

The Iron Condor

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1 The Iron Condor

1.1 What

- The setup is the following
 - Sell a Call (more expensive)
 - Sell a Put (more expensive)
 - Buy a further OTM Call (cheaper)
 - Buy a further OTM Put (cheaper)
 - All Options with the same Underlying and with the same expiration date.
- It is essentially a combination of one Call Credit Spread and One Put Credit Spread. It is a way to have a strangle with limited risk.
- It is a neutral strategy. You'll make money as long as the Underlying does not move below the strike price of the short Put, or above the strike price of the short Call. For complete neutrality, both the Call side and the Put side should have the same probability of expiring ITM.

1.2 Recommendations

- We recommend the sold Options be:
 - OTM
 - Around 1.5 SD away from the current price levels, with less than a 20% probability of being ITM on expiration day.
 - With 1.5 months to 1 week of life left on the Option.
- We recommend the bought Options be:
 - Further OTM
 - More than 1.5 SD away from the current price levels, with less than 15% probability of being ITM upon expiration.
 - With 1.5 months to 1 week of life left on the Option.
 - Essentially the more OTM sister of the sold Option.

1.3 Risk/Reward

- Maximum profit: Limited to the total premiums received, (premium from the sold Call plus the premium from the sold Put) minus (premium spent in the purchase of the bought Call plus the premium spent in the purchase of the bought Put).
- Maximum risk: Limited to the difference of the strike prices between the bought and the sold Option, minus the total premium received.
- Breakeven: Strike price of the Call plus the total premium received and the strike price of the Put minus the total premium received. The Underlying must be between these two breakeven points in order to make money.

1.4 Example

You sell the ORTY \$40 Oct15 Call for \$5 and you also sell the ORTY \$30 Oct15 Put for \$5

You buy the ORTY \$45 Oct15 Call for \$3 and you also buy the ORTY \$25 Oct15 Put for \$3.

1. Scenario A:

In October, ORTY trades at \$35. Since \$35 is lower than the sold Call's strike price, and higher than the sold Put's strike price, both options you sold are OTM and so they expire worthless. The Options you bought also expire worthless. you keep 100% of your profit: (the \$5 received when you sold the Call plus the \$5 you received when you sold the Put) minus (the \$3 spent to buy the Call plus the \$3 spent to buy the Put) = $10 - 6 = 4$.

2. Scenario B:

In October ORTY trades at \$60. Since \$60 is higher than the Call's strike price, the Option is \$20 ITM, that is your loss. However, the Call you bought is \$15 ITM, so your loss on the Call side is $20 - 15 = 5$. On the other hand, both the Put you sold and the Put you bought have expired worthless. The \$5 loss from the Call is compensated by the \$4 total premium received, so your total loss is only \$1.

1.5 When

- Look for Underlyings that have high IV Ranks (above 75). As this is directionally-neutral, a pure volatility play, this condition is essential to succeed. This will also mean you will have to pay more for the cheaper further OTM Options, but your main profit generator is the selling of the Options and the buying is just a hedge.
- Liquidity is absolutely critical in this strategy, as it will be very hard for nicely-priced Iron Condors to get filled in Underlyings with poor liquidity. So look for big cap, liquid, popular stocks that have high Options trading activity.
- This strategy attempts to profit from both people's excessive greed and fear. It is especially useful when dealing with Underlyings in which people expect big movements but are unsure over the direction (eg. before an earnings report is released). This uncertainty and expectation drives up the implied volatility and therefore the price of both Calls and Puts. So you sell both OTM junk Calls and Puts. It's just that you also buy cheaper Calls and Puts in case the movement is larger than you expected.
- You believe the expected movement will not be as significant as people think. History tends to prove that the predicted moves are usually less than the moves the stock ends up experiencing. However, in case the Underlying moves more than expected your risk is capped because you have the long Options in your back pocket.

1.6 Pros

- Compared to just selling two credit spread, doing both at the same time gives you double the premium, without increasing your risk (as the Underlying can only move in one direction at one time, and therefore at least one of the sides will expire worthless).
- Compared to selling a strangle, the Iron Condor allows you to limit your risk very significantly, and therefore reduce the cash and margin requirements that your brokerage firm will require from you before you can trade this.
- You can make money if the Underlying falls, doesn't move, or moves up, as long as it doesn't move in such a significant way that the breakevens are crossed.
- You know exactly what your maximum possible profit and your maximum possible risk are before entering the trade.
- If you follow our recommendations, you are very likely to be successful, as the odds are in your favor.

1.7 Cons

- As it is a multi-legged Option strategy (you are trading four different Options), you will face:
 - Higher commissions, which increase your costs and harm your returns.
 - Liquidity and volume issues, which means it might take a long time for your order to get filled at the price you wanted, and you might have to settle for less initial premium in order to get your trade filled (price slippage).
 - It is harder to track, as there are four different Options in your portfolio and each one moves independently.
- Time decay is no longer overwhelmingly on your side as its beneficial effects on the sold Options are offset by the value erosion experienced by the bought Options.

1.8 The Greeks of The Iron Condor

- Δ : Neutral
If done properly, the price of the Underlying doesn't affect you unless it moves big.
- Θ : Neutral
The decay from the long Options are offset by the gain from the short Options.
- Vega: Neutral
The long Options gain is again offset by the short Options loss.