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Understanding the Iron Condor

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OIC The Options Industry Council℠

Understanding the Iron Condor

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Presentation Outline

- Overview of Vertical Spreads
- Call Credit Spread
- Put Credit Spread
- Iron Condor
- Closing Thoughts

A Spread Transaction

A spread involves two or more positions:

Buy or sell one option and **buy or sell** another option:

- Likely the same underlying
- Likely the same expiration dates
- Likely different strike prices
- Possibly different quantities

- Spreads could also involve a stock position

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Vertical Spreads

***Buy* one** option and ***sell* another** option

- Same underlying and expiration
- Different strike prices
- Defined risk/reward characteristics

- **Debit Spread *(calls & puts)***
  - You pay premium to initiate the position
- **Credit Spread *(calls & puts)***
  - You receive the premium to initiate the position

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Call Credit Spread

Why a Call Credit Spread?

- Investor motivation:
  - Neutral and/or bearish outlook on the underlying
  - Defined risk / reward
  - Favorable break-even point
  - Profit potential heavily influenced by the amount of credit received

- Risk control
  - Defined profit potential
  - Defined maximum loss
  - Position monitoring is critical

Call Credit Spread Example

XYZ @ $88.50   28 Days to Expiration

- Sell 1 28-day 90 Call $ 3.50
- Buy 1 28-day 95 Call $ 1.80

Net Credit $ 1.70

- This investor is short the 90 / 95 call spread

This is a **neutral/bearish** call spread

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Call Credit Spread Example

XYZ @ $88.50   28 Days to Expiration

Sell the 90 – 95 call credit spread at $1.70

Maximum Gain: $1.70

Maximum Risk: $3.30

Margin: $3.30

Break-even: $91.70

What is this spread worth with XYZ at $88.50 in 21 days? In 7 days?

