LT Options Trading System

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An options trading system based on Credit Spreads and Iron Condors in indexes.

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4.6. When everything fails

There is no single trading strategy that works in all market conditions. Selling Out of the money Credit Spreads also has a killer environment, and that is a sustained move against your position. Some traders argue that a spike in volatility after you are already in a position is your worst enemy. That is not entirely true, because when selling a Credit Call Spread you are benefited if the market falls, even though during that fall volatility increases.

A market that consistently moves in one direction (against your position), be it to the upside or to the downside, throughout the entire life of your trade is what can truly impact you negatively. The more persistent the move in the same direction, the greatest the danger of seeing your initial position threatened as well as the adjustments made to it.

A realistic trader should understand this scenario and be aware of his potential worst losses in order to properly define his capital allocation per trade, total portfolio exposure, as well as a consistent trade adjustments strategy. Let's analyze some possible really negative outcomes.

First a falling market

You sell a Credit Put spread when there is extreme pessimism in the market. Usually, by the time the number of stocks above their 20 DMA is less than 30%, the McClellan Oscillator below -150 and Stochastics below 20, the market has already fallen around 4%-5% from its most recent swing high (sometimes even more). That's a piece of the move where you were not exposed and it is in your favor. That's why it is good to wait for that extreme first and then deploy your capital when trading individual credit spreads.

You place the out of the money Credit Put spread at the 10% probability of expiring in the money mark or around 10 deltas. By doing that, you are far from current price action. How far? Well, that really depends on time left to expiration plus current volatility of the instrument. But for illustration purposes let's use a real life example.

On August 1, 2014 the market reached an oversold extreme as defined by the three indicators previously explained. SPX closed at 1925 that day and the 1720 October SPX Put had a 90% probability of expiring out of the money (48 days to expiration). 1720 is 205 points below 1925, or 10.65% below.

The most recent swing high of SPX had been reached 8 days earlier, on July 24. It was a high of 1991. This means the market had already fallen 3.3%. A bet on the 1715/1720 Put spread, 10.65% below would only be penetrated if the market made a total swing from 1991 down to 1720. That's a significant correction of 13%, which obviously doesn't take place every month. Logically you're destined to win frequently with this approach.

Now, if the market had actually fallen close to that level, you could have adjusted the trade before it became a full loser. Volatility would have expanded and the new 10% probability Put would be located much farther than the first one sold 10.65% away from market price. It's because of that volatility expansion and fear in the market that the new 10% probability Put could be 12%-15% away from market price or even more. Again this depends on time left to expiration and how much volatility actually incremented. For simplicity and to make it harder for the trader, let's assume you could place the new Put spread just 10% below market price (same percentage value away as the original trade) even though volatility has expanded. That would be 1720 minus 10% = 1548. You are now challenging the market to fall from 1991 down to 1548. A 22% fall in less than two months. How frequent is that? How frequently does it happen that the market (S&P 500) falls more than 20% in less than two months?

Well, it is not frequent at all. From 1950 to 2014, the market has lost 20% of its value during a two month period in just 5 occasions. That's in 64 years. Look at the following table for consideration:

Market falls of 20% or more in back to back months since 1950.

Year	1st month decline	2nd month decline	Comments
1974	-7.78% (July)	-9.03% (August)	Not quite a 20% fall, but close
1974	-9.03% (August)	-11.93% (September)	1974 market crash
1987	-2.42% (September)	-21.76% (October)	1987 market crash
1987	-21.76% (October)	-8.51% (November)	1987 market crash
2008	-9.56% (September)	-16.79% (October)	2008 market crash
2008	-16.79% (October)	-7.48% (November)	2008 market crash
2009	-8.54% (January)	-10.69% (February)	Not quite a 20% fall, but close

How much money would you have lost selling Credit Put spreads under these very unfavorable circumstances?

If 15% of the portfolio is put to work on a position and no adjustment is made, that is, you let the market run over it, that's all you lose: your maximum risk on the position. In this case 15% of the portfolio.

Whether a 15% draw down is acceptable for you or not is a matter of personal preference, risk tolerance, financial goals etc. Of course this assumes that you only had one position being affected. If you had two Credit Put spreads, one in SPX and another one in RUT and the market does this to you, then it wouldn't be a 15% portfolio drawdown but presumably 30% if both are penetrated at the same time. The more positions on, the greater the risk you are taking. You can reduce your capital allocation per position if these drawdowns are too much to stomach for you. **However, this is assuming that no adjustments are made to the positions.**

As you already know, I am a proponent of defending threatened spreads. In other words, adjusting them before price of the underlying instrument penetrates them. Assuming 15% of the portfolio is deployed in one position using options with the same 10% probability of expiring in the money, and that an adjustment is made when they hit the 30% probability mark, then you won't have a full loser. As we already saw in previous chapters, when trading Put options the loss for the portfolio will be about one fifth of the maximum risk on the position. So, with 15% of the capital deployed in one position, if you adjust Puts at the 30% probability, the loss would be around 3% for the overall portfolio.

