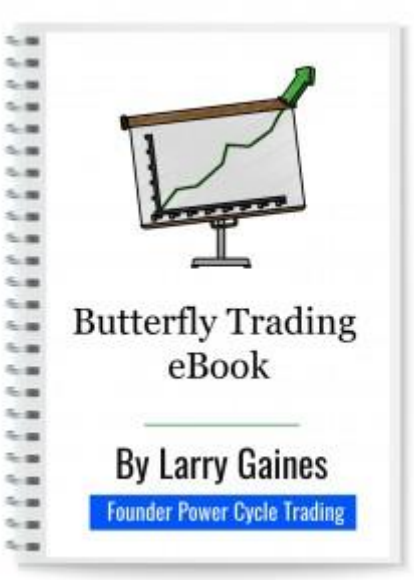


Why and How to Trade Butterflies to Beat Any Market

By Larry Gaines, Founder PowerCycleTrading.com, 30 Year Trading Professional

Butterflies provide a low-risk high reward trading opportunity more than any other option strategy. As most traders know, markets direction can go through months and even years of higher than usual uncertainty. While there's always some degree of uncertainty that traders and investors must accept, there can be long frustrating periods of higher than usual conflicting signals.

Or often, technical analysis paints one picture, while the economic or political environment paints another picture. This can be said for both broad market direction and individual securities. Higher levels of uncertainty can be both stressful and costly for traders waiting on the sidelines. Plus, for traders who have come to rely on regular income from trading, loss of that income can cause serious lifestyle problems. These situations call for a strategy that will work no matter which direction the market heads.

That's exactly what the highly versatile Butterfly strategy does. It gives you a trading advantage in any type of market environment. This makes it a powerful strategy that **every serious trader will want to add to their arsenal of skills.**

Many traders have heard about the advantages of Butterfly strategies, yet they may have avoided it because of its complexity. Initially, the setup can seem overly complicated. This is because most traders try to master the Butterfly without truly understanding a few basic option trading principles first.

In this presentation, I'm going to simplify the Option Butterfly Strategy for you. The reality is that once you grasp these basic concepts, you'll see that the Butterfly is just marrying a couple of simple setups that **you probably already know**. Serious traders take the time to master the skills to increase their returns while lowering their risk. The Butterfly is one powerful way to do that. Since many traders avoid the Butterfly, by taking time to master it is going to give you a powerful edge up on traders who continue to avoid it.

Here is what you'll learn

I. Best Market Conditions for Butterflies
II. Benefits of Butterflies
III. The Option Greeks You Need to Know First
IV. The Most Important Option Factor
V. The Butterfly Setup
VI. The 8 Types of Butterfly Option Strategies
VII. Long Call or Put Butterfly Spread Example

I. Best Market Conditions for Butterflies

Unlike other option strategies such as iron condors, credit spreads, or debit spreads that only work with an identified objective based on probable market direction, Butterflies can be set up and traded for a variety of objectives based on where a trader thinks the security or market is headed, as outlined below. One of the best things about Butterflies is that they are ideal regardless of market direction!

Each of the scenarios below can apply to the broad market or individual securities.

1. Don't Have Any Idea Where the Market is Headed

Non-Directional – Here's the real beauty of the Butterfly! In their simplest form, butterflies can be delta neutral or non-directional trades. This means they can be used successfully when you simply DO NOT KNOW the market direction. While all traders like to work with a probability of market direction, sometimes it's just too unclear and it comes down to guessing, which is risky. Delta neutral butterflies can be set up to take the guesswork out of trading.

2. You Feel Pretty Sure the Market is Headed Up or Down

Directional – The Directional Butterfly Spread can also be used for bullish or bearish exposure to the market while also managing risk and retaining large potential returns.

There's no such thing as a free lunch: Butterfly spreads cannot offer unlimited profit potential. But they usually cost less than buying options outright while providing a powerful positive risk-reward trade set-up that simply cannot be found with other trading strategies.

3. You Don't Want to Lose Your Shirt!

Hedging – The Directional Butterfly can be used as a fast way to hedge positions that are moving against you. This is exactly what the most sophisticated companies do. They hedge, and so can individual traders!

By simply knowing that trading positions can be hedged, traders have less stress. And less stress leads directly to more controlled, non-emotional trades that are logic driven. But you've got to know the Butterfly strategy before you need it, not when you suddenly realize that you need to hedge a position!

Constructing a butterfly around a strike that is under pressure from another core trade (such as a credit spread, or debit spread) controls risk.

This allows you to keep the original position open, buying time. Often, additional time is all that's needed for a trade to move back to profit territory. At that point, you can then remove the butterfly hedge and stick with your original trade.