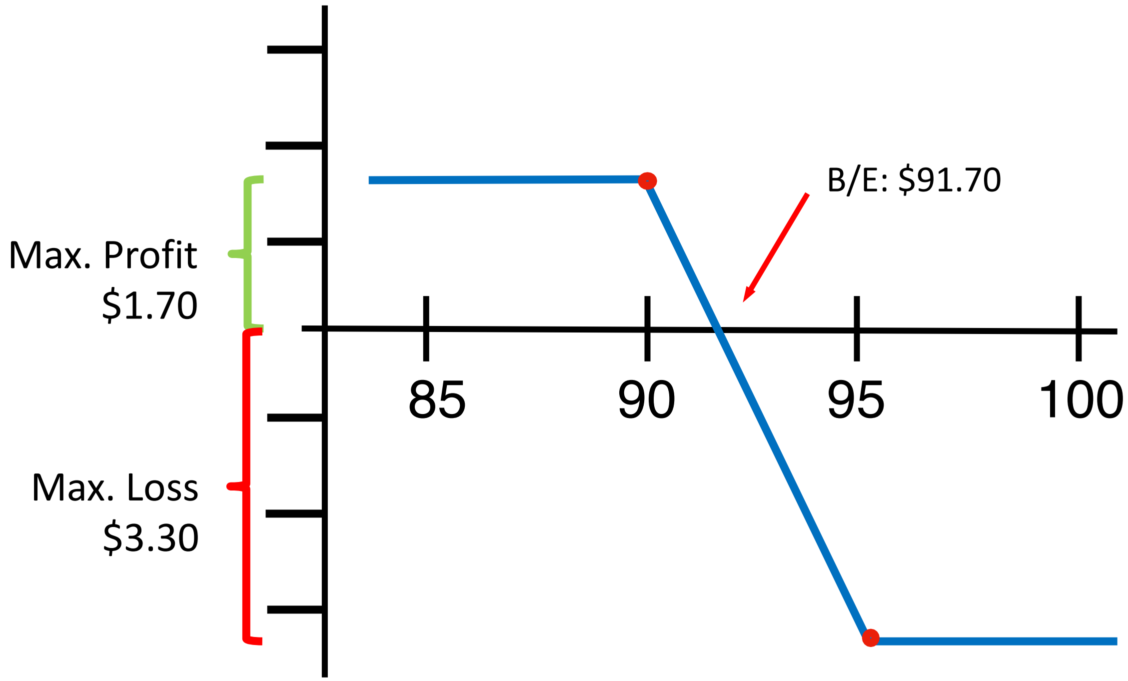
Excludes transaction costs

Call Credit Spread Example

Sell a lower strike call and ***buy*** a higher strike call

- Sell 1 90 Call $3.50
- Buy 1 95 Call <u>$1.80</u>

  Net Credit $1.70



What Happens at Expiration?

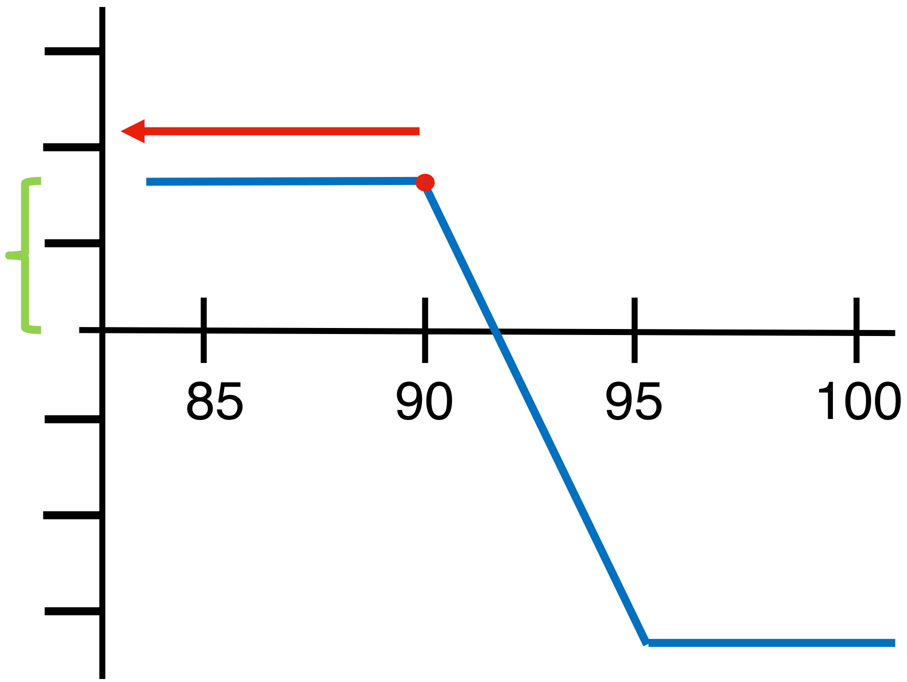
Stock is < or = $90?

Sell 1 90 Call $3.50

Buy 1 95 Call $1.80

Net Credit $1.70

Assignment risk: If stock is very close to $90, the uncertainty of assignment on the short 90 call results in uncertainty of possible stock position after expiration.



What Happens at Expiration?

