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Strategy: Skip Strike Butterfly Spread

BY DAN KEEGAN

Let's look at SPX, IBM and FB to determine which one is the best candidate for a skip strike butterfly. SPX is trading at 2083.56, IBM at 156.32and FB at 95.12. A normal long call butterfly combines a 90-95 bull vertical call spread with a 100-95 bear vertical call spread. Each spread has an equal amount of contracts. The strike price differential is the same for both vertical spreads. A skip strike butterfly combines a 90-95 bull vertical call spread with a 105-95 bear vertical call spread. The vertical spread that you are selling is twice the width of the one that you are buying. A gap move to the upside would be disastrous for the holder of this spread.

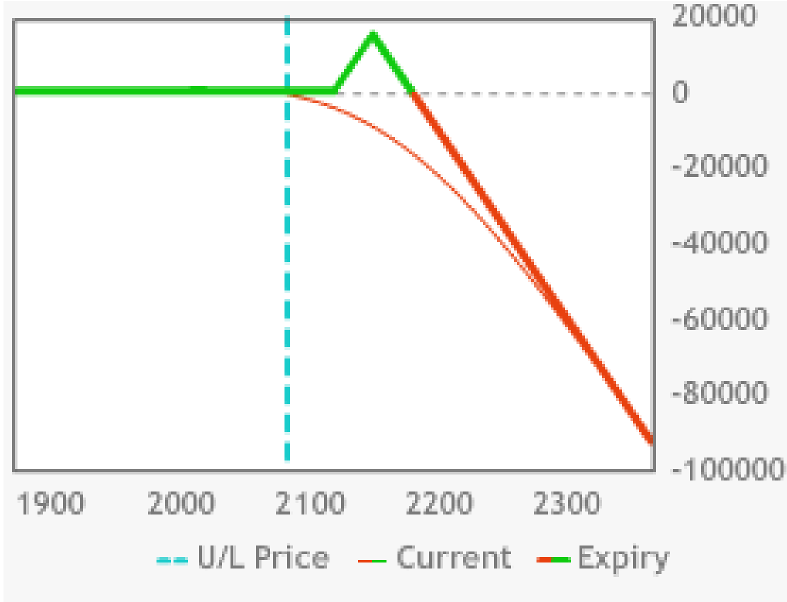
To determine which underlying product would work best for a skip strike butterfly you first have to determine what the skew is for each product. That is determined by the implied volatility (IV) for each strike price along the options chain. IV is the price level for the time value that is embedded in the options premium. The more time value there is the higher the IV is.

The SPX Oct 2085 strike at the money (ATM) IVOL is 12.13%. The Oct 1985 strike in the in the money (ITM) IV is 16.61%. The Oct 2185 out of the money (OTM) IVOL is 9.7%. The IBM Oct 155 ATM IV is 17.16%.The Oct 140 strike ITM IV is 20.77%. The Oct 170 strike OTM IV is 16.90%. The FB Oct 95.00 strike ATM IV is 30.21%. The Oct 85 strike ITM IV 31.48%. The Oct 105 strike OTM IV is 30.28%.

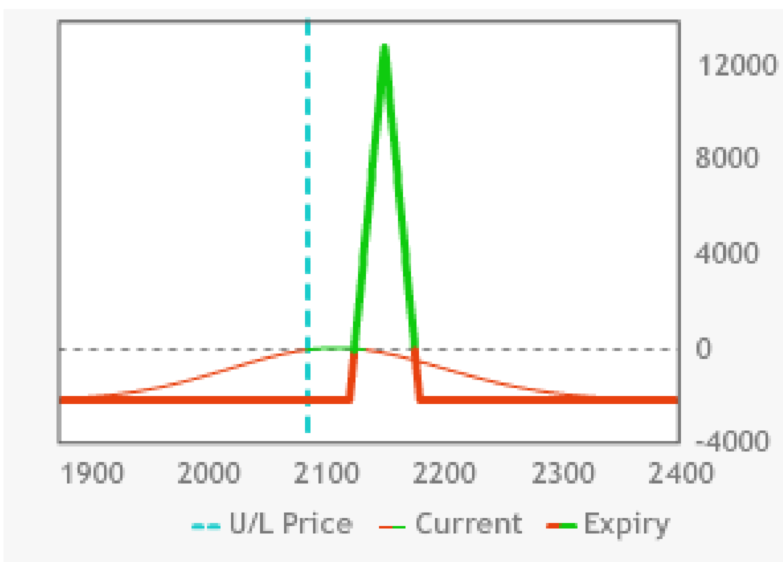
IV	FB	IBM	SPX
ITM	31.5	20.8	16.6
ATM	30.2	17.2	12.3
OTM	30.3	16.9	9.7

