The Iron Condor Trading Guide

By Doc Severson
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Foreword

If you’ve been trading stocks or options 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 a whole year 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.

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.

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 wrote this trading guide to complement the OptionsMD IncomeRx newsletter. I trade options credit spreads on major US stock indices to generate monthly income in a safe, consistent manner.

And you can, too.
Introduction - The Mission

As Stephen Covey would say, let’s begin with the end in mind. The purpose of this trading guide is to show you how to build a consistent income-producing system that can pay you anywhere from 1% to 10% a month on your risk capital.

At first glance, that might not sound like a lot. But annualize that, and 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 couple of pages 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.

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 will use for this type of monthly trade 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.

What does an Iron Condor look like on a chart? Refer to Figure 1; 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 1, it usually trades within a defined range:

![Figure 1](image)

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), the Russell 2000 (IWM), and the Dow 30 (DIA). 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. 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, DIA 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 position for all of the strategies that I play to no more than 40% of my account. This means that if I am trading a $10,000 account, I would use no more than $4000 of it, for all strategies during a given month. And on any given trade, I 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.

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.

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 2 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:

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. 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 in the context of a football team:

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 3. 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.
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 4 how the price tends to move back and forth, all the time under the influence of a larger, slower trend:

Figure 4
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, DIA 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. Don’t overtrade your account.

For example, in Figure 5 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 5](image)

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 use an “extrapolation entry” (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 IWM as my primary instrument, then I will use the SPY 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 Entry**

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**

I will make this a quick primer as there are plenty of great references to teach the reader about the basics of entering an Options-based credit spread. An excellent book is “Options Made Easy” by Guy Cohen.

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.

**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!

Better online brokers now offer these measurements. 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 .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 6 shows a thinkorswim chain of the IWM July 2008 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 62 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 (100-12.25%) = 87.75% 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.

For the 60/62 strike prices, the spread is showing a Natural Credit of (.43-.32) or $.11, and a Natural Debit of (.46-.26) or $.20. The “Midprice” of this spread is halfway between $.11 and $.20, or about $.16.

Figure 6

<table>
<thead>
<tr>
<th>Exp</th>
<th>Strike</th>
<th>Bid</th>
<th>Ask</th>
<th>Prob Exp</th>
<th>Delta</th>
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</thead>
<tbody>
<tr>
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<td>.11 C</td>
<td>.16 C</td>
<td>4.51%</td>
<td>-.03</td>
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<td>.32 C</td>
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<td>-.07</td>
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<td>10.36%</td>
<td>-.08</td>
</tr>
<tr>
<td>JUL</td>
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<td>.46 C</td>
<td>12.25%</td>
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</tr>
<tr>
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<td>14.48%</td>
<td>-.12</td>
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<td>-.14</td>
</tr>
<tr>
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</tbody>
</table>

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

**IWM July 60/62 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)
I can also evaluate the spread which is one strike further out of the money at IWM 59/61. Using the same process, this spread is currently showing $.08 Natural Credit x $.135 Midpoint; this would be difficult to fill for a minimum $.15 credit and would take an additional move down, or a volatility spike for the numbers to support a reasonable chance of filling a $.15 minimum credit.

Similarly, the strike pair at IWM 61/63 (which is closer to the money) is showing a $.14 Natural Credit x $.18 Midpoint; this would be a rather easy fill at $.15 credit but your position is now one strike closer than the IWM 60/62 pair. 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 lower than 90%; 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 67% probability spreads that offer a 1:1 risk/reward ratio. (these are featured in the OptionsMD Daily Newsletter as “Low Probability” trades) In the meantime, the key behind long term success with 90% 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 7 we show the July IWM 60/62 spread being entered by right clicking on the 62 strike, and selecting the “Vertical” spread option:

**Figure 7**

Once you select this option, the order entry dialog will show at the bottom of the screen as shown in Figure 8, which is where you will specify your minimum credit, the strike pair, quantity, and terms of the order:

**Figure 8**

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. **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 3) 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 that 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 75% 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.
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 .25 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 10 shows how this trade would be entered:
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.

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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 credits larger than $.15, and by playing the larger Index options. Early exits on $2 ETF spreads receiving a $.15 credit are difficult to achieve 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 4:15pm ET.

But that closing price is not what your monthly options are based on. It’s the SPX Settlement price (symbol $SET, or $RLS 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 to the upside. 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 will are detailed in the OptionsMD Mentoring course.
Final Thoughts

I hope this Iron Condor Trading 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. 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. The concepts are not simple and will require diligence on your part to achieve competency, but I’ve laid out everything required in a very graphical and illustrative manner in the OptionsMD Mentoring Program.

I hope for your continued success! I am always available to help in any way possible, either through direct emails, or through my daily newsletter.

Good trading.....

Doc Severson
Appendix A - What Instruments should we trade?

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, 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 - inotherwords 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, new brokers have become available that trade any quantity of options for a flat or reduced-commission fee; this might significantly change the economics of these trades in your favor.

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.
About the Author

Doc has been investing in the Market since 1996, and has focused exclusively on Options and Futures since 2004. Not unlike the rest of the Retail Investor crowd, he did well with stocks in the late 90’s and had mixed results with applying a directional strategy towards long Options. Spectacular gains were mixed with confounding losses as underlying equities whipsawed back and forth and generally did the exact opposite of what they were “supposed” to do.

Being a problem solver, he sought out professionals; how were they making money? Over time, it became apparent to him that Options Sellers held the edge, and doing so on a stock index increased that edge due to the consistent price action. Doc now actively trades the system outlined in this eBook for a living, and provides trading commentary through his 5x weekly newsletter.

He holds two degrees in Electrical Engineering, and an MBA. He spent 19 years in the Telecommunications field, and is an Adjunct Professor in Business and Economics; explaining difficult topics in a simple manner is his passion.

He can be reached with comments or questions at doc@tradingconceptsinc.com