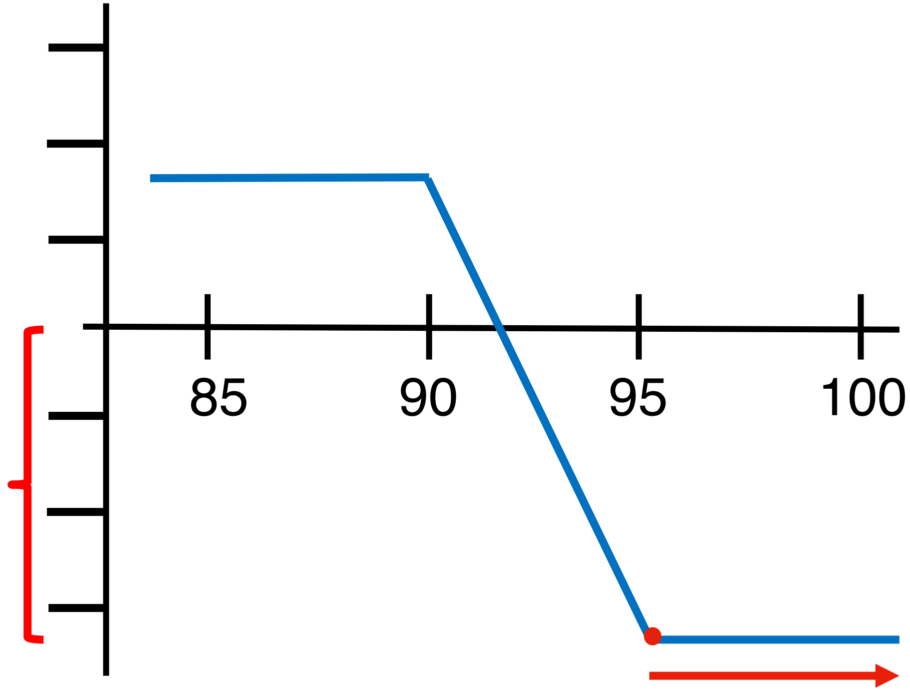
Stock is > or = $95?

Sell 1 90 Call $3.50

Buy 1 95 Call $1.80

Net Credit $1.70

Maximum loss = difference in strikes ($5) less premium received ($1.70) = $3.30
Short call is assigned, long call can be exercised to avoid stock position.



What Happens at Expiration?

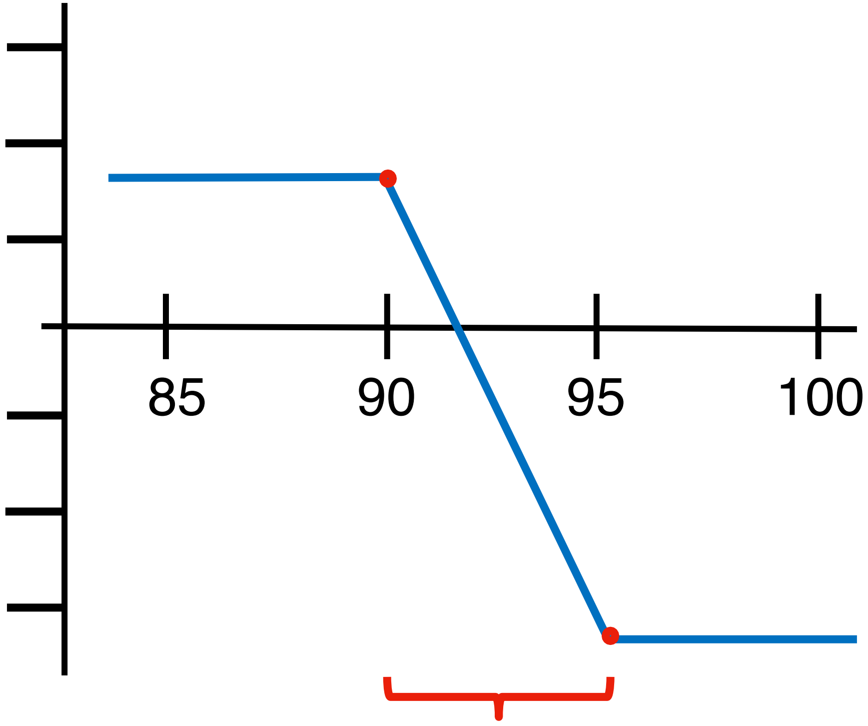
Stock is > $90 and < 95?

Sell 1 90 Call $3.50

Buy 1 95 Call <u>$1.80</u>

Net Credit $1.70

Short call is assigned = ***short stock***
Margin required
Long call expires out of the money/worthless



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Put Credit Spread

Why a Put Credit Spread?

