

Breakthrough Backtesting Results for IV-Based SPX Iron Condor Option Trading System

-Updated To Include Impact of Market Correction of
May-June, 2006

PART 1 – Introduction and 2005 Results

Steve Burke

© Perazzim Capital Management, Inc.
3220 Mcleod Ave, Suite 100
Las Vegas, Nv 89121

Version 2.0 June 15, 2006

NOTICE: You do NOT have the right to re-print or resell this eBook!

You also MAY NOT give away, sell or share the content herein.

If you purchased this ebook from anywhere other than <http://www.breakthroughbacktesting.com>, or from <http://www.clickbank.com> or <http://www.paydotcom.com> you have a pirated copy.

Please help stop Internet crime by reporting this to:
<mailto:support@breakthroughbacktesting.com>

Copyright 2006 Steven Burke

ALL RIGHTS RESERVED. No part of this report may be reproduced or transmitted in any form whatsoever, electronic, or mechanical, including photocopying, recording, or by an informational storage or retrieval system without the expressed written, dated and signed permission from the author.

Any trademarks, service marks, product names or named features are assumed to be the property of their respective owners, and are used only for reference. There is no implied endorsement if this book uses one of these terms.

LIMITS OF LIABILITY / DISCLAIMER OF WARRANTY:

U.S. Government Required Disclaimer - Options trading has large potential rewards, but also large potential risk. You must be aware of the risks and be willing to accept them in order to invest in the options markets. Don't trade with money you can't afford to lose. This book is neither a solicitation nor an offer to Buy/Sell options. No representation is being made that any account will or is likely to achieve profits or losses similar to those discussed in this book. The past performance of any trading system or methodology is not necessarily indicative of future results.

HYPOTHETICAL OR SIMULATED PERFORMANCE RESULTS HAVE CERTAIN LIMITATIONS. UNLIKE AN ACTUAL PERFORMANCE RECORD, SIMULATED RESULTS DO NOT REPRESENT ACTUAL TRADING. ALSO, SINCE THE MOST OF THE TRADES HAVE NOT BEEN EXECUTED, THE RESULTS MAY HAVE UNDER-OR-OVER COMPENSATED FOR THE IMPACT, IF ANY, OF CERTAIN MARKET FACTORS, SUCH AS LACK OF LIQUIDITY. BACKTESTED SYSTEMS IN GENERAL ARE ALSO SUBJECT TO THE FACT THAT THEY ARE EXECUTED WITH THE BENEFIT OF HINDSIGHT. THE AUTHOR HAS TAKEN EXHAUSTIVE STEPS TO DETERMINE THE EXPECTED RETURN (PROFIT or LOSS) OF CERTAIN OPTIONS TRADING SYSTEMS. HOWEVER, NO REPRESENTATION IS BEING MADE THAT ANY ACCOUNT WILL OR IS LIKELY TO ACHIEVE PROFIT OR LOSSES SIMILAR TO THOSE SHOWN.

This manual contains material protected under International and Federal Copyright laws and Treaties. Any unauthorized reprint or use of this material is prohibited.

| | |
|---|----|
| Introduction..... | 4 |
| What is the Problem?..... | 4 |
| Why Hasn't the Problem Been Solved Yet?..... | 4 |
| What is Possible?..... | 4 |
| How to Read This Book – PLEASE READ THIS:..... | 5 |
| Update Now Includes Jan, 2006 to May 2006..... | 5 |
| SPX Index Iron Condor System..... | 6 |
| SPX Index Iron Condor System..... | 6 |
| Overview..... | 6 |
| SPX Index Iron Condor System Rules..... | 6 |
| Iron Condor Examples..... | 6 |
| SPX Iron Condor System Raw Results for All 2005 Trades..... | 14 |

Introduction

What is the Problem?

Most retail option traders are net losers. Many go to different training classes, spending thousands of dollars. After following the experts systems and advice, they still lose. Examples showing classic technical analysis, Elliot Wave patterns, or time premium generation work well in the class room, but fail in your trades. You have expectations of making 300%, but keep selling at 50% stop losses.

Why Hasn't the Problem Been Solved Yet?

