PROFITING WITH IRON CONDOR OPTIONS

STRATEGIES FROM THE FRONTLINE FOR TRADING IN UP OR DOWN MARKETS

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Pour ma mère,
For my beautiful wife Adira,
and for my wonderful children
Yehudah, Shimon, Chana, and Chaim

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Foreword

Option traders have an advantage over other investors because they can structure positions that generate a profit regardless of the direction of movement of the underlying security. Many of these trades generate their maximum profit if the underlying stock remains motionless for an extended period of time. Condor is such a trade. Simply stated, condors generate large profits when the underlying security remains range-bound for the duration of the trade. Properly structured condors can absorb large market changes and still generate impressive profits.

This characteristic has made condors one of the most popular trades among knowledgeable investors who have discovered the benefits of not betting on the direction of anything. Their view is exactly opposite that of a stock picker who spends all his time searching for "underpriced" securities that can be purchased below fair value. Condor traders assume that the market knows the fair value of a stock or index, and that it will continue to trade close to the current price until additional news generates a distinctly different view. Moreover, because option prices are based on volatility, they normally comprehend the effects of such news. A knowledgeable option trader, therefore, should be able to structure profitable condors in most markets.

As always, the devil is in the details. If structuring profitable condors was easy, everyone would be rich; there would be nothing to write about, and this book would collapse into a single page with a bulleted list of rules. But nothing could be further from the truth. Condors have four moving parts that are each affected by time and volatility. Volatility, in turn, has a structure that varies according to strike price and expiration date. It often rises or falls in a complex pattern that can be difficult to understand. Writing these words causes me to remember a conversation with Michael where he pointed out that the trade is somewhat asymmetrical because volatility falls in a rising market but rises in a falling market. Adjustments on the call side should, therefore, be handled differently than adjustments on the put side. That little nugget of gold and its associated details are just one of hundreds contained in this book.

Just a few years ago, private investors could dabble in the market and still make money. Those days are gone forever. Today's complex markets are a challenge for even the most sophisticated investor. Successful trading strategies are built around complex trade structures, careful risk management, a detailed understanding of how the market responds to news and events, and precise timing. This book explores all those topics and more for one of the most popular trade structures. More importantly, it represents the accumulated knowledge of many years of trading with millions of dollars in one of the most turbulent markets in history.

—Jeff Augen
Author of *Trading Options at Expiration*
December 2010

Acknowledgments

First, I'd like to thank my Creator who makes all things possible. I never forget (Devarim 8:11-18).

A book like this happens because many people along the way helped me get to where I am. I want to thank David Goldberg, Joseph Benporat, and Shelly Rosenberg for opening the door and helping me get through it. Oscar Rosenberg, Fred Todd, Miky Goldschmiedt, Susan Diamond, and David Schwarcz for having faith and confidence in my abilities and, literally, pushing me into this. Thanks, Susan, for all the opinions, ideas, articles, and support. Steve Lentz for always being there to answer the tough questions. Frank Fahey for his insights and direction. Alex Lushtak and Anatoly Tikhman for giving me a chance. Gene Lushtak who still can explain what I do better than I can. To my wonderful in-laws Steve and Carolyn Kayne for being the perfect "average investors" for me to test my ideas. Jim Boyd at FT Press who actually understands options and for giving me this opportunity. Michael Thomsett for doing a fantastic editing job and saving me from myself.

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I'd especially like to thank my Options Guru, Jeff Augen, on a number of levels. Not only would this book have not come to fruition without his direct involvement, but he profoundly changed the way I think and approach options as a trader. Read his books and be transformed. I look forward to the day when you ring the bell.

Finally, without the patience and encouragement of my wife Adira and my kids Yehudah, Shimon, Chana, and Chaim, I never would have finished the book.

Thanks one and all!

About the Author

Michael Hanania Benklifa manages millions of dollars worth of condor trades every month for private investors through his firm, Othello Consulting. He formerly served as a Financial Advisor for UBS and as an M&A Analyst for several large pharmaceutical companies. Benklifa holds an MBA from Texas A&M, as well as a Diplôme (Masters in Management) from École Supérieure de Commerce in France, and a BA in Philosophy from the University of Texas.

