Iron Condor Trading Plan

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Introduction: This report will gives you the basics of what an iron condor is, how it works, the pros and cons of the strategy, and how to trade it.

It will also give you a specific trading plan to trade conservative iron condors.

The basics come first, then the trading plan. I urge you to read the basics first to get a firm understanding of how I think about the condor. This will give you a better understanding of how and why I developed the trading plan.

The Iron Condor

The iron condor is an option trading strategy that uses two credit spreads.

The strategy is simple: Sell credit spreads out of the money: both puts and calls thus creating a "box". As long as the underlying, stock, etf, or index stays within this box, the trade makes money. Since you are selling options the trade results in a credit, and this credit is the maximum amount you can make on your iron condor trade.

When you place an iron condor trade, you will be selling the condor. In most circles this is considered a short iron condor. I myself do not know too many traders that trade long iron condors, mainly because in a long iron condor you want the stock to move a lot and if you feel a stock is going to make a large move, there are other option strategies that can make you more money. So I will focus on the short iron condor.

When you trade an iron condor, you want the underlying not to move very much. The biggest threat of the iron condor is a large move in one direction, especially if it is early in the trade. The condor is a slow trade, meaning that it takes time for the options to decay and lose value.

The iron condor is also considered a very conservative trade because you can set it up to have a very high probability of profit. The iron condors I trade are in the 75-80% probability of profit range. And since the underlyings that I choose do not move much, I do not need to spend much time monitoring my position.

Let's look at an iron condor example. Let's say I trade a condor spread on IBM. If IBM stock is selling at 100, I might short the following iron condor:

Sell the 115 Calls, Buy the 120 Calls.
Sell the 85 Puts, Buy the 80 Puts.

This trade creates a box that puts my expiration breakeven points at roughly 85 and 115. As long as IBM stays within those prices, my iron condor example will make money.

If I have this trade on, I can check IBM's price movement 1-3 times a day. As long as it is not near an adjustment point, I don't have to do anything.

The Lazy Man's Trade

Put it on, watch it once or twice during the day, and that's it. Entering the trade takes less than ten minutes when you know what you are doing, adjusting it takes just as long if you have a trading plan, and exiting the trade can be as easy as doing nothing and letting the options expire worthless or exiting the trade (which is the same as entering but easier).

The Benefits of the Iron Condor

1. High Probability of Profit

2. High monthly return on investment: 8-15% a month

3. You can do the same trade month after month on the same underlying. You do not need to "wait for a set-up".

4. Easily adjusted so you can save your trade if it goes against you.

5. Takes very little of your time.

6. Can be done anywhere in the world with access to the internet.

The Negatives of the Iron Condor

1. Since the reward is high, the risk can also be high. An iron condor trader can risk $9 to make $1. He will win most months. But even one loss of $9 will wipe out several months of gains.

2. The trade takes time and patience. A trader has to wait for the options to lose value.

3. The iron condor is not the best trade in very volatile markets.

Iron Condor Philosophy

Stocks move up and they move down. Very rarely do they move in only one direction for an extended period of time. Since most of the time, stocks trade in a range, why don't we make money from the range, instead of trying to determine if they are going up or down?

That in essence is the philosophy of the iron condor spread. No need to determine which way the market will move, because within a 30-50 day time period chances are that the market will stay in a range. Over time, it may move in one direction. But in a short period of time it probably won't.

So let's sell options that are far out of the money, which have very little probability of hurting us, and make money by selling time. As days go by, the options lose value, the markets go up and down, and we profit.

Iron condor spread trading is non-directional trading. An iron condor trader does not need to know which way the market is going. It helps if he does know, but my opinion is that no one can accurately predict over and over which way the market is going or where it will go to.

So when people ask me what I think of the market, I tell them "I don't know". And as an iron condor spread trader I don't really need to know. As long as it gets to wherever it is going slowly, my iron condor spread trades will make money.