Professional traders that teach or provide advisory services may not do the tedious academic task of backtesting an options trading system results using lots of samples during a whole year or more. Or if they did, they do not present the results FOR THE CURRENT MARKET. What may have worked in directional markets like 1999 (up) and 2001 (down) may not work now!

Finance professors in academia focus on researching options pricing theory and finding elegant formulas but do not test with large samples of real trades. I am filling that gap between the professional trader and the academic by properly backtesting stock options trading system with a set of statistically significant real trade samples.

There are too many lessons to learn about how the market operates. The teachers can't cover all of them in a seminar.

- An earnings warning reverses a trend.
- An analyst downgrade comes out of nowhere.
- Overall market sentiment overrides an individual stock's trend.
- Implied volatility crush cancels out a stock's rise in price.
- Position sizing and risk management are not emphasized as much as they should be for beginners.

Unfortunately, people learn these lessons one at a time. Many trade large positions such that each sequential lesson eventually wipes out an account.

What is Possible?

In this special report, I will present the results of backtesting one major strategy presented at typical option trading seminars and presented in various options books. Visualize a valid expectation of performance of this Iron Condor strategy before you trade your money! Learn your lessons NOW! – Not after 2 years of sequential trading and losses. Understand graphically how the different lessons affected performance.

Receive a bonus of a new system using a new Elliott Wave indicator as compared to the NASDAQ index. The backtesting results will increase your understanding of the overall

market's impact on individual stocks that will reduce the number of Elliott Wave trades that are destined to go wrong.

You will have any idealized vision of tripling or octupling your total account in a year replaced with REALITY! There are profitable systems out there that can generate income in the long run. They just may not be the ones you think. Unrealistic fantasies will be replaced by hard empirical facts of backtested results for a year or more using a statistically significant number of samples. When you have realistic expectations of a certain amount of profit per year, you can begin to trade with less emotion and with a more systematic "robotic" attitude. This only improves performance.

How to Read This Book – PLEASE READ THIS:

The next two major chapters describes the results of backtesting an options trading system using real trades. There are general findings like system X had a yearly profit of 60% of total account size – or system Y had a loss of 10%. **But the real learning is in meditating on the rules and re-reading the comments on the actual individual trades listed in the tables.**

You want your mind transformed into that of a confident trader by seeing how mechanical and relatively non-subjective the rules are. The more you meditate on trade after trader and see the different lessons learned from each trade, the more you feel as if you made those trades and act as if the lessons are yours! One lesson in the SPX Iron Condor System chapter is that if the S&P 500 comes within 10 points one of your short strikes during expiration week, it is best to just exit. Exiting the trade with a smaller than planned profit is better than letting the trade become a loss. If you meditate on that lesson long enough, then when you actually place a real trade and that scenario happens, you'll have your plan ready to take the proper corrective action. Therefore, please re-read the chapters on the systems you plan to trade over and over to get this in your trading psyche.

Also, this will be mentioned again, this book is not a general options tutorial. Please read the classic books on options listed in the Recommended Reading list at the end of this book.

Update Now Includes Jan, 2006 to May 2006

After the market correction (or mini-crash) of May-June 2006, I wanted to see how the Iron Condor trading system of this book worked out. Would the directional system finally make some real profits? Would the non-directional systems suffer large losses? There is a separate section at the end of Iron Condor section to discuss the additional trades that were signaled for the Jan-June, 2006 time frame. The lessons revealed during this time period will further improve your understanding of how overall market conditions affect various trading systems.

SPX Index Iron Condor System

Overview

Out of all of the strategies I have backtested, this one is my favorite. An iron condor is the combination of an out-of-the-money (OTM) call credit spread and an OTM put credit spread. The result is a trade that gives you a credit, which requires margin, when the stock stays in a certain range. See [MacMillan] in the Required Reading section for more details on the properties of an iron condor and how to construct one. The strategy here is to put on an iron condor for every month's expiration using an index option like the SPX. Since index options do not have the surprises we discussed in the introduction above (earnings gap, analyst downgrade, takeovers, etc.), the probability of the index staying in a range from month to month is higher than doing a condor on a single stock.

