you going to blindly hold the trade past the point of no return because you *hope* something good happens.

I define "Defense" in three ways:

Static Risk Management: This is similar to a "stop loss" with a Stock trade; you define the point at which you are unwilling to let the position lose any more value, and you adjust it.

Dynamic Risk Management: Since we are defining such a large range of profitability for these positions, can we not proactively add some positions that will actually **gain value** as the price attacks one of our Iron Condor credit spreads? The answer is YES! We have the ability to add all sorts of dynamic hedge trades through the flexibility of Options. We don't have the space to cover it here but these trades can be placed during "times of peace" so that they can gain a lot of hedging value during "times of war."

Active Risk Management: This is what I call "common sense" risk management. If we enter a neutral Iron Condor position, and our forecast of sideways price action is wrong and the price erupts into a violent trend, can we not recognize that and take appropriate steps to manage risk? Absolutely! One of my favorite techniques is to "thin out" the attacked position by submitting break-even limit orders so that intraday pullbacks help to reduce risk on that "side."

The most basic and important of these Risk Management/Defensive techniques is Static Risk Management, which we'll focus on in this report.

You're going to start your defense by defining your exits. Distance alone is not the only defense that you want to employ, but be wary of the "black hole". If you wait too long and allow the price to get too close to your spread, you will enter this hole where it is literally so expensive to shut down the trade that you may not be able to adequately recover your losses through a position adjustment. So defend early, there is no shame in being a professional coward when it comes to Options Trading!

When I began trading this strategy, I would actively use the "Lines of Defense" (see Figure 6) that I identified prior to setting up the trade to help me determine decisions as to whether I should stay or go. With the increase in volatility that we've seen in the Markets since 2007, this is no longer an acceptable tactic. We can use the Lines of Defense to help us develop a better edge with the trade when we ENTER it, however we cannot use those Lines of Defense to help us DEFEND it or make active

exit decisions. We need something more objective than our ability to read lines on a price chart.

This is not to say that I completely discount them; as long as the price stays inside my first “line of defense” then there’s nothing to be concerned about. If the price gets past my second line of defense then I need to be more vigilant, and anytime the price gets past my third line of defense I will watch my numerical exit signals (defined shortly) very carefully.

Another concept when defending your trades; if possible, look for what happens after 230pm ET to determine your “stay or exit” decisions. The professionals in the Market usually make up their minds by this time of the day as to whether they’re going to buy or sell. Many times during the day you’ll see a quick run up to new highs, only to see those gains sold off after 230pm. Many traders get whip-sawed by these intraday movements, so it takes real discipline to be patient enough to wait for the Market to show its *real* hand for the day. But that one skill alone could be worth thousands to you.

Probability can also be employed to determine an appropriate exit point. Using the Probability Analysis, trades that show a winning percentage of around 70% and lower are candidates for an adjustment, unless there is a very, very strong case through technical analysis that the trade is well-defended. As a proxy, you can use the option greek “Delta” of that particular sold strike price to determine the probability that the price will be “at the money” by expiration day. A delta of .25 would equate to a 75% Probability of Success, and is constantly updated intraday.

My final and most important defensive consideration is the “Net Debit” of the exiting trade. The “Net Debit” is the final cost that you’re left with after closing down the trade (for the “gross debit”) minus the credit that you originally got when you entered the trade. For instance, if you received a \$.15 credit when you originally entered the trade, but had to spend \$.60 to close down the spread, your Net Debit would be \$.45. (commissions omitted) The Net Debit is kind of the “bottom line” of defensive measurements, because this is one measurement that you’ll live with the consequences of. **I don’t like to see the Net Debit exceed \$.45 on a \$2-wide ETF spread.**

For example, if I receive a credit of \$.18 to initiate a trade, then I will watch all of my defensive metrics, and if an exit seems imminent, then I will make sure that I exit for no more than a spread debit of \$.63. By doing so, this will keep me within my max debit exit criteria of \$.45.