Two Types of Condor Traders

There are two major schools of thought when it comes to the Iron Condor spread. The first school says that the condor spread trade is a strategy that works on its own. In other words, no adjustments are needed. If you let it do its thing, over time the trade will make money.

The other school of thought says that you should adjust your condor spread trades when they get into trouble.

I fall into the second school. I don't like losing money and taking a max loss on a condor trade by not adjusting it can be a depressing event.

By adjusting a condor, I mean to make changes to the original position to impact the trade. There are many different adjustments possible, and I will cover them later in this mini-course. By adjusting the trade, you give yourself an even better chance to make money. But every time you do an adjustment, you reduce the maximum yield you can make on the trade.

What Probability Do You Want?

Once an iron condor trader has decided if he will adjust or not, he must decide what probability of profit he wants to aim for. Does he want 60%, 70%, 80% or more? Based on this number he will pick his strikes (options to sell). The further away from the money, the greater the chance that the iron condor spread will make money, but the lower the yield and the greater the max loss.

I like to be in the 80% probability range.

Another way to influence the probability is the amount of time to be in the trade. A trader can be far from the money, with a high probability of profit, and a higher than normal yield, but only if he stays in the trade longer.

For example, an iron condor that is entered 50 days to expiration has more yield and option premium than one entered 25 days to expiration. But those extra 25 days add risk that something could happen in the market to hurt the position during that time.

How to Determine Strikes

When it comes to strikes, again we have two schools of thought.

One group of traders uses technical analysis to determine which strikes to sell. They look at the charts, find the support and resistance levels and whatever other technical indicators they use and sell strikes that they feel give them the best chance of making money.

The other group, of which I belong, use statistics and math to determine which strikes to sell. By using statistics you can set your strikes to have a high degree of confidence that your strikes will be safe. For example, you can set your strikes one standard deviation away from the money, or two standard deviations away. These deviations are calculated, using option prices, the volatility of the underlying, the time left to expiration, and several other factors.

Whichever of these two methods you use, keep in mind that there is no guarantee that the market will not violate your short options. So even with a high probability of profit, you can still lose money.

Risk Management

So far we have talked about how the iron condor has great probability of success and can generate a decent return month after month.

In this section we are going to talk about what happens when things go wrong.

Most traders say that iron condor options trading is a conservative strategy. Others say it is very risky because you can lose a lot more than you can make.

It all depends on how you set up the condor spread. You can choose strikes that are way out of the money and that give you a 95% probability of success or you can choose strikes that are close to the money and give you a 40% chance of success.

The closer your short strikes are to the money, the more your iron condor becomes a butterfly. A butterfly is also two credit spreads like a condor but close to the money.

As an example, let's look at a condor spread that has an 80% probability of success. In our example we get a credit of $1.00 and the max we can lose is $9.0. So we can make $100 per spread or lose $900. As you can see you don't have to lose too many times to lose all your money. Even if you win 9 times and lose once, you will be negative. And since the odds are saying you will win 8 times and 2 two times for every ten trades this is a losing proposition.

But no one said you have to lose the whole amount.

By using money management you can limit your losses in the months your condor spread is not going to make money. And yes, there are months where no matter your adjustments, you are still going to lose unless you are willing to throw an endless supply and money at it and are willing to roll into other months.

Instead of letting our condor spreads go all the way to the max loss; let's say we decide to limit our loss to 20%. For simplicity sake we will limit our loss in the example to $2. Once we enter the trade, we get $1. But if we are ever down $2 or $200 per spread then we exit the trade.

What about Stop Loss Orders?

You can use them. Place orders to buy back your spreads at whatever you decide as an acceptable max loss. That should help you sleep at night.

What about another 9/11 event?

The iron condor does well when the markets are flat. Or if they go in one direction then it works if the move is a slow on. A major event like a 9/11 event that makes the market move huge in one day can kill an iron condor trader.

Normally, these types of moves happen to the downside. If there is a nuclear explosion, or war, or earthquake, or anything similar, the markets will drop. As is the common phrase "Bulls go up the stairs. Bears go out the window.”