Preface

I used to hate trading. The problem with stock trading is that you have to know too much in order to be correct, or you have to trade on blind faith. People buy and sell stock every day without having the slightest idea about the company or the stock they are trading.

A while back I used to work in Mergers and Acquisitions. My job was to determine the viability of businesses for acquisition by large corporations. Let's scale it down and say you have $100,000 and you want to buy a small business. What kinds of things do you want to know about that business? You need to look at the books and track revenues, profits, and expenses. But to buy a business solely on that information would be foolish.

You also want to know about the competition, market share, number of competitors, and competitive advantage. Without an understanding of the competitors and who they are, you don't really have a grasp of the future of the company.

There's more. Who are the suppliers? What contracts exist? Who else do they supply? The supply line is crucial for the bottom line.

There are even more questions about the employees. You need to know who is indispensable and who isn't and what kind of employment contracts are in place. You need to talk to the sales staff and marketing department to get their perspective.

There are many more questions you should ask about a business before investing. Yet almost everybody who invests in stocks cannot answer the most basic questions about a company. Pick your favorite company. Can you name its five biggest competitors? How about the main suppliers? Would you buy a business by just looking at charts? Usually just those few questions are enough to stop people cold. Still, people will put their life savings on a name about which they really know nothing.

Who actually knows the answers to those questions? Maybe there are things about the company that full-time experts know and that you never will know. Even those experts still will get it wrong some of the time.

So I hated trading because I didn't believe I had the confidence to make sound decisions that wouldn't just be guesses at the end of the day. I was a Financial Advisor and people were always asking me about what I thought about the market or whether I had a good stock tip. It wasn't too impressive to say, "I don't know," but it was an honest answer. I mostly recommended Structured Products, hybrids of stocks, options, and bonds designed for hedging risk. Some of those Structured Products were unfortunately issued and guaranteed by venerable institutions like Lehman Brothers. The more I learned about these products, the more I started to learn about the intricacies of options.

What appealed to me about options was that there were strategies that worked even if you didn't know anything about the company whatsoever. You didn't even need to know whether the price was going to go up or down. In fact, the trade had nothing to do with either the company or the price. It had to do with the fear built into the price and how much time was left until expiration. The actual ticker was irrelevant. So now I realized I could trade without having an opinion.

Over time, I worked on and studied various options strategies and adopted condors as my favorite. There are a number of ways to trade this strategy and I tried them all. The strategy presented in this book is the one that I find works best in a variety of market conditions. In the very difficult market conditions of the past few years, I've managed to generate pretty decent returns on a regular basis. Don't be surprised if your returns are in the 30% to 60% range in a year. No guarantees, but it can be done.

There are a few questions I'm always asked after I explain what I do. The first is always, "What's the risk?" The second is, "Why have I never heard about this before?" The third is, "Why doesn't everybody do this?"

As to the first question, I always describe the risky nature of the trade. There is a lot of risk in this trade. Everybody should consider the nature of the trade and how much they are willing to risk and who they are willing to risk it with. Results count. I'm generally far more risk averse than I am for the clients whose capital I trade.

"Why have I never heard about this before?" The answer to this question is not so simple. The ordinary investor either is trading his own stocks or has handed a portfolio over to an advisor to manage for him.

Advisors by and large don't really want anything to do with options. What they do understand about options is generally very limited, and their approach is pretty simple. They trade them like stocks. Buy this or that option and see what happens at expiration. The other officially condoned strategy is covered calls. Additionally, my experience at large firms is that they actually dissuade advisors from trading options in any sophisticated manner. There are generally no tools on the system to do proper analysis of options even if they wanted to trade effectively. I was told by a chief options strategist at a major brokerage that they don't want their advisors trading options because they are worried about big mistakes. That is a smart decision on their part but truly limits what you as a trader and investor can do to earn money and protect your assets.