Note that if you have defined the Static Risk Management at these levels, then I am **essentially setting up a 1:1 risk/reward ratio for the entire Iron Condor!** If I receive a \$500 credit from each “side” of the Iron Condor for a total possible credit/profit of \$1000....and I am forced to close down one credit spread for a \$.45 net debit, or in this case \$1500....then my maximum potential loss is \$1000. This is a huge point

because it flies in the face of the crowd insisting that “one bad month will lose you ten months of profits”! As always, it’s not what you earn, it’s what you keep, and Static Risk Management is the best way to minimize losses when the Market decides to go on an extended trend. And as we discussed above with the other techniques of “Dynamic Risk Management” and “Active Risk Management”, there are other techniques to minimize those losses as well.

Getting back to Static Risk Management....in order of priority, (lowest to highest) here are the metrics that I use to determine my defensive actions:

5. **Absolute Distance from the sold strike** - this measurement looks good on a chart and helps me visually plot my defenses, but absolute distance has no bearing on how much the Market can move, measured by the VIX and Implied Volatility. This metric is just to give me a “sense” of distance.
4. **Lines of Support or Resistance** - determining the risk based on how price acts at these levels is the next important indicator.
3. **Probability of Winning the Trade** - I am aware of a potential trade exit once this value reaches 70%.
2. **Sold Strike Delta** - I am aware of a potential trade exit once this value exceeds .30 Delta.
1. **Net Debit** - I never want my Net Debit above \$.45, under any circumstances. This would mean a gross debit “exit” cost of \$.60 if I had originally received a credit of \$.15.

Exiting the Trade

If you've been trading long enough, you'll agree with the statement "putting on a trade is easy, but determining exits is a lot tougher". It's true; how you handle exiting your trades makes all the difference to your bottom line. If you have a solid game plan and know when and how to use which exit, then you'll be far ahead of most traders.

We may exit the trade under one of these circumstances:

- The spread expires worthless out of the money, no action required
- The price closes past our pre-defined exit, and we adjust the position further out, prior to expiration. (known as a "rollout")
- We are profitable in the position, and we close down the position to free up maintenance to use for an additional trade.
- We are currently profitable in the position, and we close down the trade early to minimize event risk.
- It's the Thursday prior to expiration and your European-settled option is within a certain threshold of the sold strike near the close of trading at 4pm. We close down the trade to avoid settlement risk.

On any given month we will evaluate any/all of these potential exits, at all times trying to maximize our returns by making the best use of our capital. And sometimes we will close down a trade early for less-than-maximum profit just to assure that we *do* profit. Normally you want to cut your losers short and let your winners run in trading. Trading spreads can be a little trickier due to the additional variables involved; sometimes it's best to take profits early if the trade is showing too much risk.

Let's discuss each of the potential exits in detail:

[Letting a Spread Expire Worthless](#)

This is our favorite exit strategy, as it means that we were correct and our credit spread is well out of the money on the third Friday of the month. We can let both options expire out of the money for max profit.

If you are trading the larger index options (SPX, RUT, etc) then before you accept this as an exit, read the section below on "Settlement Risk" exits and see if your trade still qualifies to let it expire without any attention on your part.

Adjusting a Position Using a Rollout

This is a fairly simple concept which appears to be complex. When you put on the trade, you received a credit. Let's use the following example:

IWM February 64/66 Bull Put Spread, sold for \$.15 credit, 20 contracts.

You just received a net credit of \$300 for this trade. (we'll leave commissions out of this for clarity)

You have pre-defined your final exit criteria as "I will exit this spread if the gross exit cost hits \$.60". This would give you a Net Debit of \$.45. If the exit cost of this spread hits that level, you will first need to shut down the old trade.