- Investor motivation:
  - Neutral and/or bullish outlook on the underlying
  - Defined risk / reward
  - Favorable break-even point
  - Profit potential heavily influenced by the amount of credit received

- Risk control
  - Defined profit potential
  - Defined maximum loss
  - Position monitoring is critical

Put Credit Spread Example

XYZ @ $88.50   28 Days to Expiration

- Sell 1 28-day 85 Put $ 2.05
- Buy 1 28-day 80 Put <u>$ 0.70</u>

Net Credit $ 1.35

- This investor is short the 85 / 80 put spread

This is a **neutral/bullish put** spread

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Put Credit Spread Example

XYZ @ $88.50   28 Days to Expiration

Sell the 85 – 80 put credit spread at $1.35

Maximum Gain: $1.35

Maximum Risk: $3.65

Margin: $3.65

Break-even: $83.65

What is this spread worth with XYZ at $88.50 in 21 days? In 7 days?

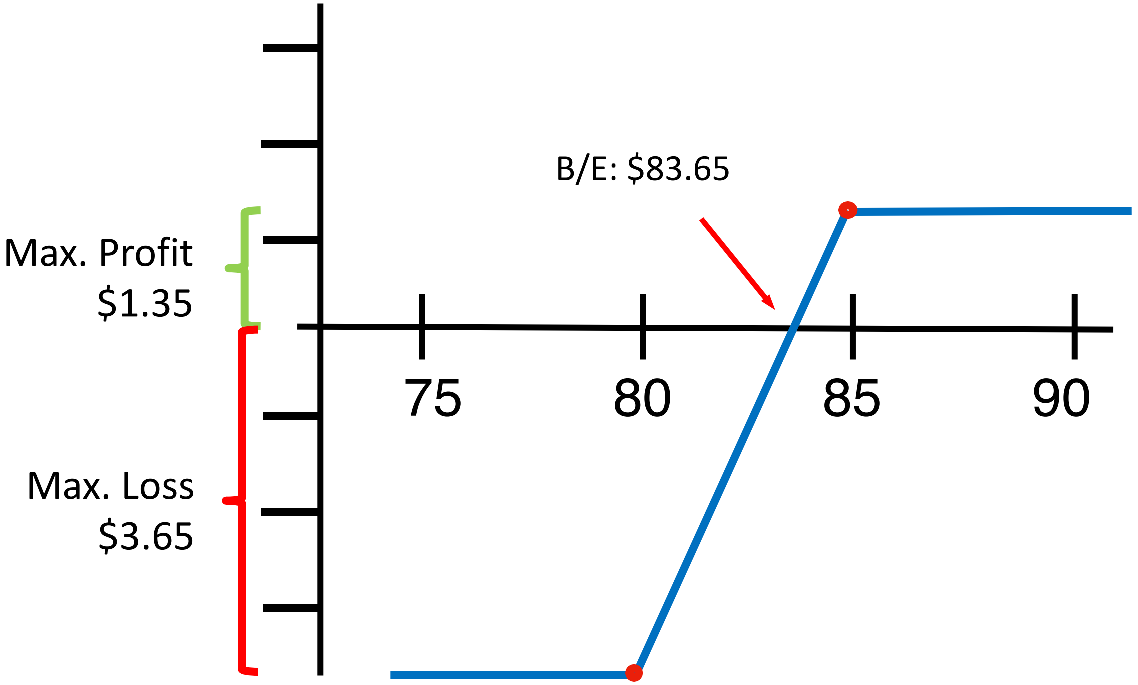
Excludes transaction costs

Put Credit Spread Example

Sell a higher strike put and ***buy*** a lower strike put

- Sell 1 85 Put $2.05
- Buy 1 80 Put <u>$0.70</u>

Net Credit $1.35



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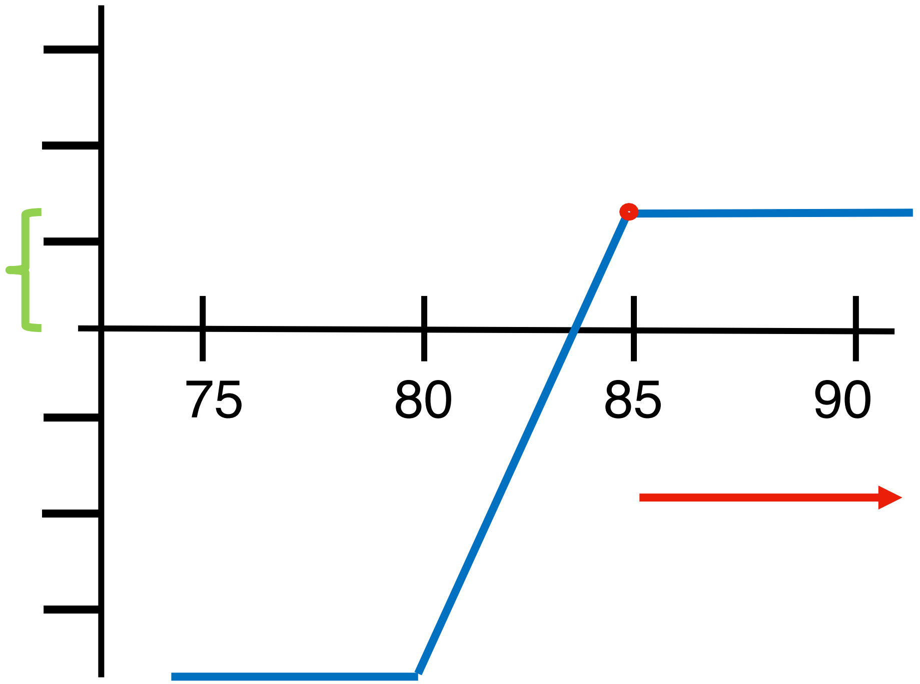
What Happens at Expiration?

Stock > or = $85?

Sell 1 85 Put $2.05

Buy 1 80 Put $0.70

Net Credit $1.35



Assignment risk: If stock is very close to $85, the uncertainty of assignment on the short 85 put results in uncertainty of possible stock position after expiration.

What Happens at Expiration?

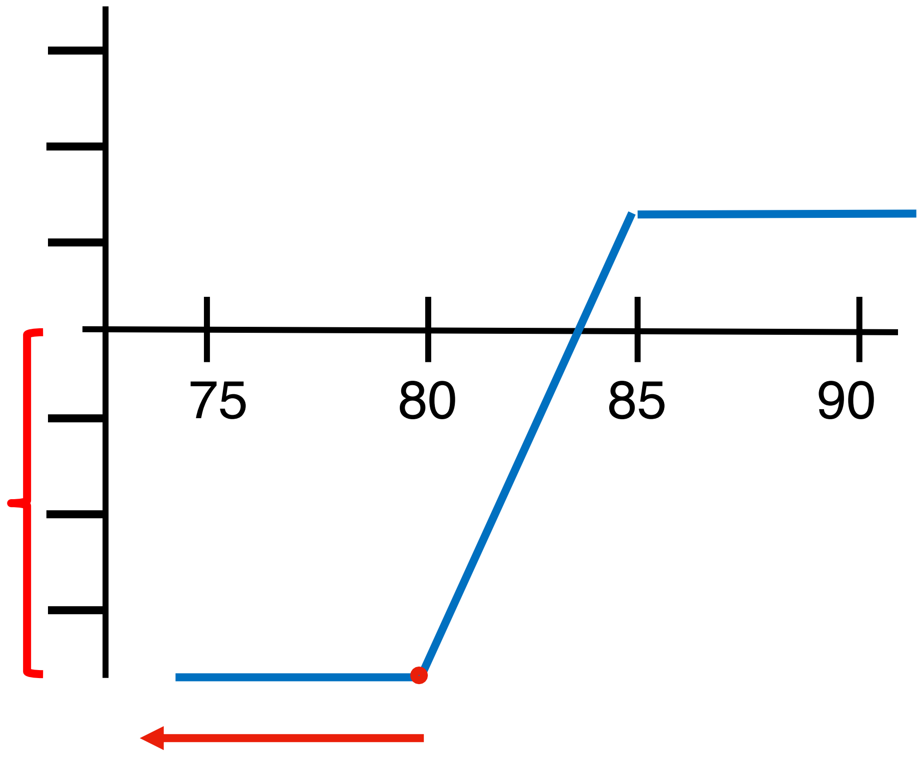
Stock < or = $80?