SPX Index Iron Condor System Rules

Here are our rules:

1. ENTRY RULES: Use the SPX or other major index option. However, cash settled indices like the SPX are preferable to stock or certificate settled indices.
 - a.
 - b.
 - c. **PLEASE BUY THE COMPLETE IRON CONDOR REPORT for \$17 to RECEIVE THE DETAILED ENTRY, ADJUSTMENT, and CLOSING RULES THAT ANYONE CAN FOLLOW!**
 - d.
 - e.
 - f.
2. ADJUSTMENT RULES:
 - a.
 - b.
 - c.
 - d.
3. CLOSING RULES:
 - a.
 - b.
 - c.
 - d. **HERE IS ONE RULE: If a short strike is crossed by more than 5 points intra-day, then just GET OUT! This is a new rule added due to the May-June 2006 mini-crash. See the updated results on pages [50-52](#).**

Iron Condor Examples

Let's look at every, that's right, every condor trade for 2005. I really recommend you read through each of these as you can see how most months require no mandatory adjustments, but some are intense. The bottom line profit for the year yields the best overall return when you consider ALL of the factors that go into trading:

1. Time spent managing the trade. Iron Condors require maybe 30 minutes at the most on the day you put it on to find the short strikes and place the trade. You do NOT need to watch this every trading hour for every day. This is why index options are chosen. They have the fewest surprises.
2. Margin is the parameter that is exploited the most. That is, by requiring \$2500 for each side of the condor, you are technically risking a lot to make a \$250 to \$350 credit per month. We are using the math formula in the entry rules to make this surface level high risk trade a high probability profit trade. So we are balancing risk versus probability of profit towards the side of probability. Note that the backtesting of directional Elliott Wave trades risk a small amount. But the probability of long term profit is smaller than you think for Elliott Wave trades.
3. Long term profit using MOST of your account.

OK, let's step through the first trade for 2005.

1. To put on a trade for the January 21st, 2005 expiration we can trade on December 13th, 2004. Using the formula defined in the entry rules gives short strikes of 1256 for the call credit spread and 1127 for the put credit spread. If we choose the 1250 and 1275 calls and the 1125 and 1110 for the puts, we have a maximum margin of \$3500 if your broker keeps margin for both sides. \$2000 is only needed if the broker is nice enough to realize that the price can only cross one of the short strikes at expiration (or any time). This will yield a credit of \$235 if the market makers do not let you shave some discount off of the bid/ask spread. You can get \$275 if one third of the bid/ask spread is given to you by the market maker. I saw an e-mail discussion that talked about how some market makers like retailers to submit trades that are marked as iron condors. This is because the iron condor is a delta neutral trade and requires no hedging work by the market maker. Apparently, they may give you half of the bid/ask spread.