This risk protection isn't free, but Butterflies provide cheap protection! Many longer-term investors and swing traders buy puts for portfolio insurance. What many investors don't know is that long term out-of-the-money put butterflies, however, can be a much cheaper method of portfolio protection than pure long puts.

II. Benefits of Butterflies

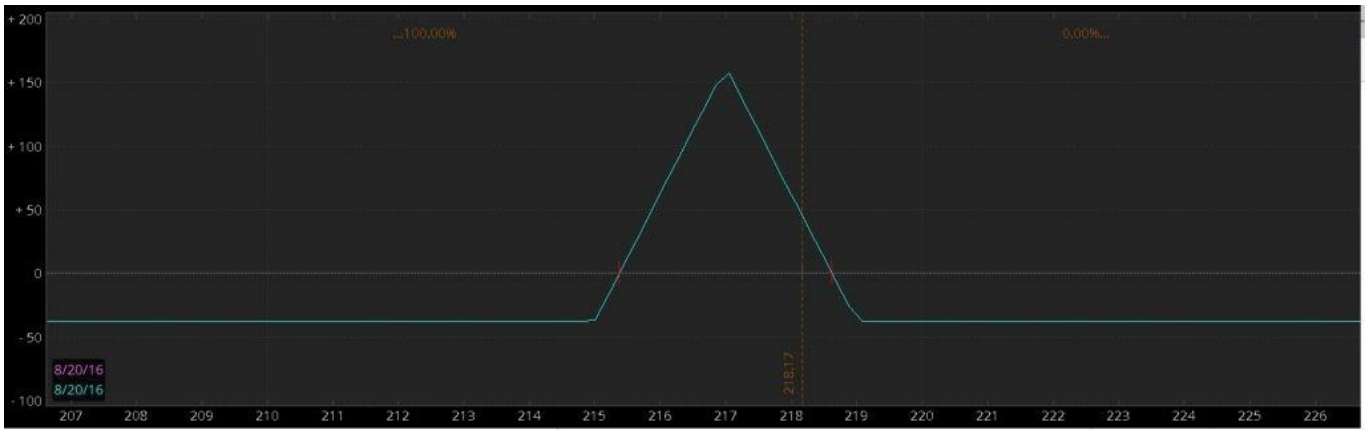
Income – Butterflies can be used to generate income from stocks that appear to be going nowhere in the short term. This alleviates overall portfolio returns in flat markets.

Low Cost – Butterflies can be structured and traded at a very low cost.

Risk Reward – An astounding 10-to-1 or higher Reward-to-Risk is common. This fantastic risk-reward ratio makes them well worth the effort to learn the structure.

Low Maintenance – Butterflies are sometimes called **"vacation trades"** due to their low risk and need for only very infrequent monitoring.

- Butterfly trades are generally very slow moving early on in the trade.
- But get more exciting and volatile as they approach expiration and are within the **profit tent (Zone).**



III. The Option Greeks You Need to Know First

Understanding the following Greek measurements is a precursor to successful butterfly trades, as well as most other option strategies. For this reason, these important tools will be covered briefly next.

The "Greeks" provide a way to measure the sensitivity of an option's price to quantifiable factors. The Greeks are strictly theoretical. That means the values are projected based on mathematical models and all of the best commercial options-analysis packages will do this, and on some of the better brokerage sites, they are free.

Brief Review of the Greeks

Theta – (decay movement) measures your time decay (per day) – increases each day as it gets nearer EXP. & at zero at EXP.

Implied Volatility – (price movement) what the marketplace is "implying" the volatility of a stock will be in the future & its effect on where the price will be

Delta – (price movement) measures the change per $1 change in the underlying & a measure of price probability

Vega – (volatility movement) measures the change per 1% change in volatility, decreases each day & at zero at EXP.

Gamma – (price movement) is the rate of acceleration of delta based on a $1 change in the underlying – most at risk & largest impact last week of EXP.

IV. The Most Important Option Factor

The most important option factor for profit generation using the Butterfly Strategy comes down to understanding the concept of TIME, and its effect on the price of an option…

Time Value is used for trading strategies that take advantage of the accelerated Time Decay of an option into its Expiration. Butterfly Strategies are very tied to Time Value (Theta) & the impact it has on the price of an option.

What exactly is Time Value?

Time value (TV) (*extrinsic*) of an option is the premium a rational investor would pay over its *current* exercise value (intrinsic value), based on its potential to increase in value before expiring. This probability is always greater than zero, thus an option is ***always*** worth more than its current exercise value. The change in the value of an option, based on Time Decay, can be measured using the Greek, **Theta…**

Option Theta

Theta tells you how much an option's price will diminish over time, which is the rate of time decay of a stock's option.