Sell 1 85 Put $2.05

Buy 1 80 Put <u>$0.70</u>

Net Credit $1.35

Maximum loss = difference in strikes ($5) less premium received ($1.35) = $3.65. Short put is assigned, long put can be exercised to avoid stock position.



What Happens at Expiration?

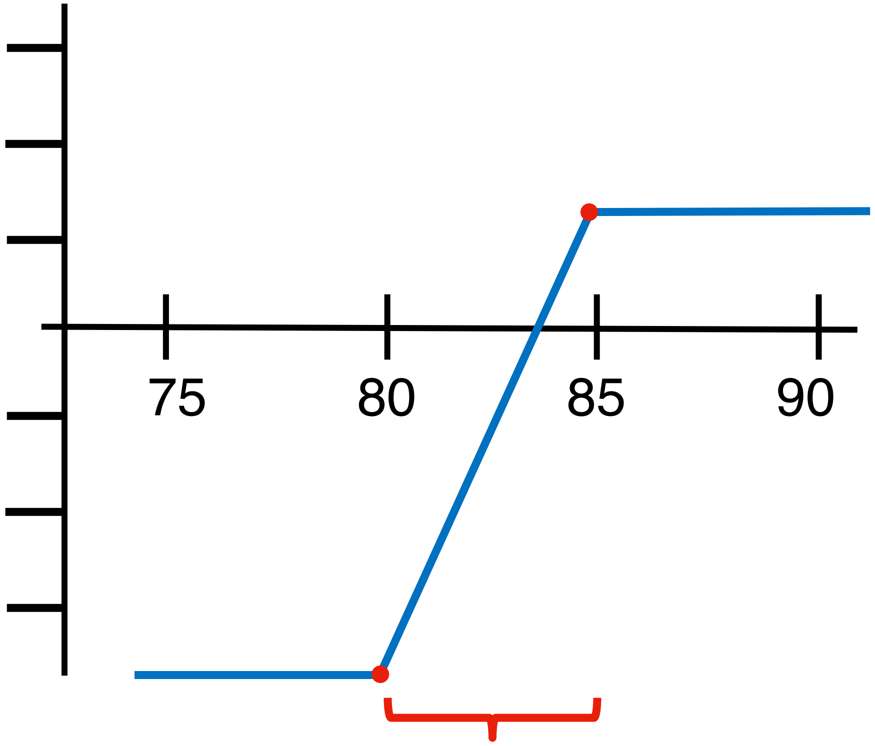
Stock > $80 and < $85?

Sell 1 85 Put $2.05

Buy 1 80 Put <u>$0.70</u>

Net Credit $1.35

*Stock price **between strikes** at expiration:*
Short put is assigned = long stock
Long put expires out of the money/worthless