An iron condor trader can protect herself from such an event by buying Put insurance. You simply take some of the credit you get and buy enough put protection to protect yourself in case the word ends. With this insurance, if the markets go down enough you can still make money even if you lose the max on the condor spread.

To mitigate the risk of getting to the max loss, you simply decide on an exit point. “When I am down ____ % or $_____ I will exit the trade and live to trade another day.”

And to protect yourself from the end of the world, simply buy some Put(s) as insurance. How many puts and which puts is a matter of personal preference and depends on your trade size.

Creating Your Own Trading Plan

There are as many iron condor trading strategies as there are iron condor traders. Everyone has their own preferences and style.

To create your own iron condor strategy you have to first choose the underlying. You don’t really need an iron condor screener or software program to find suitable candidates for you. Stick to Indexes and ETFs at first. As you become more experienced you can move into stocks.

Indexes and ETFs have the benefit of being composed of several companies and so the news, good or bad, of any one company will not affect the price as much. Pick one that you feel is relatively stable. Some good candidates are: SPX, SPY, RUT, IWM, DIA, QQQQ, NDX, MNX, XLE, XLF, and RTH.

Step two in creating your own iron condor strategy is to decide how far out from the money you want to go. The farther out, the greater the probability of profit but the lower the return. You have to offset this by going out farther from expiration.

So let’s say you are looking to sell an iron condor on SPY that has an 80% probability of success. If you sell it at 60 days from expiration your max gain can be 18%, but if you sell it 30 days from expiration you can get only 11%. Which do you go for? With experience you will be able to determine which is the best time to get into a condor that is best suited to your risk tolerance and trading style.

Step three in creating your iron condor trading strategy is creating your trading plan.

How many spreads will you trade?
How much money will you put at risk?

Will you get into both the puts and call at one time, or will you leg in?
Will you use all your capital or keep some in reserve for adjustments?
Will you adjust or not?
Will you enter all the spreads at one time, or will you enter some today and more a few days later to try to diversify the trade?
What will be the max loss you are willing to accept?
Will you take the trade off for a profit before expiration?
If yes, then when, and under what circumstances?

As you can see there are a lot of things to think about when trading iron condors. The better your trading plan, the less you have to worry about when you are in a trade that goes bad.

Adjustments

Adjustments are what separate the men from the boys.

Some traders and advisories say that you do not need adjustment. That they only lower your return and increase your commissions. That without adjustments your trades should work out due to the probabilities.

That has not been my experience. I have backtested several no adjustment iron condor strategies and have not found one that worked on a consistent basis without very large drawdowns in equity.

So why would an advisory not like adjustments?

I think it is because it makes it much harder to keep subscribers. The easier the trade, the more people will stick around with the service.

Even with my service when a trade gets hairy and there are several adjustments, members lose confidence and drop out.

But I still have to trade the way I know how. If some people drop out, there is nothing I can do about it.

The iron condor trade will need an adjustment about 50% of the time if you are a conservative trader. When to adjust and how to adjust are difficult concepts that can take several trades to master. When it comes to iron condor trading, experience really is the key to success.

You should know when you will adjust before you enter the iron condor trade.

1. One common method of choosing an adjustment point is by watching the deltas of your short strikes. For example, one trader I know enters a condor spread position 27 days from expiration using short strikes that have a 18 delta (or as close to it as he can find). He then will adjust his position when his short strike is one or two strikes away from the money.

So if he was trading the RUT, and his short call strike was 600, he would adjust his call spread when the RUT got to 590. And he would adjust by using a butterfly to roll his call spread up one strike.

If he is trading one spread, he would be short 1 600 call and long 1 610 call. To adjust he would Buy 1 600 call, Sell 2 610 calls, and Buy 1 620 call. The result of this adjustment is that he is now short 1 610 call and long 1 620 call.

2. Keeping It Delta Neutral

Another method of adjusting the iron condor trade is to keep the position delta neutral. The delta of the trade tells you much you will make or lose should the underlying move up or down 1 point. If your trade has a delta of 50, you will make $50 if the underlying goes up 1 point. Thus, the lower your delta the less you make or lose when the underlying moves.