Additionally, sophisticated option trades require constant supervision. An easy trade needs no attention, but you can never tell which one is an easy trade until you are done. Markets can move on a dime and you have to be ready to respond. Unless you have the luxury to pay attention to the market and place orders when necessary, you could increase your risk in a trade substantially.

The last question is, "Why doesn't everybody do this?" This has a few different answers. First is the poor experience investors have had with options in the past. Most of those burned by options have lost money buying options, which is all too often a sucker's bet. Second is a genuine lack of education and understanding of options and particular strategies, which this book seeks to help remedy. The third answer is that no one will do this job for you. Your advisor will not manage options strategies for you because there is not enough money in this for him relative to the risk involved. He will not monitor it because he has 100 other clients for which he has to make financial plans. Mutual funds don't do this because it's not in their charter. Hedge funds are too big. They can't just step up and start spending a billion dollars in the options market.

Many people have asked me why I'm giving away my strategy. They wonder, wouldn't that ruin its effectiveness? First of all, I didn't invent condors nor am I reinventing the wheel. This is a merely a strategy and not a formula. Think of it as a method or an approach to trading condors. What's missing for a lot of traders or people who would like to trade options is a proper understanding of how options really work. There are a lot of moving parts to track. I imagine stock trading akin to flipping a coin. Options trading is more like playing chess.

Two caveats before going forward:

> **Caveat #1:** By their very nature, condors are high-risk strategies. They can blow up on you and you can lose all or most of the money you put up in the trade. This book takes that possibility into account and points out ways to diminish but not eliminate the risk. You will learn that picking the right instrument to trade, picking the size of your condor, strategically choosing your entry and exit points, limiting your time in the market and, especially, not getting greedy will all help to mitigate risk. But there is always the possibility of total failure regardless of all the risk management in the world.

Caveat #2: This is not an income strategy. In order to entice people to attend classes or buy books, many people would call this an income-generating strategy because of how successful it can be on a regular basis. But calling this an income strategy is misleading and inaccurate.

An options condor is a trade. That's it. No more and no less. If you start thinking of this as an income strategy or, worse still, depending on it for your income, you will lose all of it. You will push this strategy too far and too hard and the condor will swoop down and eat you alive.

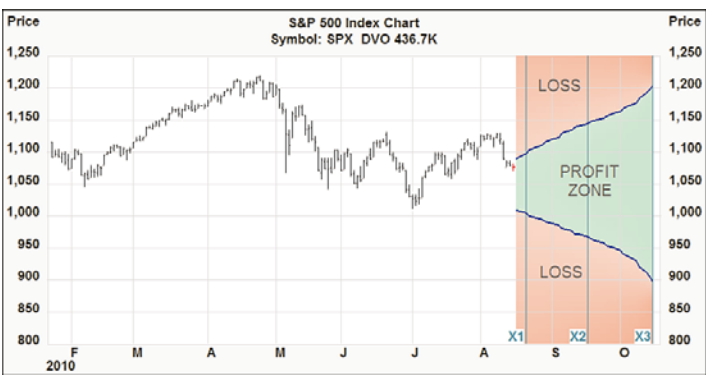
Caveats aside, I absolutely love trading condors. I've made a lot of money for myself and my clients even though I've also had many sleepless nights. However, making money is never easy and never without risk. Still, there is a certain pride about making stellar returns even when I am wrong about market direction.

A condor is a big bird with a wingspan that can reach 10 feet. When it flies, it flaps only occasionally and glides most of the way. The silent, patient image of this lovely bird floating through time and space will provide a useful metaphor for the trade you will learn. Like the flapping of its wings, the opening and closing of a condor trade should be done infrequently. The patient drift through calm air reflects the slow and steady time decay and the low volatility that will lift our profits. Treat this awesome bird with the respect it deserves and you can ride on its wings.