Time decay occurs because the extrinsic value, or the Time Value, of options, diminishes as expiration draws nearer.

By expiration, options have no extrinsic value and all Out of the Money (OTM) Option expire worthless.

The rate of this daily decay all the way up to its expiration is estimated by the **Options Theta Value.**

Understanding Option Theta is extremely important for the application of option strategies that seek to profit from time decay.

Options Theta – Characteristics

Option Theta values are either positive or negative.

All **long stock option** positions have **negative Theta** values, which indicates that they lose value as expiration draws nearer.

All **short stock option** positions have **positive Theta** values, which indicates that the position is gaining value as expiration draws nearer.

Theta value is highest for At the Money (ATM) Options

And progressively lower for In-The-Money (ITM) and Out-of-The-Money (OTM) options. ITM and OTM options have much lower extrinsic values, giving little left to the decay.

Option Theta Example

An option contract with Option Theta of -0.10 will lose $10 per contract every day even on weekends and market holidays.

The buyer/holder of an option contract over a 3-day long weekend with a price of $1.40 or $140 per option contract and an option theta of -.10 will find the price of that option at $110 instead of $140 after the 3-day weekend.

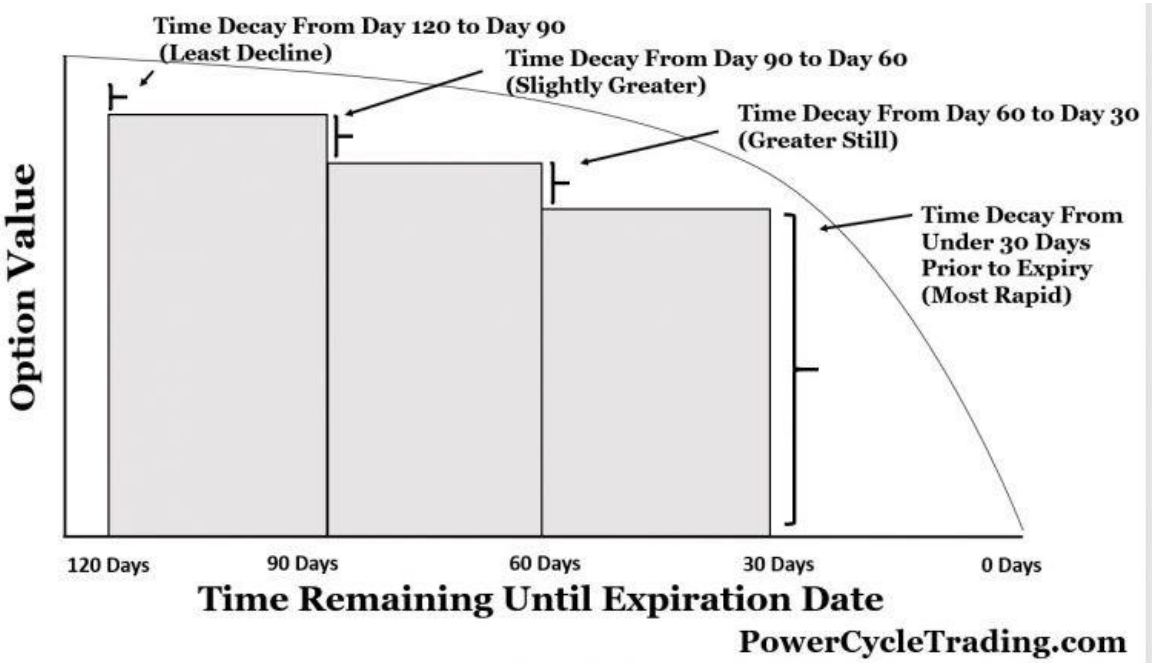
Theta Decay Strikes!

Option theta does not remain stagnant.

It increases as expiration draws nearer and decreases as the options go more and more In-The-Money or Out-of-The-Money.

In fact, the effects of Option Theta decay are most pronounced during the final 30 days to expiration where theta soars.

Take a look at the following chart to see just how predictable and powerful this option paradigm is!



The following charts demonstrate option value and time decay for Netflix at 5 days and 47 days before expiration.