We will now **Buy to Close** our 66 puts, and **Sell to Close** our 64 puts for a debit that we specify to our broker, as a complex order. (this is much easier and executes better than trying to shut down each leg of a spread individually)

Figure 12 shows how this trade would be entered:

Figure 12

SPREAD	SIDE	QTY	SYMBOL	EXP	STRIKE	TYPE	TRADE DATE	PRICE
IWM								
VERTICAL	BUY	+20	IWM	FEB 08	66	PUT	1/17/08	.60
	SELL	-20	IWM	FEB 08	64	PUT		DEBIT

In this example, we originally took in a credit of \$.15. We shut down the trade for a debit of \$.60, meaning that we have an overall net debit of \$.45, or \$900 for those 20 contracts. (plus commissions)

Some would have you just shut down the trade and wait for a better day. I prefer to fight back. You can use the power of the move that just attacked your position to place a *new* trade *further* out! We know that we need to recoup our \$900 loss at the very least, and would still like to make our original \$300 profit. If you have enough time left in the month, you may be able to place another 90% "Probability of Success" trade, in this case a February 58/60 Bull Put Spread for \$.15 credit, using twice the number of contracts as the original trade. So in this case I would enter the following trade the next day:

IWM February 58/60 Bull Put Spread, sold for \$.15 credit, 40 contracts.

I would receive a net credit of \$.15 for this trade, or \$600 in net credit.

Keep in mind that increasing the size of the rollout position (*martingaling*) is a more aggressive defensive strategy and I will only do this if the attacking trend appears to be running out of steam just as it "takes out" my original spread. Under no

circumstances will I establish a position that puts more than 2% of my account value at risk, so I will only trade a larger “rollout” position like this if it meets this criteria.

And this is where good money management comes into play, since you must have an adequate reserve in place to be able to utilize this strategy. Notice that I have not replaced the \$900 net debit from the previous exit, however winning this trade will go a long way towards reclaiming your original credit. I find that even though these “roll out” trades sometimes seem a little frightening - you just closed down a trade that was attacked, and now you’re placing another trade in the same direction - they tend to work out well because the price has usually come a long way in a short period of time, and the trend is usually exhausted by this time.

Sometimes, if there is a **very** strong persistent trend in place, it might be best to honor the power of that trend. Rolling a trade further out in the same direction of the trade might get you into trouble again in a short period of time, if the trend does not break down and reverse. Sometimes it is better to place the rollout position *behind* it and let the trend continue to run away from your new position. Experience is the best judge of when to play the rollout in the same direction, or the counter direction. You can also play both sides of the fence with the “moving the goalposts” tactic, described shortly.

Rolling out, if done early enough in the month, will give you the opportunity to roll to the current, or *front* month. This is great because it won’t require you to wait another month to reclaim some of your lost profits. If you wait until the last three or four weeks of the expiration month to close down your trade, you may have to roll the trade to the next month (*back month*) to receive an adequate premium; remember, options premiums shrink quickly in the last weeks of the month.

Whenever I’m in doubt about whether to roll to the front or back month, I usually defer to the back month to give myself more distance and premium to work with. I really don’t care if I have to take a net debit for one month, if it puts me in position to safely win several months. Make sure that you take the longer timeframe perspective for this strategy; you’re looking for consistency, not daily profits. An out-of-the-money credit spread is not a trade that you want to push hard; use the back month to get more distance and premium whenever there’s a doubt.

[Closing Early to Free Up Maintenance Money](#)

Plays like credit spreads often follow the 80/20 rule; 80% of your gains are made in the last 20% of time in the month. So shutting down a spread early may require you to give up a significant portion of your gains to free up that maintenance for another play.

If the price runs away from your position, however, then you may be in a position with a couple of weeks to go in the trade where you can exit for about 80% of your gains intact.

This type of exit is much easier to achieve with Low Probability Iron Condors, discussed shortly. Early exits on \$2 ETF spreads receiving a \$.15 credit are difficult to achieve profitably due to the additional commission costs.