Chapter 1

The Horse Race

An iron condor is a complex options trade that creates a "zone," as illustrated in Figure 1.1, in which a profit occurs over time and within a specific price range. Correctly picking the direction of price movement is not necessary. Understanding the dynamics involved in the trade is the key to long-term success and limited risk.



Source: OptionVue 6

FIGURE 1.1 *S&P 500 Index chart*

Too Good to Be True

Too many people trade options without knowing about the range of risks they face, or without first acquiring the knowledge they need. This book addresses that problem with respect to condor trading. Nonetheless, condors are lucrative and you can create profits quite easily; but you can also lose money in a condor trade. Condors are the most consistently profitable trade you can create, with potential annual returns reaching 30%, 40%, 50%, or more if put together correctly.

Just as there are different ways to play chess, there are different strategic methods for trading options. This book presents a conservative strategy designed to maximize gains and minimize risk.

Introduction to Trading

Ironically, with condor trading, having an opinion about a company or the direction of the market is the easiest way to lose money. The more convinced you are that your opinion is correct, the more you'll hold onto a losing position and ignore the realities, not of the company but of your trade. A wise investor named Bernard Baruch once said that the main purpose of the stock market is to make fools of as many people as possible. The best response to this advice is to not have an opinion.

There are very few places where not having an opinion is actually profitable, and surprisingly the options world is one of those places. Some options strategies are "market neutral," meaning their potential to generate a profit is not dependent on whether the market goes up or down. Actually, these market-neutral strategies do best when the market moves up *and* down within a given timeframe.

Once upon a time, a myth was perpetuated that all you had to do was keep your money in the stock market and you would get rich and retire. This assumption was considered so obvious that something called an "Individual Retirement Account," or IRA, was created so that people could put their money in the stock market and benefit from tax incentives. The fundamental problem with this way of thinking is that people forgot that the stock market is a place of investment with all of its associated risks and dangers. It is *not* a retirement account. After the 2008–09 crash in the market, most people are now painfully aware of this fact. The buy-and-hold strategy is *not* guaranteed to create wealth.

Investing also presents you with a huge obstacle, namely, acquiring and applying knowledge. Do you really know more than the stock market? If Apple is priced at $200, you need to know something that nobody else knows in order to believe that the market has mispriced Apple and that the company should be worth either much more or much less. Actually convincing yourself that you have an edge against full-time professionals with their massive supercomputers and their team of Ph.D. programmers is delusional. Chances are if you do make money investing in the market, you are likely riding the wave that is making everybody else money as well—in other words, you got lucky!

There is another way to make money in the stock market that has nothing whatsoever to do with investing: *trading*. Investing requires, or at least should require, research, understanding, careful analysis, and strategy regarding a company and its sector. Trading is simply about making money. The shorter the timeframe involved in the trade, the less significant fundamental information and all the accompanying research becomes.

Swing traders like to trade in a timeframe of days or weeks. Day traders like to trade in a timeframe of hours or minutes or even seconds. Now computers are involved in high-frequency trading (HFT), which moves money in and out of positions in millionths of a second. Computers have taken any kind of qualitative edge away from human traders. They can process all relevant news and information and trade accordingly before the nerves in your eyes can electrically send the visual information of the words you just read to your brain.

There is one domain where computers will not drive out the human competition. That is the world of options trading. Options traders observe and rely on the market's emotions, fear, and panic, and design their moves to maximize or minimize the effects of time. Increased fear means increased prices in options, and decreased fear means lower prices. Although computers have been programmed to exploit mispriced options in an instant, fear is something computers don't understand…yet.

How Options Work

Options can be thought of as the Swiss Army knife of trading. The combinations and maneuvers available in options trading strategies seem endless. By comparison, stock trading is a simple directional trade. The decision to buy or sell a stock is usually done through fundamental analysis or technical charting techniques. Options traders look at these tools and so much more.

This section is not meant to be an introduction to options, but rather an introduction to options *trading*. Most options books focus a great deal on comparing completely different options strategies and on what happens at the *end* of an options trade. A skilled options trader, however, might be in and out of the trade several times before expiration.