Now, let's say you entered the first Credit Put spread, it was threatened and you adjusted (3% portfolio draw-down). The market keeps falling, you adjust a second time (another 3% portfolio loss). The market keeps falling and you adjust for a third time (another 3% portfolio loss). By now 3 adjustments to the original Credit Put spread have been made and you have a portfolio loss of 9% at most. At this point the market has probably fallen 30% – 35% already in a short period of time (less than two months). Your last adjustment should be a winner and the 9% portfolio drawdown is mitigated with the final winner, resulting in a 7%-8% portfolio draw-down in the end for the entire operation.

Now the case of a very strong market

By the time 70% of stocks are above their 20 SMA, Stochastics above 80 and the McClellan oscillator overbought (+150), the market has probably made a 4% - 5% run upwards from its most recent swing low. If at that point you sell an out of the money Credit Call spread with a 10% probability of expiring in the money, you are presumably placing it 4%-5% above the current price. Obviously this depends on current volatility levels and how much time left there is until expiration. With this Bear Call spread position you would be challenging the market to make an 8% – 10% move up in a month.

Let's go with a real life example. On February 18, 2014 the market reached a short term overbought extreme as defined by the three indicators we follow. SPX closed that day at 1840.76 and the most recent swing low was 1737.92 hit 13 days earlier (February 5). The market went up +5.92% to reach this overbought extreme (extreme optimism).

The 1905 March Call option (30 days to expiration) was the closest one to 10% probability of expiring in the money, which was 3.8% above the market price at the moment of 1840.76. In order for the market to penetrate this 1905 level, the total run would have to be from 1737.92 to 1905 or +9.6%. All that in a period of 43 days. If that move had actually taken place, we could have deployed a new Credit Call spread, probably 2%-3% above market price (Farther than that if we decide to roll out to the next month).

With that first adjustment, assuming we placed the new Calls 3% above the first play, now the market would have to move up almost 13% in total from its recent swing low to affect this adjustment. We could then deploy a second adjustment 2% or 3% above the last one if necessary or roll out to the next month to place our new positions even further up.

How often does the market (SPX) move up 15% in less than two months?

There have been a few instances since 1950:

Year	**1st month run up**	**2nd month run up**	**Comments**
1955	+8.09% (June)	+5.66% (July)	Not quite a 15% run up, but close
1974	+16.30% (October)	*November was negative, but October alone qualified as a +15% period*	
1975	+12.13% (January)	+5.99% (February)	
1982	+11.06% (October)	+3.60% (November)	+15.06% compounded
1987	+13.18% (January)	+3.69% (February)	
1998	+6.24% (September)	+8.03% (October)	Not quite a 15% run up, but close
1998	+8.03% (October)	+5.91% (November)	Not quite a 15% run up, but close
2002	+8.64% (October)	+5.71% (November)	Not quite a 15% run up, but close
2009	+9.36% (March)	+9.98% (April)	
2009	+9.98% (April)	+5.32% (May)	

In all these cases, the second Call spread adjustment could have been threatened, leading you to enter a third one, which presumably wins the fight.

If you entered the first Call spread with a 10% probability of expiring in the money and adjusted once it hit the 30% probability mark, you would lose about a third of the maximum risk. As we already discussed in earlier chapters, a threatened Call spread would lead to a 5% portfolio drawdown (when putting 15% of the portfolio to work on a position). If you lose your original position plus two adjustments after that, you cause a 15% drawdown to the portfolio at most. If history is any indication, the third adjustment should work and mitigate that 15% portfolio drawdown a little bit. Again, this is all assuming a 15% portfolio allocation per initiated position and that all the adjustments are deployed at the 10% probability of in the money area (or 90% probability of success).

This is not an exact science because in reality the adjustments are being made a little before the positions are actually penetrated. Meaning that you may need an extra adjustment here or there. At the 30% probability, the distance between your short option and the instrument's price is not always the same as it depends on volatility and time left to expiration. But this is still a useful exercise to get a rough idea on how you would be affected when facing the strongest moves of the past. It's also necessary to point out that the tables shown above only consider month closing prices. It is possible that in

the middle of the months the swings got to be a little larger at some point. In any case, 3 adjustments should be enough, but you can assume the need for a fourth one to be extremely cautious.