[Closing a Trade Early to Minimize Event Risk](#)

We see event risk in the Market every day. Since we're trading essentially the Whole Market in the S&P500 or Russell 2000, entire sectors can blow up or crater at any given day. Sometimes gains in one sector are balanced by losses in another sector. (such as gains in Oil being dampened by losses in Consumer Retail) So while we lead a less eventful life by trading indices vs. equities, event risk is still with us every day. FOMC releases, economic reports, and other external events can really rock the Market these days as the Herd reacts to news.

If you're profitable on a trade, yet you're *really close* with only a couple of days left to go, it may pay just to grab your profits while you can and eliminate your risk on the trade. That \$300 that you gave up in profit to end the trade early could turn into a \$9400 loss instead if you don't manage risk efficiently. Guard your trading capital jealously, and either close down a profitable trade, or roll out an unprofitable trade to a more advantageous location.

The key here is to **act**, and not to **hope**. Be the master of your own trading destiny.

[Closing a Trade Early to Minimize Settlement Risk](#)

What is the Settlement and why should you care about it?

Everyone generally knows when Options Expiration Friday is in a month. Not everyone knows that large index options like the SPX and RUT actually quit trading the day before, Thursday at 415pm ET.

But that closing price is not what your monthly options are based on. It's the SPX Settlement price (symbol \$SET, or \$RSL for the Russell) which is derived from the opening print of all 500 stocks the next morning (Friday). Whatever the opening price is of all 500 stocks, those are tabulated every day and a \$SET price is determined.

What this means is that during periods of high volatility at the open, the \$SET price often has nothing to do with the closing price on Thursday. This seems to mostly affect bear call spreads during uptrends, and bull put spreads in downtrends. We have seen several examples of 15+ point gaps (from Thursday's close to Friday's

Settlement) in the past year. And recently we've seen a 39 point SPX Settlement gap on August 17, 2007, and the SEC-induced 72 point Settlement gap on September 19, 2008.

If you play the larger index products, I believe that ALL positions should be closed early unless you have ~100 points of room. If you play the IWM and SPY ETFs, then where the instrument stops trading on OpEx Friday is where it settles.

What About Other Exits?

The Leg Out. Most people who have traded spreads have heard of other exits, such as the "leg out". If a spread is being attacked with a strong trend, just buy back your short Option and let the long Option "run". If it moves far enough, your long Option will gain enough value to potentially not only cover your loss, but also make a huge profit for you.

No argument, this is absolutely true and an accepted strategy. However, I have a problem with it. First, we moved to trading spreads due to acknowledging that directional trading was very difficult and that we were essentially in a neutral posture on the Market. By buying back your short call, you've now declared the fact that you're an excellent directional trader, and not only that, but an extremely aggressive one, too. You're not? Well, you'd better be, because you've now opened yourself up to greater losses if the SPX whipsaws back and your OTM front month long option is now losing value at an alarming rate. Just close them down and roll them out; it's much easier and safer.

Another term that I've used in the past is called "Moving the Goalposts". This is a more complicated version of "rolling out". When we roll out, we normally roll in the direction of the trend, since the odds are in your favor that the move may soon be overdone.

Moving the Goalposts. Moving the Goalposts means that you're going to set up another mini-Iron Condor with your roll-out adjustment trade.

If in our example of rolling out the 64/66 Bull Put spread to the 58/60 Bull Put spread, we only recouped about two-thirds of our debit via the roll-out. We could make up for this deficiency by placing a Bear Call spread above where the IWM currently was, and most brokers will not require additional maintenance! In this case we could have played the IWM February Bear Call Spread with an additional 20 contracts, which would have let us recoup all of the debit cost required to close down the original attacked IWM 64/66 position, and get back our original profit.

The "Moving the Goalposts" strategy is best left to expert traders who are comfortable with defending positions. It does increase risk because you've had to bracket these rollout trades above and below the current price, probably a lot closer

than you'd want to. This type of exit offers higher returns in exchange for the higher risk of having two positions close to the fire. For this example, a new February Bear Call Spread at IWM 75/77 would have come under heavy pressure in early February of 2008, as the big downside moved bounced violently. For this reason I almost always roll out in the same direction as the attacking move.