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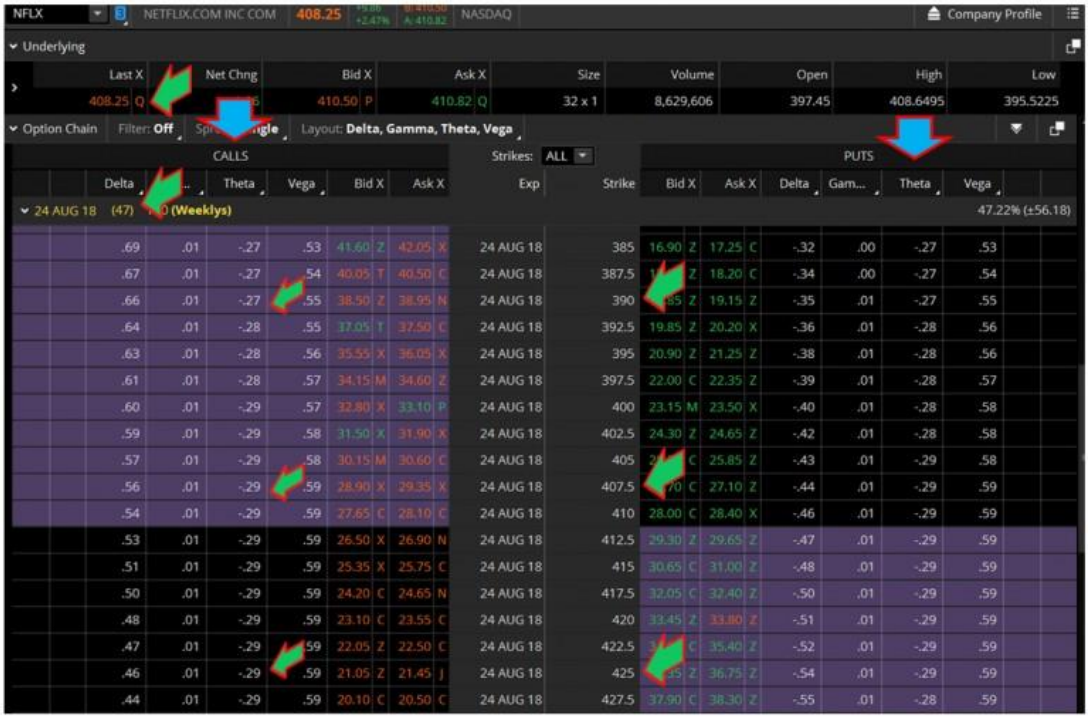
NFLX Theta Values 47 Days From Expiration



How Option Pricing Works

The Greek measure covered above, Implied Volatility, is at the core of option pricing. Here's the formula to value an option

Time Value (x) Implied Volatility (x) Intrinsic/Extrinsic Value

Once you know these variables then you are ready to price an option and know what its option premium should be.

The chart below illustrates the option pricing concept further.

Option Value Numerical Approach

	TIME VALUE	IMPLIED VALUE	INSTRINSIC/ EXTRINSIC	PREMIUM
Thursday	1.00	300	1.00	$300.00
Friday	0.88	300	1.00	$262.50
Saturday	0.75	300	1.00	$225.00
Sunday	0.63	500	1.00	$312.50
Monday	0.50	800	1.00	$400.00
Tuesday	0.38	500	1.00	$187.50
Wednesday	0.25	600	1.00	$150.00
Thursday	0.14	100	1.00	$14.29
Friday	0.00	50	1.00	$ -

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After getting a clear understanding of how traders can use the Greek tools to their advantage, and how options are priced, the next step is to master the foundational setup for butterfly trades.

V. The Butterfly Setup

The structure for butterfly trades consists of a Vertical Debit and a Vertical Credit Spread as outlined below.

Vertical Debit Spread:

A "bull call" spread, entails buying one call and selling a higher-strike call that will be lower in price to offset some of the premium cost & theta decay

A "bear put" spread entails buying one put and selling a lower strike put, that will be lower in price to offset some of the premium cost & theta decay

These spreads create a debit in your account

Vertical Credit Spread:

A "bear call" spread, entails selling one call and buying a higher-strike call that will be higher in price to hedge the short call. Premium collection.