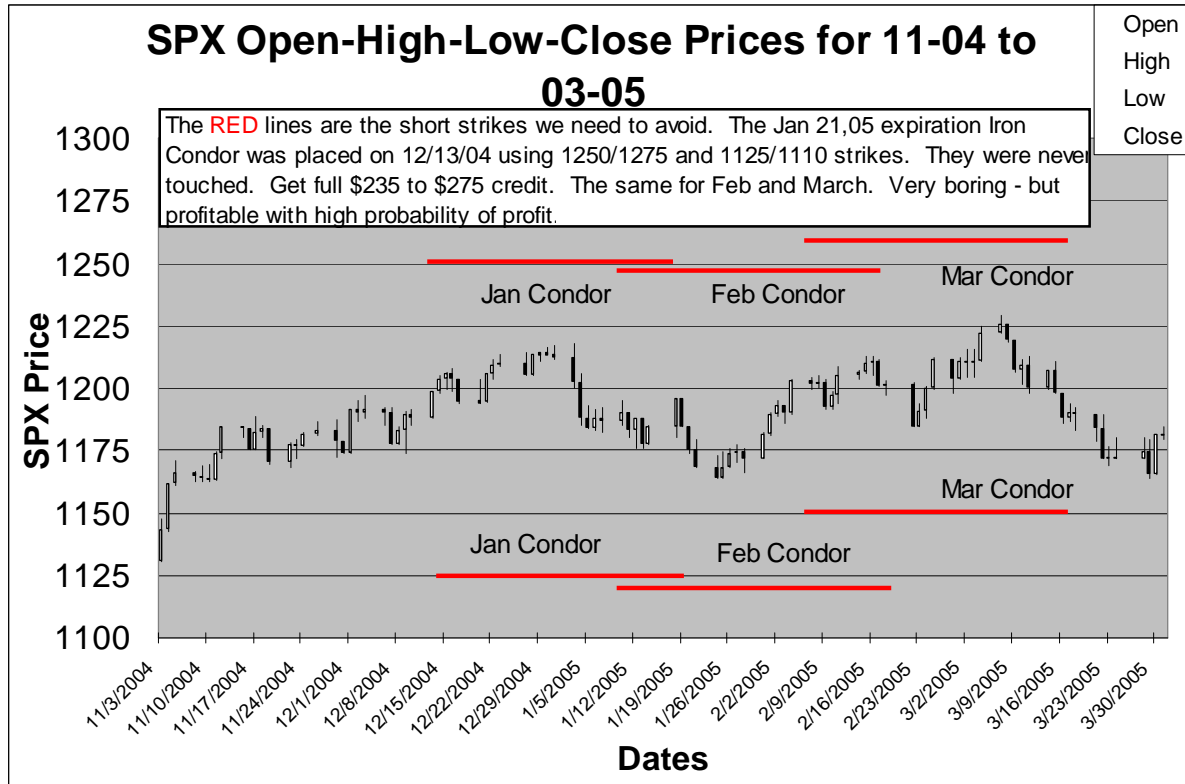


Chart 13. This chart has the short limits for 3 condors taken for the Jan05, Feb05, and Mar05 expirations. You can see how these relatively wide limits provide a reasonable, but not greedy, amount of credit each month.

