

The Iron Condor

By [Mark Wolfinger](#)

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You may have heard about [iron condors](#), a popular [option](#) strategy used by professional money managers and individual investors. Let's begin by [discussing what an iron condor is](#), and then how you can benefit from learning how to trade them.

What Is an Iron Condor?

[An iron condor is an option strategy](#) that involves four different contracts. Some of the key features of the strategy include:

- An [iron condor spread](#) is constructed by selling one call spread and one put spread (same expiration day) on the same [underlying](#) instrument.
- All four options are typically [out-of-the-money](#) (although it is not a strict requirement).
- The call spread and put spread are of equal width. Thus, if the [strike prices](#) of the two call options are 10 [points](#) apart, then the two puts should also be 10 points apart. Note that it doesn't matter how far apart the [calls](#) and puts are from each other.
- Most often, the underlying asset is one of the broad-based market indexes, such as SPX, NDX or RUT. But many investors choose to own iron condor positions on individual stocks or smaller indexes.
- When you sell the call and put spreads, you are buying the iron condor. The cash collected represents the maximum profit for the position.
- It represents a 'market neutral' trade, meaning there is no inherent [bullish](#) or [bearish](#) bias.

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Iron Condor Positions, Step by Step

To illustrate the necessary components or steps in buying an iron condor, take the following two hypothetical examples:

To buy 10 XYZ Oct 85/95/110/120 iron condors:

- Sell 10 XYZ Oct 110 calls
- Buy 10 XYZ Oct 120 calls
- Sell 10 XYZ Oct 95 puts
- Buy 10 XYZ Oct 85 puts

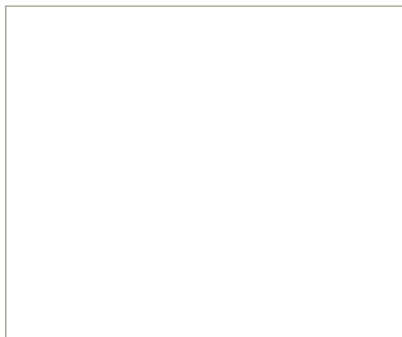
To buy three ABCD Feb 700/720/820/840 iron condors:

- Sell three ABCD Feb 820 calls
- Buy three ABCD Feb 840 calls
- Sell three ABCD Feb 720 puts
- Buy three ABCD Feb 700 puts

How Do Iron Condors Make/Lose Money?

When you own an iron condor, it's your hope that the underlying index or security remains in a relatively narrow [trading range](#) from the time you open the position until the options expire. When expiration arrives, if all options are out-of-the-money, they expire worthless and you keep every penny (minus commissions) you collected when buying the iron condor. Don't expect that ideal situation to occur every time, but it will happen.

Sometimes it's preferable to sacrifice the last few nickels or dimes of potential profit and close the position before expiration arrives. This allows you to lock in a good profit and eliminate the risk of losses. The ability to manage risk is an essential skill for all traders, especially ones employing this strategy.



The markets are not always so accommodating, and the prices of underlying indexes or securities can be volatile. When that happens, the underlying asset (XYZ or ABCD in the previous examples) may undergo a significant price change. Because that's not good for your position (or pocketbook), there are two important pieces of information you must understand:

- How much you can lose; and
- What you can do when the market misbehaves.

Maximum Loss Potential

When you sell 10-point spreads (as with XYZ), the worst-case scenario occurs when XYZ moves so far that both calls or puts are in the money (XYZ is above 120 or below 85) when [expiration](#) arrives. In that scenario, the [spread](#) is worth the maximum amount, or 100 times the difference between the strike prices. In this example, that's $100 \times \$10 = \$1,000$.

Because you purchased 10 iron condors, the worst that can happen is that you are forced to pay \$10,000 to cover ([close](#)) the position. If the stock continues to move further, it won't affect you further. The fact that you own the 120 call (or 85 put) [protects you from further losses](#), because the spread can never be worth more than the difference between the strikes.

Loss Buffer in Premiums

There's some better news: Remember, you collect a cash [premium](#) when buying the position, and that cushions losses. Assume you collect \$250 for each iron condor. Subtract that \$250 from the \$1,000 maximum, and the result represents the most you can lose per iron condor. That's \$750 in this example.

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Note: If you continue to hold the position until the options expire, you can only lose money on either the call spread or the put spread; they cannot both be [in-the-money](#) at the same time.

Depending on which options (and underlying assets) you choose to buy and sell, a few different circumstances can come about:

- The probability of losing can be reduced, but reward potential is also reduced (choose further out-of-the-money options).
- Reward potential can be increased, but the probability of earning that reward is reduced (choose options that are less far out-of-the-money).
- Finding options that fit your comfort zone may involve a bit of trial and error. Stick with indexes or sectors that you understand very well.

Introduction to Risk Management

The iron condor may be a [limited-risk](#) strategy, but that doesn't mean you should do nothing and watch your money disappear when things don't go your way. Although it's important to your long-term success to understand how to manage risk when trading iron condors, a thorough discussion of risk management is beyond the scope of this article.

Just as you don't always earn the maximum profit when the trade is profitable (because you close before expiration), you often lose less than the maximum when the position moves against you. There are several reasons that this might occur:

- You may decide to close early to prevent larger losses.
- XYZ may reverse direction, allowing you to earn the maximum profit.
- XYZ may not move all the way to 120. If XYZ's price at expiration ([settlement price](#)) is 112, then the 110 call is in-the-money by two points and is worth only \$200. When you buy back that option (the other three options expire worthless), you may still have earned a small profit - \$50 in this scenario.

Practice Trading in a Paper-Trading Account


If this strategy sounds appealing, consider opening a [paper-trading](#) account with your broker, even if you are an experienced trader. The idea is to [gain experience without placing any money at risk](#). Choose two or three different underlying assets, or choose a single one using different expiration months and strike prices. You'll see how different iron condor positions perform as time passes and markets move.

The major objective of paper trading is to discover whether iron condors suit you and your trading style. It's important to own positions within your comfort zone. When the risk and reward of a position allow you to be worry-free, that's ideal. When your comfort zone is violated, it's time to modify your portfolio to eliminate the positions that concern you.

Summary

Iron condors allow you to invest in the stock market with a neutral bias, something that many traders find quite comfortable. This option strategy also allows you to own positions with limited risk and a high probability of success.

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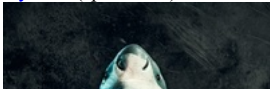
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