In this book the focus is more on practical trading strategies and less on theory. It's not what you know, it's "how" you know it. Your significant paradigm shift is to think like traders and not like investors.

Summarizing some of the basics of options trading is a good starting point for the following review. This review is not meant to be comprehensive but, rather, to serve as an *approach* that shows you what you need to know in order to get going. Even if you already have some ideas about how options work, the following discussion might still give you food for thought.

The Horse Race

The following analogy gives you a mind-set for options trading. Picture a horse race in which you place your bet. The value of your bet depends on the odds. If your horse is a 2-1 favorite, your chances of winning are high but you won't make much money. If the horse you pick is 100-1, your chances of winning are remote but if you do win the payout will be huge.

So you go to the horse race and you bet on your favorite horse, SeeBo, who is rated at 100-1, to win. The race is four laps, and as it begins you wait to see whether you will win or lose at the end. Pretty straightforward so far.

Now add a twist to make this race more interesting. You can buy or sell your bet *during* the race. If you are the kind of person who just likes to wait until the end of the race, then this twist changes nothing. If you are the kind who likes to take advantage of a positive development or if you are risk averse, this new dynamic changes everything, making it literally a whole new horse race.

Run through the possibilities to get a better picture of the complexities this twist adds.

First Lap

After the first lap, SeeBo, surprisingly, is in the lead. You hold a bet in your hand that could be worth a fortune if SeeBo keeps this up and wins the race. What do you do? Do you sell it now? There are still three laps to go, so you won't get as much for your bet now as you would in the end—but is a little profit better than nothing? You decide to hold on.

Second Lap

In the second lap SeeBo fades and starts to fall behind. You regret not selling the bet when you had a chance, but still, if you sell it now you might get some of your money back. Instead you decide to hold on because you believe he really "should" win.

Third Lap

Third lap and SeeBo has caught his second wind, now starting to close in on first place. You pat yourself on the back for your intelligence since you were obviously right. The bet is gaining in value, so why sell it now when you could win big?

Final Stretch

Final stretch, and your heart is beating fast. What is your bet worth if SeeBo is way in front? What if SeeBo is neck and neck? What if he starts to fall behind? Time is running out quickly and his position now is absolutely critical because there is almost no time for major changes in the outcome.

And the Winner Is…

It doesn't matter because now you get the idea. In a nutshell these are the kinds of dynamics involved in options trading. Just as the horse race has a finish line, options have an expiration date, the third Friday (for index options) or Saturday (for equity options) of every month, at which point either they have value or they don't. Prior to that date, the value changes based on the changing odds, being in-the-money or out-of-the-money, and the time remaining until expiration.

The energy and excitement of the race is expressed in different terms in options. The horse's position in the race is the Delta; so if your horse has a Delta of 1 he is way up front, and if he has a Delta of .1 then things are not looking so good. The speed with which he starts to catch up to first place is called Gamma. All the fear, hope, and energy of the race are expressed as Vega, also known as implied volatility. Of course, all of these concepts collapse when the race is over because all you have left is a winner or a loser.

When you buy an option, you are placing a very similar kind of bet to that of the horse race. If Apple is at $200 a share, you can place a $5 bet that it will rise to $220 during the next month. If in a month, Apple's price is $220 or more, the person who sold you the bet has to sell you Apple stock for $220. Unlike in the horse race, the potential profit is limitless because even if Apple stock goes to $300 the seller still has to sell you the stock at $220, and you get to make a cool $75 ($80 profit minus the $5 cost of the option) by reselling those same 100 shares of stock in the open market.

When you buy options and the price is in the winning zone, that option is "in-the-money." Buyers of options like to be in-the-money. Sellers would prefer that the price stay "out-of-the money."

Options are *not* investments. When you purchase options, you don't receive a dividend. You don't get annual reports or voting rights because you don't have a material interest in the company. When you buy options, all you receive are certain rights that you may choose to exercise.