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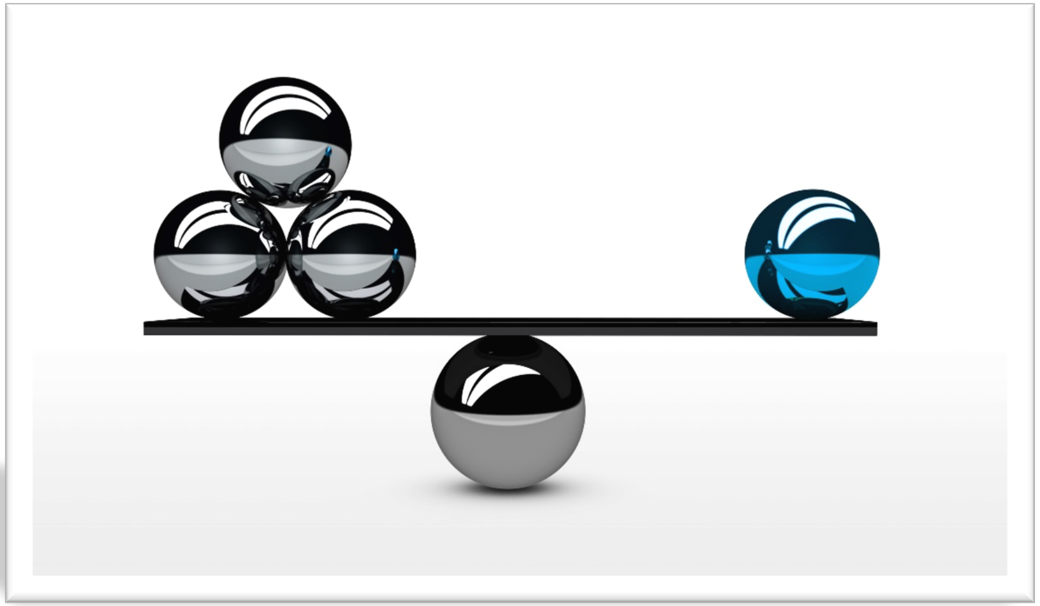
Iron Condor

The Iron Condor

There are some investors who believe that a stock is range bound – they are neutral on the stock and hope to benefit if there is not much price movement.

This is where a strategy known as the **Iron Condor** could be utilized.



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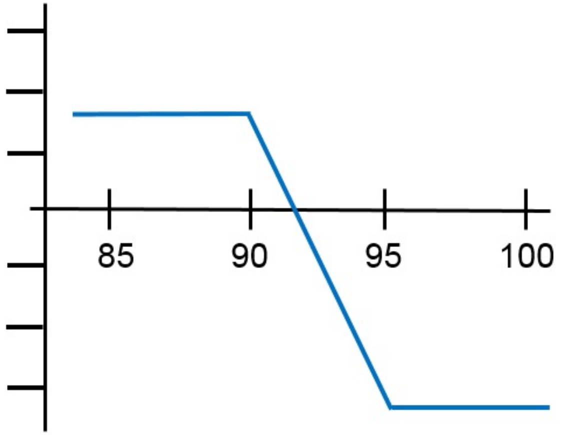
What is an Iron Condor?

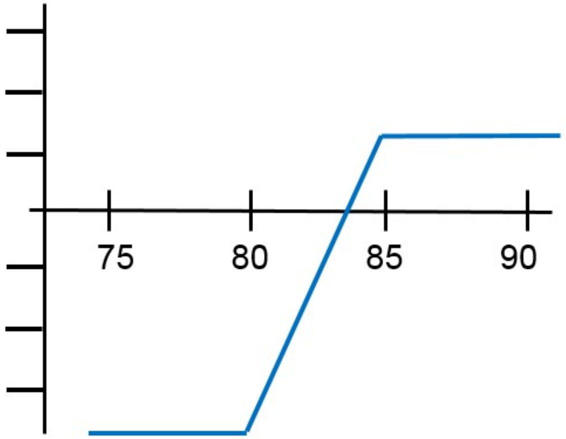
An Iron Condor is:

- The sale of a call credit spread

and

- The sale of a put credit spread





The same underlying, the same expiration month, both spreads employing out-of-the-money options

Iron Condor Example

XYZ @ $88.50   28 Days to Expiration

Expected price range: $85 to $90

Sell the 90 – 95 call credit spread at $1.70
Sell the 85 – 80 put credit spread at <u>$1.35</u>