Because this method of defending trades introduces additional risk, I use Active Risk Management techniques that are defined in the "Mastery" module of the OptionsMD course.

The Professional's Iron Condor

The first thing that anyone who has any serious Options trading experience will do, once they read about the Iron Condor trade that we just covered, is to loudly exclaim:

“That’s a terrible trade! The Risk to Reward is horrible!!!!”

And you know what? They’re right. The INITIAL risk/reward is pretty bad. Remember the first example that we went over? We were looking to make \$1460 and were willing to risk \$8540 initially to earn that sum. (although we would never allow that)

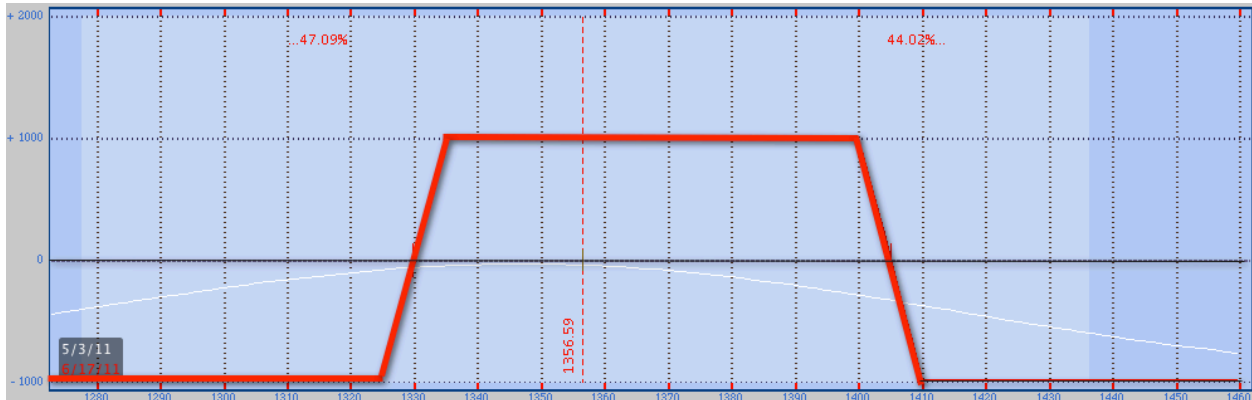
What we did show you in the “Defensive” sections of this guide is that we use Static Risk Management techniques to limit our risk to 3 times that of the credit brought in, which brings the risk/reward of the trade down to 1:1. For all of the years that I have traded this strategy, including several outright Market crashes over the past couple of years, I have never lacked the ability to adequately defend and adjust a High Probability trade. And the fact that we start off the trade with about a 90% chance of success means that most of the time, price will stay far enough away from these positions to allow you to win most of them.

But I will concede to you that there still exists the possibility, however slight, that the price might crash all the way through one of our positions and a full loss could be taken. Unexpected bad news, a Flash Crash, a Black Swan event; it certainly could happen if you trade long enough. Spreads are limited loss positions but that kind of maximum loss would certainly hurt. Ironically, this is usually the first loss that most beginning traders take when they first learn about Spread trading, however they have not completed their Jedi training to learn Static Risk Management Defense.

So professional Market Makers and off-floor Prop traders know this and generally frown on the “way out of the money”, high-probability Iron Condors and spreads. Believe it or not, they actually trade an Iron Condor with a much LOWER probability of success? Why? **Risk Management**. Managing risk to their capital is always job #1 for a professional. Once their capital is gone, they’re out of business.

A typical risk profile graph of a Low Probability Iron Condor can be seen in Figure 13; note how the potential profit (the area above the black line from about SPX 1330 to SPX 1405) is the same as the potential max loss (below 1330 or above 1405). That means that this is a 1:1 risk/reward setup from day one.