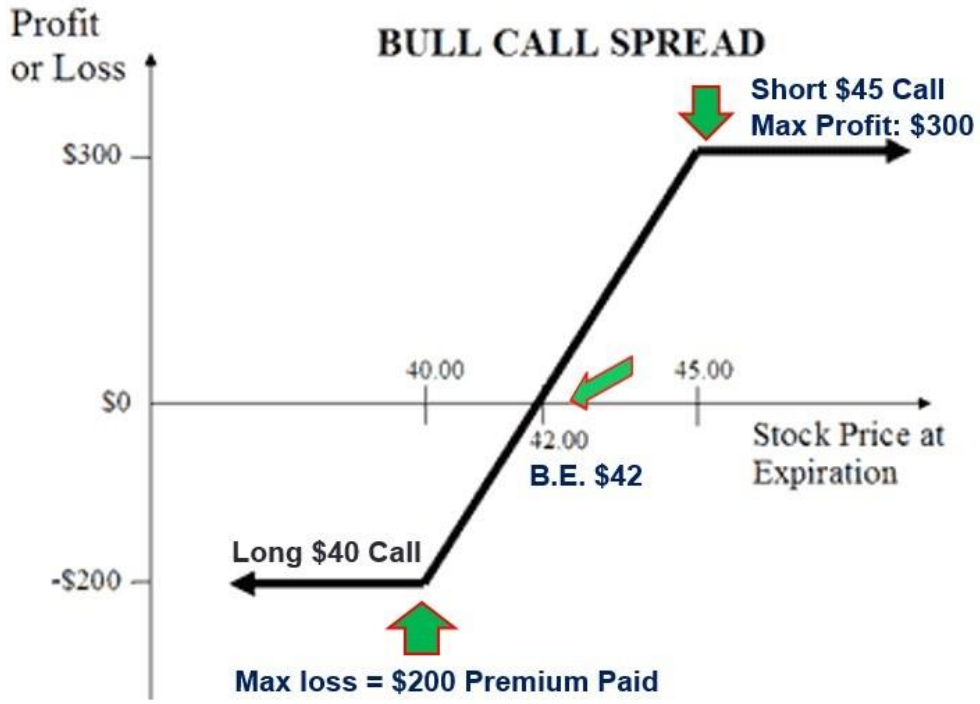
A "bull put" spread, entails selling one put and buying a lower strike put that will be lower in price to hedge the short put. Premium collection.

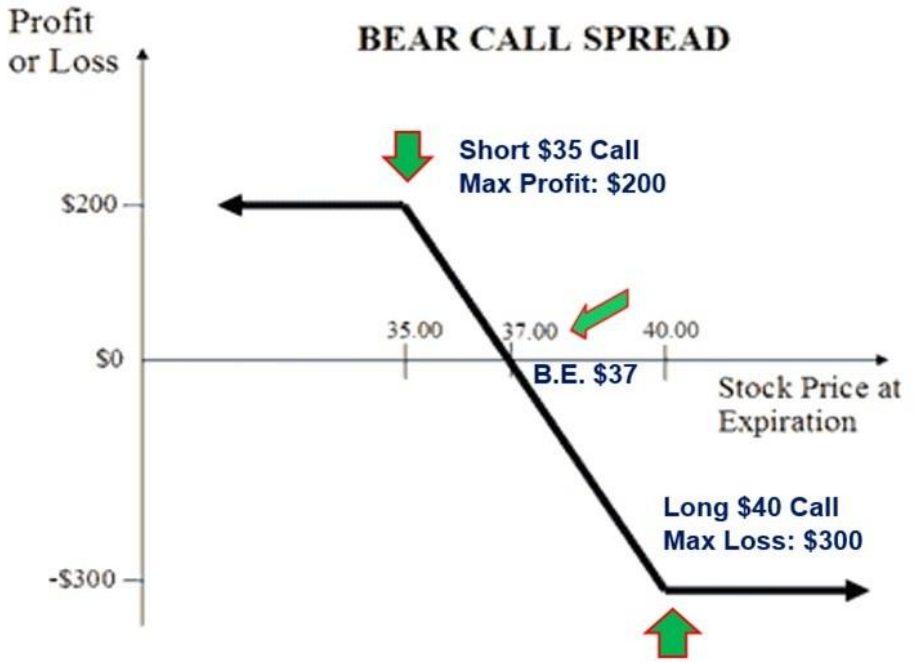
These spreads create a credit in your account.

The spreads are shown graphically in the 5 images below.

