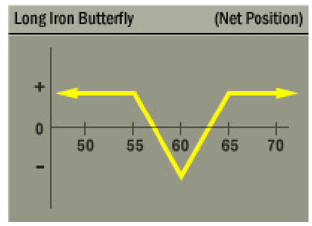
Long Iron Butterfly

Description

This strategy combines a short call at an upper strike, a long call and long put at a middle strike, and short a put at lower strike. The upper and lower strikes (wings) must both be equidistant from the middle strike (body), and all the options must be the same expiration.

An alternative way to think about this strategy is a **long straddle** with a **short strangle**. It could also be considered as a **bull call spread** and a **bear put spread**.



Net Position (at expiration)

EXAMPLE

Short 1 XYZ 65 call
Long 1 XYZ 60 call
Long 1 XYZ 60 put
Short 1 XYZ 55 put

MAXIMUM GAIN

High strike - middle strike - net premium paid

MAXIMUM LOSS

Net premium paid

Outlook

The investor is looking for a sharp move either up or down in the underlying stock during the life of the options.

Summary

This strategy profits if the underlying stock is outside the wings of the iron butterfly at expiration.

Motivation

Profit from a move in the underlying stock in either direction.

Variations

While this strategy has a similar risk/reward profile to the **short call butterfly** and **short put butterfly**, the long iron butterfly differs in that a negative cash flow occurs up front, and any
e in the future.

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ck is either above or below the body of the butterfly by the amount of premium paid to initiate the position.

Volatility

An increase in implied volatility, all other things equal, would have a positive impact on this strategy.

Time Decay

As with most strategies where the investor is a net buyer of option premium, passage of time, all other things equal, will have a negative effect on this strategy.

Assignment Risk

Yes. The short options that form the wings of the butterfly are subject to exercise at any time, while the investor decides if and when to exercise the body. If an early exercise occurs at the wing, the investor can exercise an option at the body (put or call, whichever is appropriate) to lock in the maximum gain and continue to hold the other half of the position, which might still have value. So early exercise might be a good thing, although it may require borrowing stock or financing stock for one business day.

And be aware, a situation where a stock is involved in a restructuring or capitalization event, such as a merger, takeover, spin-off or special dividend, could completely upset typical expectations regarding early exercise of options on the stock.

Expiration Risk

Yes. This strategy has expiration risk. If at expiration the stock is trading right at either wing the investor faces uncertainty as to whether or not they will be assigned on that wing. Should the investor not be assigned on the wing, they could be unexpectedly long or short the stock on the Monday following expiration and hence subject to an adverse move over the weekend.

Comments

N/A

Related Position

Comparable Position: **Short Call Butterfly**

Opposite Position: **Short Iron Butterfly**

Post Rating

11 Ratings