5 Things You Must Know about Trading Option Butterfly Spreads

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Butterflies provide a low risk high reward trading opportunity. Markets direction can go through months, and even years of higher than usual uncertainty. Technical analysis may be painting one picture, while the economic or political environment is painting another. This can be both stressful and costly. The Butterfly strategy offers a solution to this dilemma that all traders face on a regular basis.

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. This increases risk for traders and investors. Yet, waiting on the sidelines has opportunity costs. 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 know of the advantages of the Butterfly, 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 eBook, I’m going to simplify the Butterfly 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 get in this book

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

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!

1. You Just 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. Trying to pick the direction of stocks or the overall market can be stressful and expensive. 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 to execute hedge on positions that are moving against you. This is exactly what the most sophisticated companies do. They hedge, and so can individual traders! Note: This lowers trading stress!

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.

Butterflies provide cheap protection! Many longer-term investors and swing traders buy puts for portfolio insurance. 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 best structured and traded at a very low cost.

**Risk Reward** - A 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)**.

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### III. The Option Greeks You Need to Know First

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 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 seeks 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.

**For 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 is 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!
How Option Pricing Works

**How to value an option**

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

Note: Once you know these variables then you are ready to price an option & know what its option premium should be.
The Butterfly Foundation - Vertical Spreads

Butterfly Foundation: Vertical Debit & Vertical Credit Spread

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 are done for a debit

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 are done for a credit

**Vertical Bull Call Debit Spread**

![Graph showing a vertical bull call debit spread.](image)

- **Long $40 Call at B.E. $42**
- **Short $45 Call at Max Profit: $300**
- **Max loss = $200 Premium Paid**
Vertical Bear Call Credit Spread

**Short $35 Call**
*Max Profit: $200*

**Long $40 Call**
*Max Loss: $300*

**B.E. $37**
Bull Call Debit Sp. SPY: Long May $203 Call – Short May $205 Call = $200 Spread
Max Loss = Premium Paid $130 & Max Profit = $70
Bear Call Credit Sp. SPY: Short May $205 Call – Long May $207 Call = $200 Spread
Max Profit = Credit Received $90 & Max Loss = $110
Selecting the Right Butterfly Option Strategy

One major goal of every trader should be to select trades based on what provides the most consistent positive return with low, defined risk. Not always the greatest return.

And one of the best ways to achieve this is by knowing the 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.
Butterfly Strategies

- 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

The Butterfly Foundation = The Balanced Butterfly

Long Call or Put Butterfly Spread

- 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
- Called a butterfly spread because you are short the body & long the wings
- Can be used as a neutral or directional option trading strategy
- Trade results in a small net debit & max risk is the debit paid
- Due to small net debit, this strategy offers a great risk-to-reward
- Short Volatility & Theta Strategy
- A target price pinning strategy
**Max Profit**

The maximum profit occurs should the underlying stock be at **the middle strike or 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.

**Max Loss**

The Maximum loss occurs should the underlying stock be outside the wings at expiration.

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

If **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.
Long Call Butterfly = Long Call Debit Spread + Bear Call Credit Spread
Max Profit = $160 & Max Loss = $40 & Spread Width $200
**Long Put Butterfly** = Long Put Debit Spread + Bull Put Credit Spread  
Max Profit = $160 & Max Loss = $40 & Spread Width $200

Balanced Butterfly Spread Example:

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

Buy to Open 1 contract of Sept. $44 Call at $1.06  
Sell to Open (2) contracts of Sept. $43 Call at $1.67  
Buy to Open 1 contract of Sept. $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**
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Learn More about these High Reward – Low Risk Option Strategies by Clicking the Link Below Now

http://powercycletrading.com/si-butterfly

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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