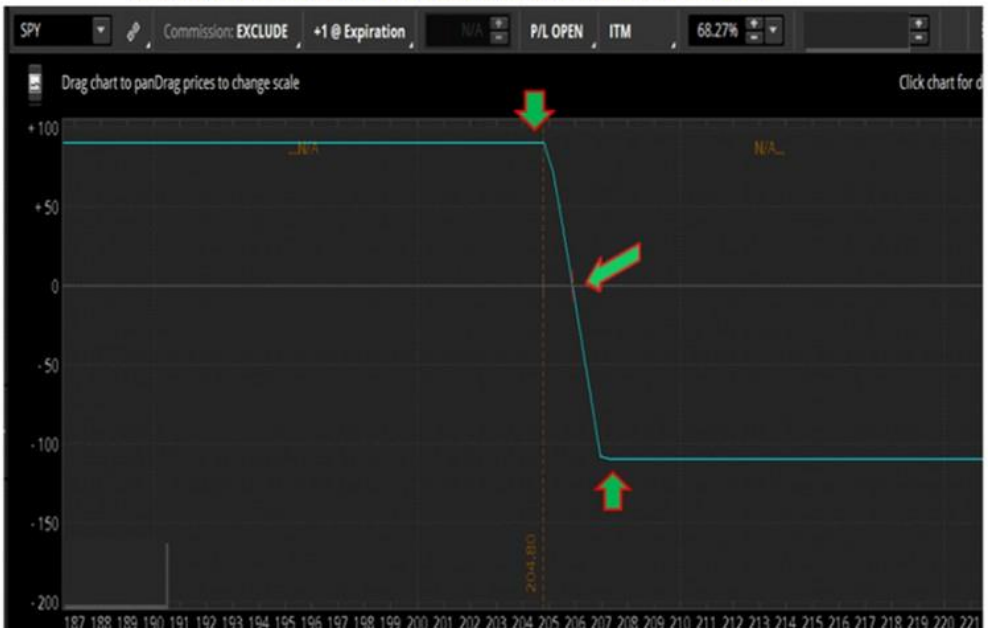
Vertical Bear Call Credit Spread

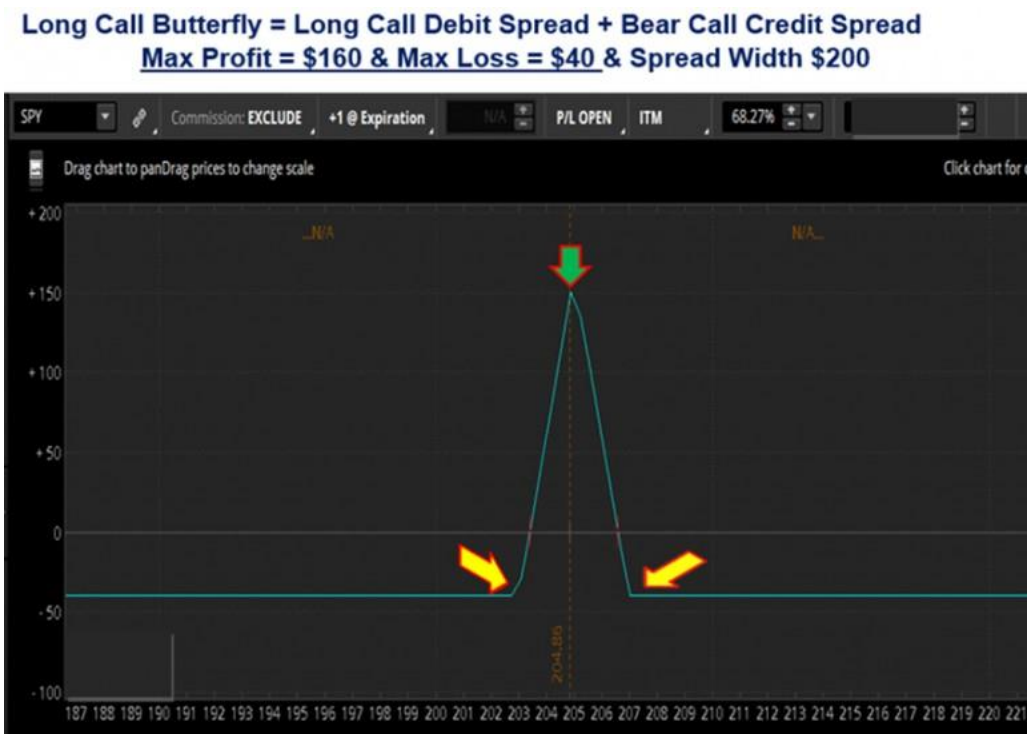
Vertical Bull Call Debit Spread:





Bear Call Credit Sp. SPY: Short May $205 Call – Long May $207 Call = $200 Spread
Max Profit = Credit Received $90 & Max Loss = $110





VI. The 8 Types of Butterfly Option Strategies

One major goal of every trader should be to select trades based on what provides the most consistent positive return with low, defined risk. This may not be the strategy that provides the greatest return for a single trade. But by choosing lower risk, not pie in the sky trades, losers are minimalized. And by minimalizing losses, traders get overall better returns.

One of the best ways to achieve this is by knowing the various Option Butterfly Strategies that are available, how they work and then selecting the one that is best suited for the market environment you are trading.