Figure 13



Now this also means that the entire trade only has a 50% probability of success. The way that the Options are priced means that with the expected forward volatility of the Options prices, the price has a 50% chance of settling inside - or outside - of the Iron Condor range by expiration day.

Because of this, you'll find that the "wings" of a Low Probability Iron Condor are dramatically "tighter" than the wings of a "way out of the money" High Probability Iron Condor.

At first glance that appears to be a bad thing; you have a reduced probability of success. And if you're a "set it and forget it" type of trader, it probably is a bad thing for you.

But for the professional, the Low Probability Iron Condor has many, many advantages:

- **Faster Profitability** - set up properly, these trades are more "sensitive" to the Options Greeks due to their closer proximity to price, and thus can become profitable much faster.
- **Risk Management** - a favorable risk management profile means that Black Swans or other exogenous events will not cause a disastrous loss of capital.
- **Reduced Maintenance** - because you are risking less per contract of the trade than a High Probability Iron Condor, you are also required to back each trade with less maintenance per contract than an equivalent credit from a HP Condor.

Now since there's no such thing as a "perfect" trade, there are some drawbacks to the Low Probability Condors as well.

- **Knowledge** - you must understand Options very well, including the Options Greeks, in order to manage these trades.
- **Access** - these trades have a narrow profitability range and you might need intraday access to effectively manage your exits.

So which type of Iron Condor should you learn to trade? What I find is that many traders who come to learn Options from the Stock trading world are used to Technical Analysis, and are used to the swing trading-type timeframes that are required for a High Probability Iron Condor to “mature” and turn profitable. For this reason I believe that High Probability Iron Condors are a good first step for a trader.

But with time, I like to see traders migrate to the superior Risk Management characteristics of the Low Probability Iron Condor. The same skills that are absolutely necessary to manage the LP Condor also work to help manage risk in other trades, whether it’s managing a Stock portfolio, or even helping risk-manage a High Probability Condor.

And if a trader comes to me with a small account and wants to get started trading Options and Condors, then there’s a strong case that they need to trade LP Condors.

These trades are the ones that the pros use, and there’s no reason why you can’t as well. It just requires knowledge and application on your end, and a desire to follow through.

Earning One Percent per Month

This is a good goal to shoot for to begin with, as we've already shown that earning 1%/month adds up to more than that. And if you get the skills to consistently earn 1%/month, then you can shoot for 2%...then 3%. And then you're in some really rarified air as you're now outperforming most money managers by a wide margin.

Now, I'm not trying to blow smoke at you here. It is possible to hit that level of consistency but it requires a very strong dedication to Risk Management and an equal dedication to continual improvement and objective thinking that doesn't pick up biases. Most traders start to do very well after a while and make the mistake of pouring on the position size, right before the Market does a complete U-turn and gives them a headache. Slow and steady wins this game.

Let's see what it would take a \$10,000 account....and a \$100,000 account....to earn one percent.

[\\$10,000 Account](#)

Let's work backwards from the goal....1% of \$10,000 is one hundred bucks. It hardly seems worth it to go after \$100/month but never lose sight of the power of compounding. Where most traders with smaller accounts lose their edge is by driving them far too hard, because they're unsatisfied with anything less than 10% a month. That kind of performance is not sustainable and you're using too much risk to earn your returns.

Now the Golden Rule of Risk Management is that we cannot place more than 2% of our account at risk on any one position, which is \$200. The Static Risk number for the HP Condor trades comes in at about \$45/contract, which means that we could trade about four contracts of HP spreads. If we are able to place the full Iron Condor, then it's possible for us to earn up to \$120 on a HP trade using four contracts of Bull Put Spreads and four contracts of Bear Call Spreads. With commissions, depending on your broker, you might be right at that \$100 mark IF you are able to let all of the spreads expire.