The IV for FB is virtually unchanged throughout the options chain. There is a 20% differential in IV between the ITM IBM 140 strike and the OTM 170 strike. The difference between the ITM SPX 1990 strike and the OTM 2190 strike is 42%. The 24.40 premium for the SPX 1990 puts is more than five times the 4.50 premium for the 2190 calls. This tells us that the upward movement in the S & P 500 is much slower than the downward movement. This is called a positive skew to the downside and a negative skew to the upside. FB has a flat skew with the upward and downward moves having equal velocity. IBM has a similar skew to SPX but the skew is not as sharp.

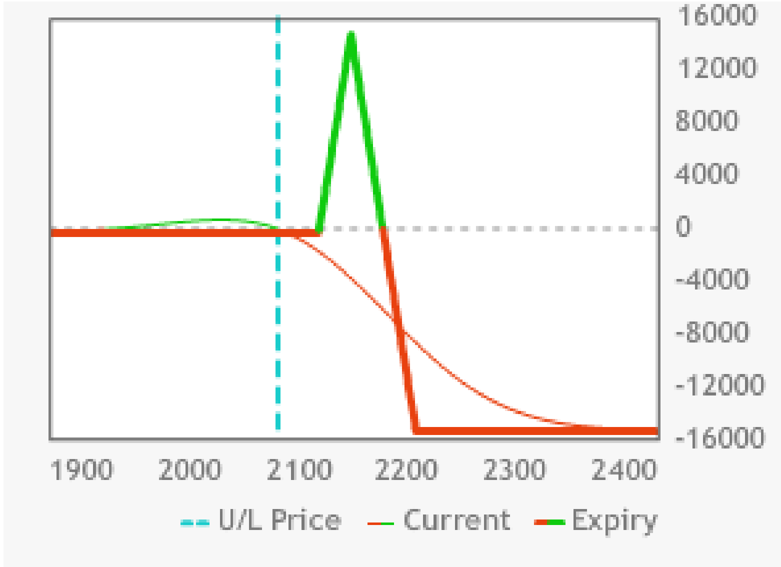
You can buy five SPX Oct 2120 calls for 25.80 and sell ten 2150 calls for 13.20, capturing a 0.60 credit. Your upside breakeven point is 2180.60 with unlimited possible losses after that. Your maximum profit of $15,300 occurs at 2150.



You can buy five SPX Oct 2180 calls for 6.20 to turn your 1×2 spread into a normal butterfly. You now have a 5.60 debit instead of a 0.60 credit. Your maximum loss, however, is now defined at 5.60 ($2,800). The smaller maximum profit of $12,200 still occurs at 2150.



Instead of buying the SPX Oct 2180 calls to protect against losses in the 1×2 spread you can buy the Oct 2210 calls for 2.30 instead. Your debit for this spread is 1.70 versus 5.60 for the normal spread. Your maximum loss has increased by $13,050 in exchange for a lower maximum loss of $850 to the downside and a greater maximum possible profit of $14,450 at 2150. The skew indicates that there will not be any gap moves to the upside so you can make an adjustment to your position as SPX creeps up. This type of position would not work for FB and IBM as well as it would for SPX.



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Dan Keegan, founder of OptionsAuthority.com is a veteran trader and educator. Dan has over 35 years experience trading stock options, etf options and options on futures. Dan started on the CBOE in 1978 with A.G. Becker as a runner, phone clerk and floor broker. In 1984, with the backing of legendary adventurer Steve Fossett,… read more

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