The 8 Butterfly Strategies

The various Butterfly strategies are listed below. Don't be overwhelmed as each strategy is implemented with a variation on the foundational structure shown above. So, by knowing the foundational structure, traders can then modify it to begin using one variation, and then another.

- Long Call or Put Butterfly
- Short Call or Put Butterfly
- Broken Wing Call or Put Butterfly
- Unbalanced-Ratio Butterfly
- Broken Wing Unbalanced-Ratio Butterfly
- Directional Butterfly
- Iron Butterfly
- Hedging – Defenses Using Butterflies

VII. Long Call or Put Butterfly Spread Example

Let's begin with a Long Call or Put butterfly spread example. It is often called a balanced butterfly spread. Note the following characteristics about this type of butterfly.

- It's a combination of a **bull call debit spread,** and a **bear call credit spread**
- It is a limited profit, limited risk options strategy.
- There are 3 striking prices involved in a butterfly spread and it can be constructed using calls or puts.
- It's called a butterfly spread because you are short the body & long the wings.
- It can be used as a neutral or directional option trading strategy.
- The trade results in a small net debit and the maximum risk is the debit paid.
- Due to small net debit, this strategy tends to offer an excellent risk-to-reward ratio.

It is a short volatility and Theta strategy.

- A target price pinning strategy enhances this trade.

Maximum Profit

The maximum profit occurs if the underlying stock is at the middle strike or the body at expiration.

In that case, the long call with the lower strike would be in-the-money and all the other options would expire worthless.

The profit would be the difference between the lower and middle strike (the wing and the body) less the premium paid for initiating the position, if any.

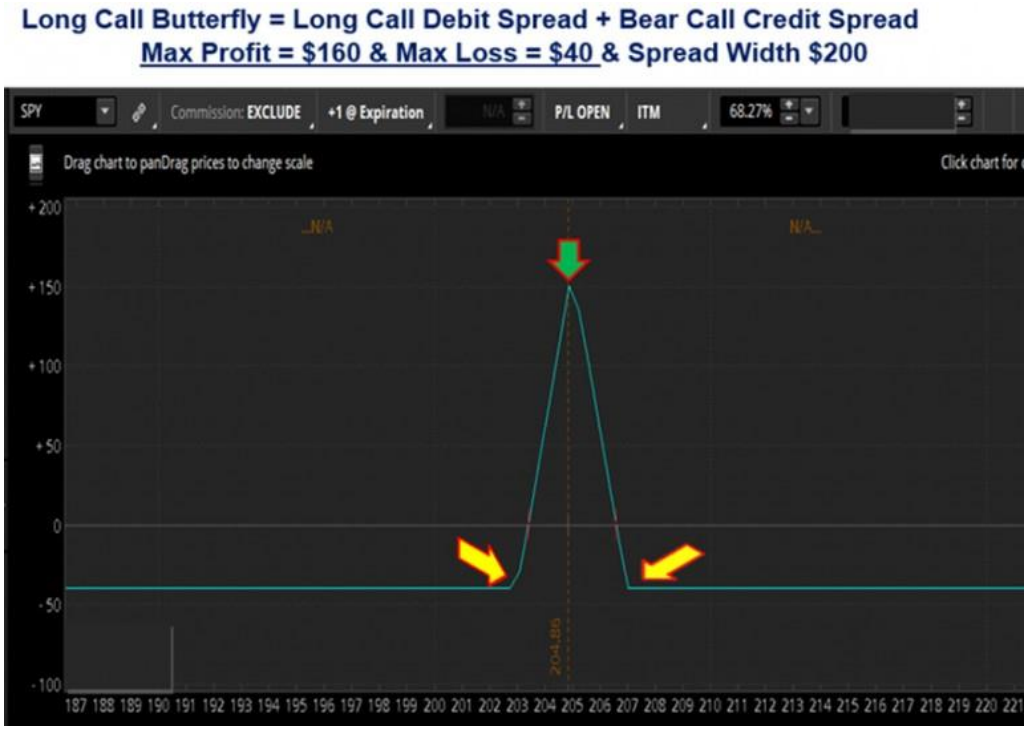
Maximum Loss

The Maximum loss occurs if the underlying stock is outside the wings at expiration.