It's really crucial to understand these numbers. Now you know how much the portfolio will suffer if you face a really extreme unfavorable move. You know how bad it can get and you understand the magnitude of having more than one position threatened in need for adjustment at the same time. That's why I avoid opening two different Put spreads or Call spreads the same day with the same probabilities. That's why I am not a big fan of having three positions on the same side of the market in the same expiration cycle. I may do it, but I know what I'm risking and I try to play them at different price levels so that the likelihood of them being threatened at the same time is lower. I do it but I will prioritize closing one or two of them early as soon as I make most of my profit. In this case I do avoid waiting until expiration with all positions on. Leaving perhaps just the safest one. Returns are attractive, but if multiple positions are simultaneously tested, then you will have a greater pressure and potential for larger draw-downs. In the long run.

The impact caused by a single bad position during an extreme market move can be mitigated if you put less than 15% of your capital to work per position and that is something you should consider. Let's say you put 5% of your capital to work on a position instead of 15%. Just 5%. Now you can have for example two Call spreads failing at the same time and that would be 10% of your capital being tested and in need for defense and not 15%, even though you have deployed two positions. So, it really depends on your allocation. But with smaller positions working, the winners will also be smaller. So, I personally use around 15% of my capital because after the first adjustment the situation is solved most of the time. The market usually reverses or stays sideways for a while. Being tested only once allows me to walk away with a very manageable portfolio loss (3% - 5%) that turns into a break even trade or even a small winner depending on the credit received with the adjustment and whether I was playing an Iron Condor. Getting tested twice is very unlikely. So, that's why I'm fine with the 15% allocation per position but of course it comes down to your personal preference and risk tolerance. Always keep in mind that based on historical evidence, a very extreme move would need you to make 3 adjustments and take some losses along the way. It is a numbers game which you play expecting not to face these large moves frequently. When they show up, it is the price of doing business. It is the risk of trading expecting above average returns. Although those extreme moves do not take place frequently, you need to have a concise idea about their impact so that you are confident in your process.

On an additional note, in the past I had instances where I lost more than 10% of the portfolio (year 2012) in a single trade as you can see on my public track record. The sad part to admit was that the market didn't make any of those really extreme moves comparable to the greatest ones seen in history or anything like that. I was simply being too aggressive. I was simply starting the positions at the 20% probability of in the money (around 20 deltas if you like to use deltas), and second, I was not adjusting my positions at the 30% probability level. I would wait much longer just to the point where my short strike was about to be touched (at the 45% probability of in the money or so). That aggressiveness, waiting that long to adjust, allows you to have fewer losing trades during the year, but the ones that become losers inevitable cause larger drawdowns. That approach is less than ideal for facing the kind of extreme moves seen earlier where you would need to adjust several times and it is therefore less scalable, because with a couple of those "late" adjustments you inevitably make much more harm to the portfolio.

With the 10% probability approach for opening trades and 30% probability for adjusting them, losses are a little bit more frequent but portfolio drawdowns are smaller. It is sometimes frustrating to adjust at the 30% probability mark, taking a small loss, only to see the market reverse afterwards and realize your original trade would have been a winner if you hadn't adjusted. That will tempt you to not adjust the next time, but be careful. It's dangerous to delay the adjustments. Adjustments at the 30% probability avoid the large drawdowns in a short period of time and it is a more powerful approach when it comes to facing the real extreme moves seen in the history of the markets and being able to survive them.

It's also interesting to notice that although Call spreads gone wrong are dangerous, (as you cannot go much further up with your adjustments) the strongest two-month runs in the history of the markets would only lead you to three Call spread adjustments. Same number of adjustments as with Puts. That's because market rallies are usually slower than market falls.

Let's now think about these extreme moves and their impact on Iron Condors.

When you trade an Iron Condor (entry rules explained in chapter 3.4) these extreme moves can hurt you a little bit more. Remember that the original analysis was based on Credit spreads initiated after the market had already gone to an extreme. Waiting for that extreme to happen before opening a credit spread kept you out of trouble during that first market move where you had no position. With Iron Condors you don't have that luxury. Entered during a no man's land condition, you would start suffering from the beginning of the market move and that would take you to apply one extra adjustment. So, assume 4 to 5 adjustments for Iron Condors instead of just 3. For this reason, it is a good idea to consider reducing your size when trading the opening Iron Condor of an expiration cycle or, as others do, simply avoid it all together.

I personally like to use Iron Condors, as waiting for a market extreme to enter a Credit spread sometimes would keep me inactive for too long where I could be making money on time decay instead. I like to sell that huge time premium when so far from expiration that allows me to go far out with the strikes selection. I also like the fact that I'm collecting premium on both sides of the market knowing only one of them can be affected at a time. History shows that the really extreme moves are likely to happen only 1 or 2 times during a 20 year trading career. Over time you learn to trust your adjustments and gain confidence when you consistently come out profitable or suffer small losses. It takes some time to get that degree of confidence. So certainly, either reducing your size when trading Iron Condors or avoiding them could be something you may want to consider at the beginning. Study and paper trade them for a while until you feel comfortable.