With LP Iron Condors, with \$200 max risk we could potentially earn \$200 with two contracts, assuming that we let the position expire OTM at expiration. This is a relatively difficult task due to the width of the LP Condor, so \$100 is a more realistic gain.

With a smaller account, the LP Condor is a better choice for your 1%/month quest due to lower commissions and better risk management.

\$100,000 Account

For this account, a 1% monthly return would be \$1000. Our 2% max risk value is then \$2000.

For the HP trades, if we divide our 2% max risk value by \$45/contract, then we can trade somewhere around 40 contracts of \$2-wide spreads, take a “max allowable debit” as defined by our rules listed earlier, and still adhere to our risk parameters. A 40 contract spread trade by itself would make us approximately \$600 minus commissions, and if we placed it as a full Iron Condor then we’d be looking at a \$1200 potential. It’s certainly possible for us to earn our 1% per month with a HP spread, although it does require a fairly “neutral” month where we don’t take any defensive actions.

For the LP trades, we could use 10 contracts of Iron Condor spreads to meet our 2% max risk limit of \$2000, so we’d be trying to earn \$2000 while risking \$2000. Again, the odds of being able to let the entire trade expire worthless are only 50%, which is why we typically do not manage them in this manner...yet your odds are good at being able to achieve your 1% return goal.

More than One Percent?

Notice that in both of these examples, we only put 2% of our capital at risk ON ONE TRADE. We can certainly put more than 2% of our capital in play during a given monthly cycle, but this is where I start to diversify by using the concept that we’ll cover in the next series called the “Income Pyramid.” You can start to use the other unused 98% of your account that’s just sitting in cash!

Final Thoughts

I hope this Guide has given you some more meat to put on the bones of your trading plan. I relate the Iron Condor trade to an unglamorous cinder block basement; it's just sort of "there", no one pays any particular attention to it, yet everything else depends on it doing its job without any care. I want these trades to be boring. I want to defend these trades early so I can sleep. I don't want to be an interminable grouch to my family and friends. So I will use the majority of my trading funds to focus on these trades and slowly grind away to the tune of 1% a month or more. There is no other trade that I'm aware of that provides consistent income without the daily drama; if there was, I'd be using it.

And guess what, there are other benefits!

Since you are now trading The Market, you become intuitively "tuned in" to what it's doing. No more trading against the trend, wouldn't *that* be nice! And since you know the general direction of the Market at any given time, why not play a small stake of SPY options directionally if you see a move setting up? Or even e-mini futures like I do? All this for the price of watching one chart.

Now there's no reason that you can't use this same strategy to trade your favorite individual stocks with....just watch out for the event risk like earnings announcements, downgrades/upgrades, etc. And few individual stocks have enough premium in their chain to get you far out of the money unless you play a breakout and catch implied volatility on a peak prior to a news event.

Leave the directional trading to a small portion of your portfolio, and consider that the gravy. The Iron Condor strategy should be your Meat and Potatoes!

Now let's talk seriously for a minute, trader-to-trader. I have used the concepts presented in this Guide for the past six years with my newsletter service. I still use every single one of these concepts every cycle, however since the additional volatility has come into the Market since approximately the 2007 timeframe, I have found it necessary to add additional skills to my arsenal to keep my trading edge. The techniques represented in this guide are what I call **Static Risk Management**; place an Iron Condor trade and then defend the trade through some static defensive measurements and limits. What I'm using now to increase my ability to handle Dynamic Risk changes are the **Options Greeks** as well as some other techniques that I call **Active Risk Management**.

By using the Options Greeks to understand how my trade's risk is changing dynamically in any one of four dimensions....as well as using the common sense techniques of Active Risk Management....I now have a much stronger approach to handling the extreme volatility that we are likely to see for some time to come. I believe what you hold in your hands is an excellent primer/introduction to get you started trading the

Iron Condor. If you are truly serious about turning your trading into a consistent business, then I encourage you to add additional skills to your arsenal by improving your trading defense to the next level. Why should the Professionals continue to have an edge over you in risk management and execution?