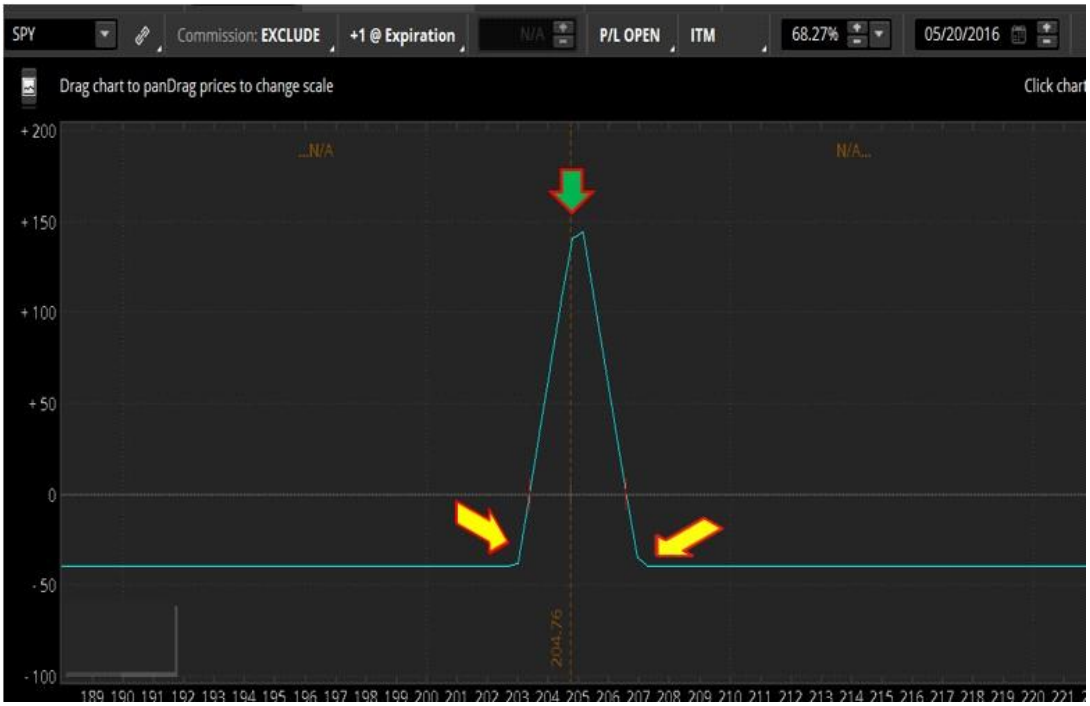
If the stock were below the lower strike, then all the options would expire worthless.

If the stock is above the upper strike, all the options would be exercised and offset each other for a zero profit.

In either case the premium paid to initiate the position would be lost. The two charts below demonstrate this type of Butterfly trade.



Long Put Butterfly = Long Put Debit Spread + Bull Put Credit Spread
Max Profit = $160 & Max Loss = $40 & Spread Width $200



Long Call Butterfly Example

Below is an example of a long call butterfly trade.

Assuming XYZ trading at $45 ~ Directional Price Target $43

Buy to Open 1 contract of August $44 Call at $1.06

Sell to Open (2) contracts of August $43 Call at $1.67
Buy to Open 1 contract of August $42 Call at $2.38

Net Debit = ($2.38 + $1.06) – (2x $1.67) x 100 = **$10.00 per spread**

Profit Calculation of Butterfly Spread

Maximum Profit = (Middle Strike – Lower Strike – Net Debit) x 100

Assuming XYZ closed at $43 at expiration.

Maximum Profit = $43 – $42 – $0.10 = $0.90 x 100 = **$90.00 per spread**

ROC = $90/$10 = **900% or R: R 9-to-1**

This example has a 9 to 1 risk reward ratio, which is not uncommon with Butterfly trades. This is why they are so popular with traders who want to focus on lower risk, more consistent trades.

"Larry, you missed the AAPL prediction by two cents, but I guess that was close enough for the Butterfly Spread! Uncanny how your $160 goal was almost exactly on-the-money.

Thanks to you, I got in on the butterfly and made 390%. Not bad for three days of work. Thanks again." Don

Results Vary. There Is No Guarantee of Similar Results with the Same Strategy.

Larry Gaines has become one of the leading coaches for successful traders and investors. He continues to develop and host, every month, new trading educational programs to help traders and investors generate greater income from their investment capital with less risk exposure.

*He founded **PowerCycleTrading.com** and the Power Cycle Virtual Trading Room following over 30 years of professional trading experience in the commodity and equity markets.*

During his tenure as head of an international trading company that often traded a billion dollars' worth of commodities in a single day, he learned first-hand the necessary elements of a successful trading system and the use of options.

*Using this in-depth knowledge and experience, Larry developed the **Power Cycle Trading™ Model** to allow for greater profits with a more disciplined, systematic degree of trading success.*

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