Net Credit $3.05

- This is a ***typical*** Iron Condor

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Iron Condor Example

XYZ @ $88.50. Sell the 85-80 put credit spread and the 90-95 call credit spread at $3.05

Maximum Gain: $3.05

Maximum Risk: $1.95

Margin: $1.95

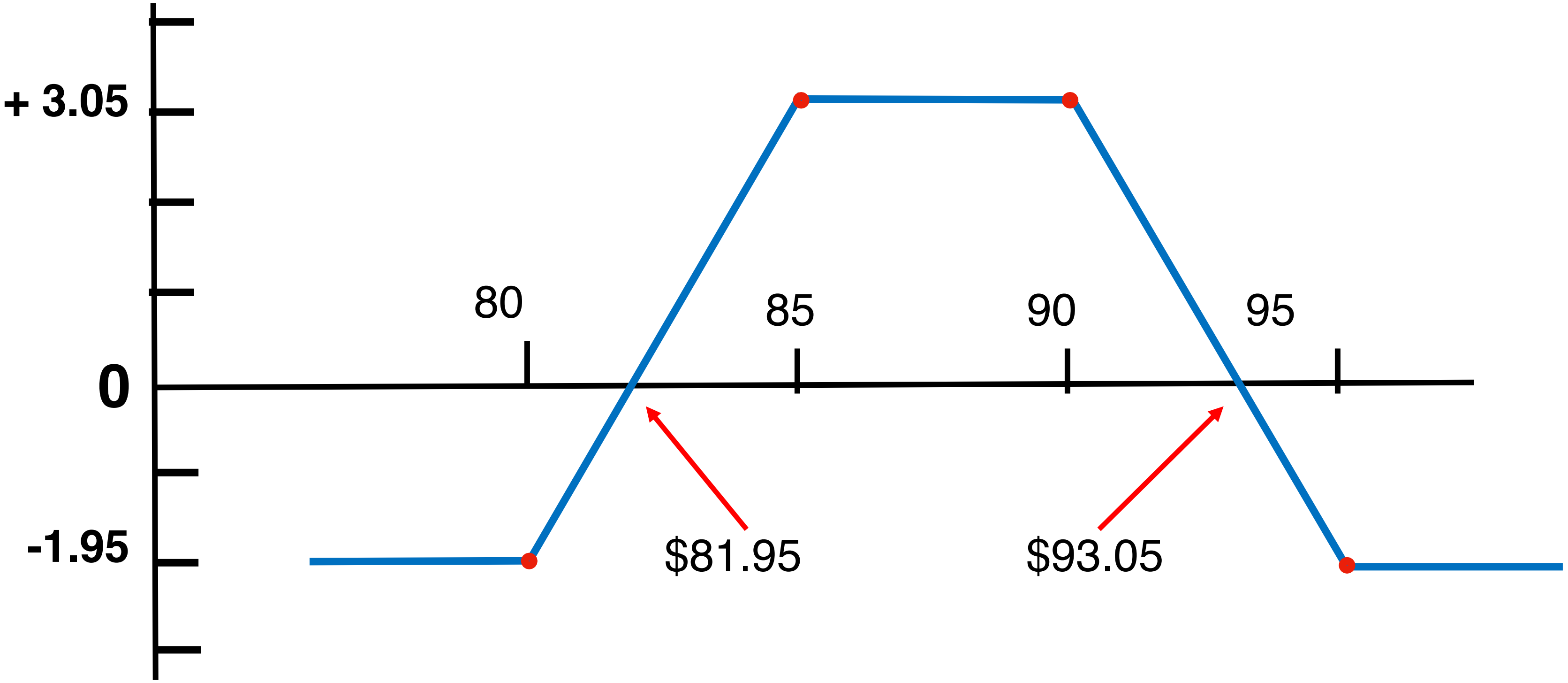
Break-even: $93.05 and/or $81.95

Excludes transaction costs

Iron Condor P & L

Sell the 90-95 call credit spread and

the 85-80 put credit spread for a net credit of $3.05



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