Options strategy: Selling an at-the-money straddle

By Dan Keegan

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In the real world there is much greater fear to the downside. On Aug. 22, 2008, the S&P 500 was trading at 1262 with the VIX at 18.81. In less than two months, the S&P 500 had plummeted to 866 with the VIX skyrocketing to 69.95 (see "Reversal of fortunes"). The VIX reached its apex of 89.53 on Oct. 24 with the S&P 500 trading down to 835. By Jan. 6, the S&P 500 had rebounded to 922. The VIX had descended to 38.56. On March 9, the S&P 500 made a new low, 672, for the move and a 12-year low. The VIX, compared to the October move, yawned, only reaching 49.68. April, May and June have been a time of steady decline in the VIX. Premium sellers have ruled. The market had all of the makings of one of those lazy, hazy range bound days of summer. On July 1, the VIX hit an intraday low of 24.80. Then July 2 came along.

The S&Ps dropped 25 points and the VIX closed at 27.95. Could this be a major break, or is the market just testing the range? It presents a premium selling opportunity.

The logical method of selling broad market premium is to sell options on the S&P 500. This can be accomplished through the selling of options on the S&P futures or the selling of options on the exchange traded fund (ETF) SPY. This example will use the ETF SPY. SPY also goes by the nickname "spider."

The SPY August 90 straddle can be sold at 6.80. The calls for 3.30 and the puts for 3.50. There are seven weeks until expiration. There needs to be at least a 7.5% move in either direction for the trade to be a loser. A short straddle is the sale of a call and a put at the same strike and is betting on lower volatility. If the S&P 500 stays between 832 and 968, the trade is a winner. The implied volatility for SPY Aug 90 puts is 24.8 and the Aug 90 calls have an implied volatility of 24.8.

SPY options are positively skewed to the downside and negatively skewed to the upside. The volatility skew is a condition where implied volatilities vary by strike. A positive skew means that the implied volatility for options increases the further the option is from at the money; a negative skew means that the implied volatility decreases further out.

The short straddle poses great risks should an extraneous event jolt the market in either direction. The purchase of a long strangle can establish a defined risk in the position.

The SPY Aug 83 put can be purchased for 1.38 (an implied volatility of 29.8). The SPY Aug 97 call can be purchased for 0.72 (an implied volatility of 22.7). That is a total of 2.10 for the strangle purchase. The most that can be made on the position is 4.70. Losses are limited to 2.30. If SPY is above 94.70 or below 85.30, the position is a loser. This position is known as an "Iron Butterfly." The cost of protection can be lowered by purchasing a July strangle for 0.97. It would provide tighter protection with July 94 calls and July 86 puts. The protection, however, lasts for only two weeks. This will work if there is a substantial drop in the implied volatility for August options or there is a major move within that two-week period.

The Iron Butterfly allows the investor to sell premium with meat on the bone, while limiting losses. That's a good combo.

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