If you have any questions or comments about this material, please post your thoughts on the bottom of the page that you downloaded this from!

Good trading.....

Doc Severson

September 2012

Appendix A - What Instruments should we trade?

Many of you already have some experience trading Options, and perhaps even placing Iron Condor positions. Should you play the SPX, the RUT, or an ETF like the SPY or IWM? At the time of this writing, I believe that retail traders lose a significant edge when trading a single-exchange pit-traded contract like the SPX when playing High-Probability spread positions, and should look at trading multi-exchange, electronically-traded instruments like the IWM and the SPY instead.

When I first started trading Iron Condors, I did a lot of research on picking a CHART first. I wanted a good chart that honored support and resistance, and traded predictably from a technical analysis basis. That chart was the SPX, and I still haven't found a better *chart* to trade.

But then I started to notice the problems with the options chain during periods of heavy volatility.

Trades that I used to be able to manage up to 70% Probability of Success suddenly were showing gross exits of \$3+ at that level. The options chain became more and more opaque, not really providing any accurate sense of what the real "floor market" was for the spread. Retail traders had lost any "edge" that they had before.

Because of this, I moved to the RUT, or the Russell 2000 index. The RUT is traded on all six major options exchanges, and they all despise each other, which is good for us Retail traders. The spreads are reasonable in width and more transparent than the SPX. Executions are faster than the SPX, and you never get those strange wide spreads that the SPX shows during times of heavy volume, where you'll see natural bid/ask of -\$2 x \$4 or something ridiculous like that.

While the RUT is an improvement over the SPX, it still seems to suffer from wider spreads during volatile movements, and several times I saw max exit debits hit showing a .22 to .25 delta - not good. During the time I was trading the RUT, I was also trading the IWM, which is the ETF version of the RUT. I was trading spreads side by side during each month - in other words trading a RUT 800/810 Bear Call Spread vs. an IWM 80/82 - and in each case the IWM spread outperformed the similar RUT spread in how it "defended". IWM spreads did not widen out during very volatile moves, so I could play the IWM trades much closer to the money before I required an exit. With the narrower ETF spreads I also saw much more consistent fills, both entering and exiting the spread.

In addition, I no longer had to concern myself with the event risk of the European Settlement process that the SPX, RUT, and other large index products have to undergo.

ETF options and smaller \$2 spreads also helps the Retail trader that is using a smaller account. It is really difficult for the owner of a \$10k account to trade one contract of SPX options every month. Using ETF options allows that trader to “dial in” the correct number of contracts for their account size.

ETF options also allow realistic stop limits/stop orders to be used should you not be available throughout the trading day. These are simply not viable order types that can be used with the larger index products, due to their spread widths.

So what’s the downside to using ETFs like the IWM and the SPY?

First of all, if you are trading a larger account, then you’ll be paying a much larger share of commissions. I incur about 5 times the commission cost to make a similar return vs. the larger index products. I adjust my credit limit slightly to help pay for these commissions. If I were trading a very large Retail account, I would probably diversify some of my orders to include the larger index options just to keep the costs down. As of this writing, some brokers offer more “wholesale” pricing that can dramatically help reduce the cost of commissions.

Secondly, ETF options are American-settled products; this means that you can’t let them get “in the money” otherwise you risk early assignment of the underlying instrument.

When you put all the factors together, I think you’ll agree that ETF options allow the average Retail trader to realize a much more precise “edge.” It’s not what you make, it’s what you keep.

As a final caveat to this, keep in mind that if you trade the Low Probability Iron Condors, you actually NEED the characteristics of the European-settled Options like the SPX, RUT, XSP, DJX, etc. With that type of strategy, the weaknesses listed above really become less impacting to you. I only trade instruments like the SPX, RUT, and XSP with Low-Probability Condor positions.