

Capital Discussions

Kevlar Butterflies

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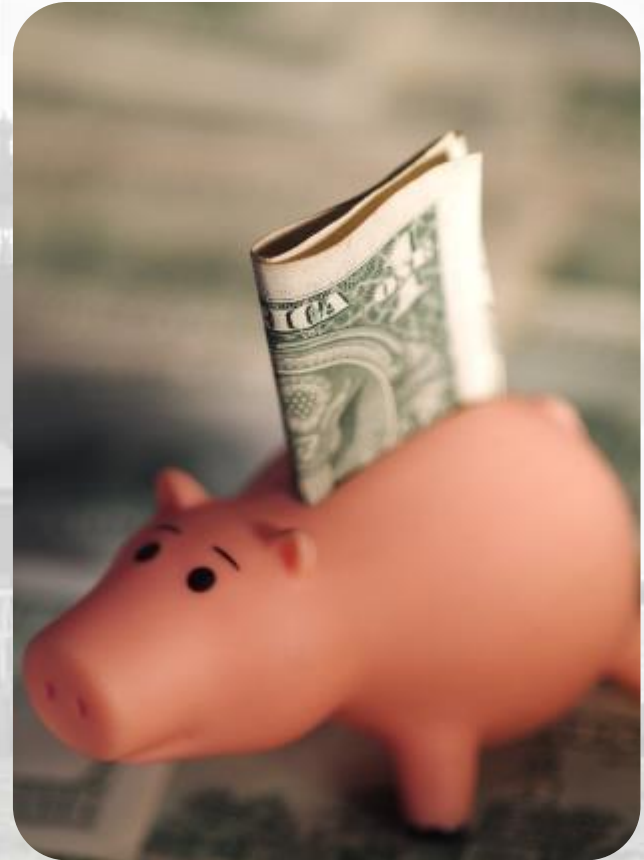
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Kevlar (Hedged Broken Wing Iron) Butterflies

Agenda

- ◆ Design Approach
- ◆ Trade Setup
- ◆ Trade Management
- ◆ Trade Exit
- ◆ Example Trade



Capital Discussions: Design Approach

- ◆ Past performance doesn't mean jack
- ◆ Markets change
- ◆ The High Frequency guys took most “edges” away
- ◆ Most Strategies (with static rules) that made \$\$\$ in the past...
 - DON'T WORK ANYMORE
- ◆ Trading strategies must adapt to these changing markets

Design Approach

◆ Goal

■ ... for my ROTH IRA

1. \$5,000 wouldn't make a difference in my life
2. ... but \$500,000 in a tax-free ROTH IRA would!

◆ Objective

1. Add \$6,500 every year until I'm 59 ½. (I am 51 years old)
2. High Risk / Higher Returns
3. \$500,00 by the time I am 59 ½ years old.



Design Approach

- ◆ Can you define your edge?
- ◆ Markets change...
- ◆ How sustainable is your edge?
- ◆ Understand and play the probabilities
- ◆ Know your risk tolerance level
- ◆ Design trade for the specific underlying
 - Implied Volatility
 - ◆ *Negative Volatility Skews or Put Skew*
 - ◆ *Volatility Term Structure*
 - Liquidity
- ◆ Trade the market you have, not the market you image



Trade Setup / Trade Management / Trade Exit

- ◆ Go read the Disclosure *again*
- ◆ Trading options is *not* easy
- ◆ Many of you will lose money...
until you “master the craft”
- ◆ If you do try this at home... ***TRADE SMALL!***
 - *As Dad said... “Do as I say, not as I do.”*

Trade Setup

- ◆ **Underlying:** SPX
- ◆ **Capital Allocation:** (Huge Risk)
 - Max IRA Margin = Account Value
- ◆ **Timing:** 45 to 28 DTE (days to expiration)
 - Best with *higher IV* and *steeper (i.e., more negative) Put Vol Skews*
- ◆ **Target Profit:**
 - Significantly above the money: Break Even (difficult, but hopefully)
 - Slightly above the money: 0-5%
 - At the money: 5-10%
 - Slightly below the money: 10-15%
 - Significantly below the money: 15-20%
 - Market crash: Break Even (difficult, but hopefully)
- ◆ **Max Loss:** 20% (again hopefully)



Trade Setup (Trade Structure per tranche)

- ◆ 2 or 3 Broken Wing Iron Butterflies (BWIB)
- ◆ BWIB centered near a Put Delta of 30 and Call Delta of 70
 - Call wing length: approx. 5 SDs (daily SDs)
 - Put wing length: approx. 7 SDs
 - Try to use 25 point strikes
 - Depending on VIX and Put Skew:
 - ◆ Low VIX => Call wing: 50 points wide and Put wing 75 points wide
 - ◆ Mid VIX => Call wing: 75 points wide and Put wing 100 points wide
 - ◆ High VIX => ???
 - ATM should be approx. 5 to 25% up the Call wing of BWIB
 - **Greeks Notes:**
 - ◆ Delta slightly negative (approx. -5 to -15 per *tranche*)
 - ◆ Theta positive (approx. +15 to +30 per *tranche*)

Trade Management (Downside Adjustments)

When? (triggered based on Position Delta per tranche)

- ◆ When SPX price reaches center of BWIB or...
- ◆ During first two weeks: when Delta turns positive
- ◆ Thereafter: $\Delta > 5$ to 10