For every buyer there is a seller, and you can be either. Selling options is also referred to as writing options because you are essentially "writing" a contract that obligates you to sell your options at the agreed price to the buyer at his discretion. In other words, you can think of an option contract as simply a promise, so options trading is merely the buying and selling of legally binding promises.

Just like the bookie in the horse race, the seller can profit only to the extent of the value of the initial bet, the sales price. The buyer is the one hoping to cash in big.

The flip side is that the buyer knows upfront how much he can lose, namely the money he paid for the option. The seller's potential loss may be unlimited if he sold a call, so his broker will require a certain amount of money to be available in order to pay in case of a big loss. This is the *margin* required to be kept on hand to protect the broker from catastrophic losses in case traders end up being wrong.

Those traders who buy calls want the market to go up, and those traders who buy puts want the market to go down. If you are a seller, you will lose money if the put you sell ends up in-the-money in the same way and proportion as if you had to pay for in-the-money call.

Buying Versus Selling

Which is better, to be a buyer or a seller? There are many factors that affect that decision, so there really is no "better." Both offer advantages and disadvantages.

The Buyer

The buyer has the advantage of potentially unlimited gains. He leverages his money through the purchase of options and can make returns several times his initial cost. He does, however, have a few things working against him.

Those who buy stocks have to get only one thing right: *direction*. If the stock goes up and they sell, they make money. Simple and uncomplicated. The buyer of options has to do the same thing, pick the right direction, but that's not all. He also has to be concerned with two additional factors: time and expiration.

Actually, picking the right direction is extremely difficult. An analyst who does nothing but study a certain company for years, talks to the CEO, knows the business inside and out, and even works at the company can still pick the wrong direction for the company's stock price. You, the ordinary investor, have access to no information that gives you an edge in the marketplace. Regardless, picking the correct direction is crucial for the stock buyer and also for the options buyer.

The options buyer can't just pick the right direction; he also has to pick the right distance the price will move. If he buys an option believing that Apple's stock price will go to $220, then Apple has to go to $220 and not just to $210. This is an example of getting the direction right but the distance wrong. Additionally, not only does the price of the stock have to reach $220, but the buyer also has to include the price of the option (for example, $5), which means the stock price has to go even further before he makes money. So you can be correct as to the strike price but can still make no money because you haven't covered your cost of purchasing the option.

Finally, the greatest difficulty the options buyer has to contend with is time. Correctly picking the direction and the strength of the move in that direction is worthless if the target is met after expiration day. If the market quickly moves favorably for the options buyer, there is a chance to make a profit if he quickly closes his trade. However, each day that goes by a little more value is lost in that option, making the likelihood of a profitable trade more remote if the stock doesn't do what the buyer hopes.

To review, the options buyer has to be correct about three things:

1. Direction
2. Distance
3. Time

All three have to be in confluence to create a profitable trade for the options buyer. Some simple odds demonstrate the difficulty in getting all three of these correct. Attribute 50/50 odds to correctly choosing each of the three elements. But 50/50 is generous. Direction is either up or down but distance and time are far more complicated. What do we get? Direction (50%) × Distance (50%) × Time (50%) = 12.5%. At best the odds of holding a profitable option at expiration are about 1 in 8. You may think you have an edge. Study after study shows you really don't.

The Seller

The seller of options has to be right about only one thing: *time*. He doesn't care if the direction works against him or even about the strength of the move. All he cares is that time works against the trade. At worst his odds are 50/50 because time will work either for him or against him. The disadvantage of selling is that if he is wrong about time, his losses could be potentially quite high.

From a risk/ratio perspective buying looks better than selling. You can lose only what you spent for the option, which is not a lot of money compared to buying 100 shares of stock. (Every option is equivalent to control over 100 shares.) The defined potential loss involved is why many people who go into options trading start by being buyers. The potential gain is unlimited. Nonetheless, the odds of a successful trade for a buyer are small. So even though the risk/reward profile is appealing, the odds of success are low.

The risk/reward of selling looks terrible. The gain is limited to the premium collected, and the potential for loss can be unlimited. To make selling more palatable,

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