If you keep your trade as delta neutral you are looking to stay in the trade until the time decay kicks in.

Staying delta neutral sounds great, but it is very hard to do since delta is always changing. A position of delta – 100 one day can be a position of positive 40 delta the next if you decide to go this route, you will be adjusting often and your commission costs will be much higher.

3. A very popular method of adjusting is called rolling. If one side of your trade gets into trouble, you simply buy back that spread and sell another one farther away from the money. If there is not enough time left in the trade, or the premium of the farther away options is not high enough you can even roll forward to the next month.

4. Buying puts and calls can also be a good adjustment.

By buying options, you will bring your delta closer to zero and even out your current p&l line.

Long options act as a buffer to the market moving in one direction against you.

5. Another method that some bold traders use is to buy back the short option in a credit spread and keep the long option hoping that the underlying keeps moving in the same direction.

So if the RUT is moving down rapidly, you can buy back the Put you sold, and keep the one you bought. If RUT keeps dropping, your long Put can make a lot of money.

Trading Rules

Ok, so now you know the basics.

Here is a trading plan you can use. A friend of mine developed this and it has been working very well for him. I use it as well.

Underlying to trade: RUT

Trade Entrance: Put this trade on 50 days before expiration. It's best to only have one trade on at one time. If you are still trading the previous month, wait until you are out of that trade to put on the next month (even if this means you put on the next month at less than 50 days).

Strikes: Sell the delta 10 strike or first strike under 10 delta on both sides.

Minimum credit: for each side/spread: .50 (.50 for Calls, .50 for Puts)

Target Profit: 60% of the total credit

Max Loss: Twice the Target Profit which is 1.2 times the total credit.

Adjustments: Adjust when either side gets to .20 delta. Take off entire trade (both sides) Wait until the next day. Reenter on a day when the underlying moves less than one standard deviation even if you have to wait a couple days. Choose new short strikes at delta 10.

Re-enter the entire condor with one and a half times the contracts you had in the original position. (See below for alternate strike positioning.) DO NOT wait significantly beyond delta .20 to adjust.

If underlying has moved more than 1 Standard Deviation or more on your adjustment day, wait to re-enter as above. You don't want to reenter on a day in which RUT is moving more than 1 Standard Deviation. <u>If you have to wait more than 3 days for movement less than 1 Standard Deviation, then don't re-enter the trade (the month is over.)</u>

Also, don't make adjustments with less than 14 days to expiration.

NOTE: Increase the size of the trade only ONCE. If you hit delta .20 a second time, you can either reposition the condor without increasing the size and reset your profit target at a lower level, or if you have hit the max loss, exit the trade.

If either spread (put or call spread) is ever worth .20 cents or less, take it off, and reposition it immediately back to the first strike less than .10 delta, but cut the size of that side in half (i.e, if you had a 10 contract spread that you took off for .20 cents or less, put the new one back on at 5 contracts.)

If you had previously increased the size by 150% due to hitting .20 delta as above, reset the size back to the original number of contracts. Check your analyze graph after each adjustment. If the total potential profit has decreased since you put the trade on, lower your profit target to be 60% of the new potential credit. Never increase the profit target from the original. Also, never increase the max loss target from the original under any circumstances.

Alternate strike repositioning: When repositioning the trade after taking it off at .20 delta:

a) If you took it off because the short call hit .20 delta (threatened on the upside), start by looking at the strikes on both sides that are the first ones less than .10 delta, and then <u>choose the strikes that are one strike lower on both sides</u>.

b) If you took it off because the short put hit .20 delta (threatened on the downside), start by looking at the strikes on both sides that are the first ones less than .10 delta, and then <u>choose the strikes that are one strike higher on both sides</u>.

The advantage here is that it doesn't take the trade back to totally delta neutral and recognizes the fact that the market is probably "tired". This works better in whip-saw markets.