Adjustments

- ◆ Buy broken wing Put butterflies, where:
 - Long Put wing: buy back original short Put BWIB wing
 - Short Put wing: $\frac{1}{2}$ length of original short Put BWIB wing
- ◆ Buy enough Put butterflies to turn the Delta negative



Trade Management (Upside Adjustments)

When? (triggered based on Position Delta per tranche)

- ◆ 1st week: do NOTHING.
- ◆ 2nd week: if ATM is above long call strike for three to five days.
- ◆ Thereafter: if ATM is above long call strike or if Delta < 15 to 25

Adjustments

- ◆ Buy broken wing Call condor, where:
 - Long Call wing: buy back original short Call BWIB wing
 - Short Call wing: $\frac{1}{2}$ length of original short Call BWIB wing
 - ◆ Short strike of short Call wing should have a Delta between 20 and 25
- ◆ Buy enough Call condors to cut Delta between -5 and -20
 - Early in the trade less negative; Later, more negative

Trade Management

Greek NOTES

- ◆ *Keep Delta slightly negative to counteract negative Vega.*
- ◆ Later in the trade, consider rolling the long BWIB Puts higher
 - This is because Gamma increases more rapidly closer to Expiration
 - Rolling the long Puts up will drastically reduce Margin required
 - ... And rolling will allow us to start next months trade earlier



Trade Exit



Taking Profits

- ◆ Start exiting taking profits once Profit reaches 20% or 14 DTE using "*peel process*"
- ◆ The "*peel process*" refers to
 - Only using close existing strikes. NO new strike should be opened.
 - Or opening Put or Call wings for next month trade

Trade Exit

- ◆ Exit trade immediately if Max Loss is reached
- ◆ Exit trade completely during expiration week
- ◆ Decide to leave to expire: "Read the SPX options tea leaves"

Kevlar Butterfly Trade Examples

- ◆ OptionVue Example
- ◆ LiveVolX (Put Skew & Risk Analysis)
- ◆ Thinkorswim: (Risk Analysis)
 - Greek calculations issue?



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Capital Discussions / SPX Kevlar Slides



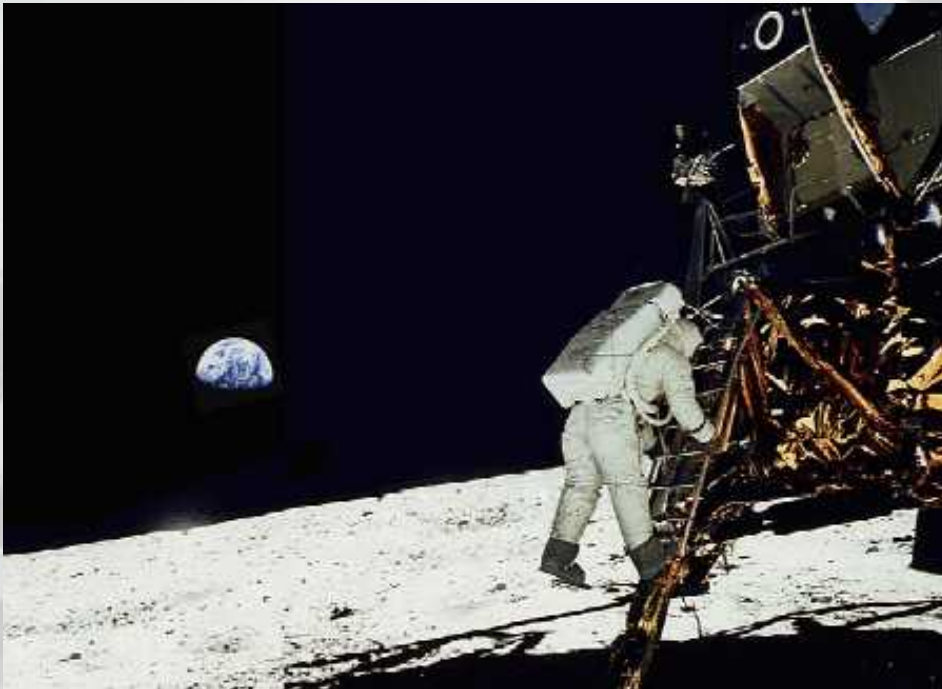
Capital Discussions: Current Status / ROTH IRA

Month / Yr	Deposit	Acct Balance	% Change
June 1, 2013*		\$5,031.68	
*Starting Balance			
Jun, 2013	\$0	\$6,867.12	36.5%
Jul	\$0	\$8,217.17	19.7%
Aug	\$0	\$8,109.18	(1.3%)
Sept	\$0	\$7,235.30	(10.8%)
Oct	\$0	\$9,183.63	26.9%
Nov	\$0	\$11,460.63	24.8%
Dec	\$6,500	\$22,531.86	39.9%
Jan, 2014	\$0	\$21,647.89	(3.9%)
Feb	\$0	\$22,001.53	1.6%
Mar	\$0	\$25,403.07	15.5%
Apr	\$0	\$25,560.98	0.6%
May	\$0	\$23,671.65	(7.4%)

- ◆ **Remember: Past performance doesn't mean anything!**
- ◆ Will I be able to replicate this performance?
- ◆ I don't have a clue!
- ◆ My Goal?
- ◆ \$500,000 in 8 years

How Can I Beat the High Frequency guys?

High Frequency guys are Engineers.
Engineers put a man on the moon
... before they put wheels on luggage.



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