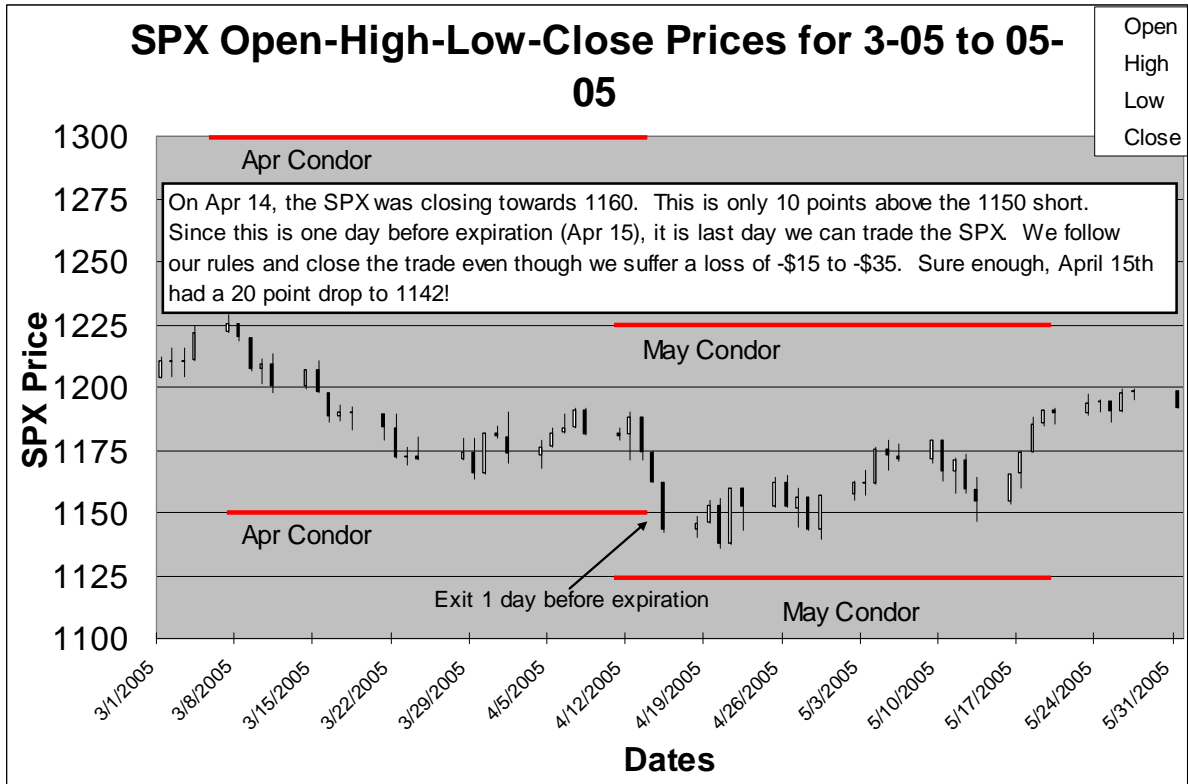


Chart 14. April, 2005. Because the last day of trading on the SPX is one day BEFORE expiration, we see that we were only 10 points from our short stride so we exit with losing our credit and even suffering a \$15 to \$35 loss depending on what time of day on Thursday you exited the trade. Sure enough, expiration Friday, April 15th, saw a large decrease in the market. The \$15 to \$35 loss would have turned into an \$800 loss. Please do not be greedy. Follow the rules and get out of your trade. Save your capital to trade another day.

SPX Open-High-Low-Close Prices for 6-05 to 07-05

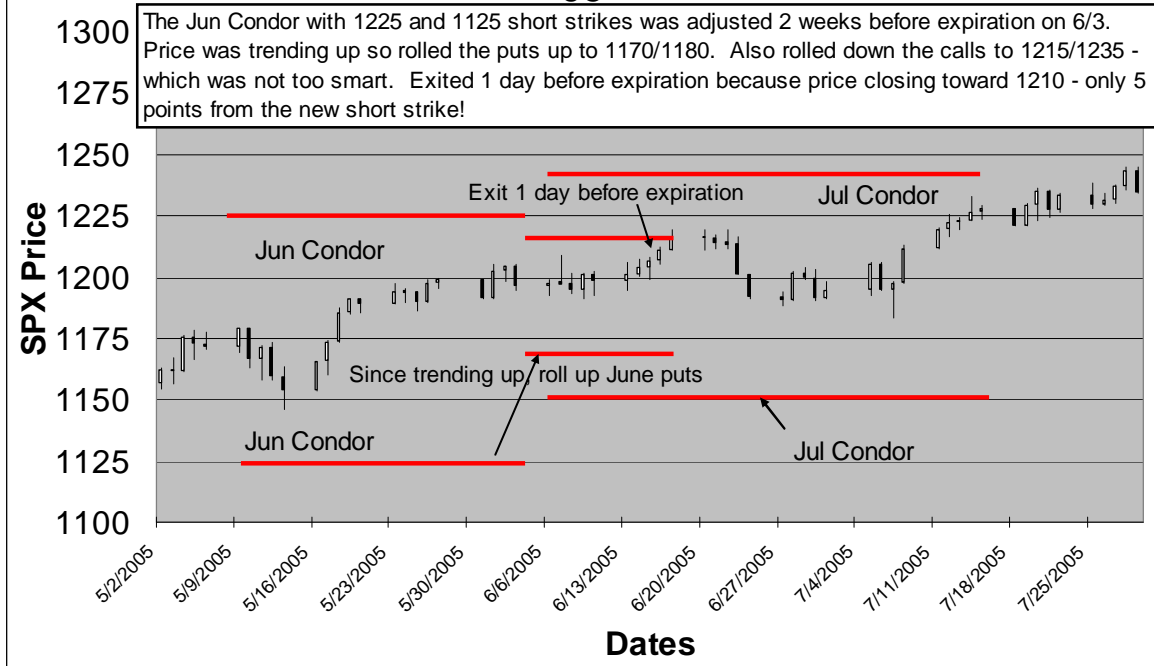


Chart 15. Shows how it is best not to adjust too much just to get a little extra credit. June was trending up steadily, so with 2 weeks left to expiration, we rolled up the puts to get more credit. However, we also rolled down the calls. This was not wise as the market continued to trend up forcing us to exit one day early one day before expiration since the market was getting too close to our short strike.

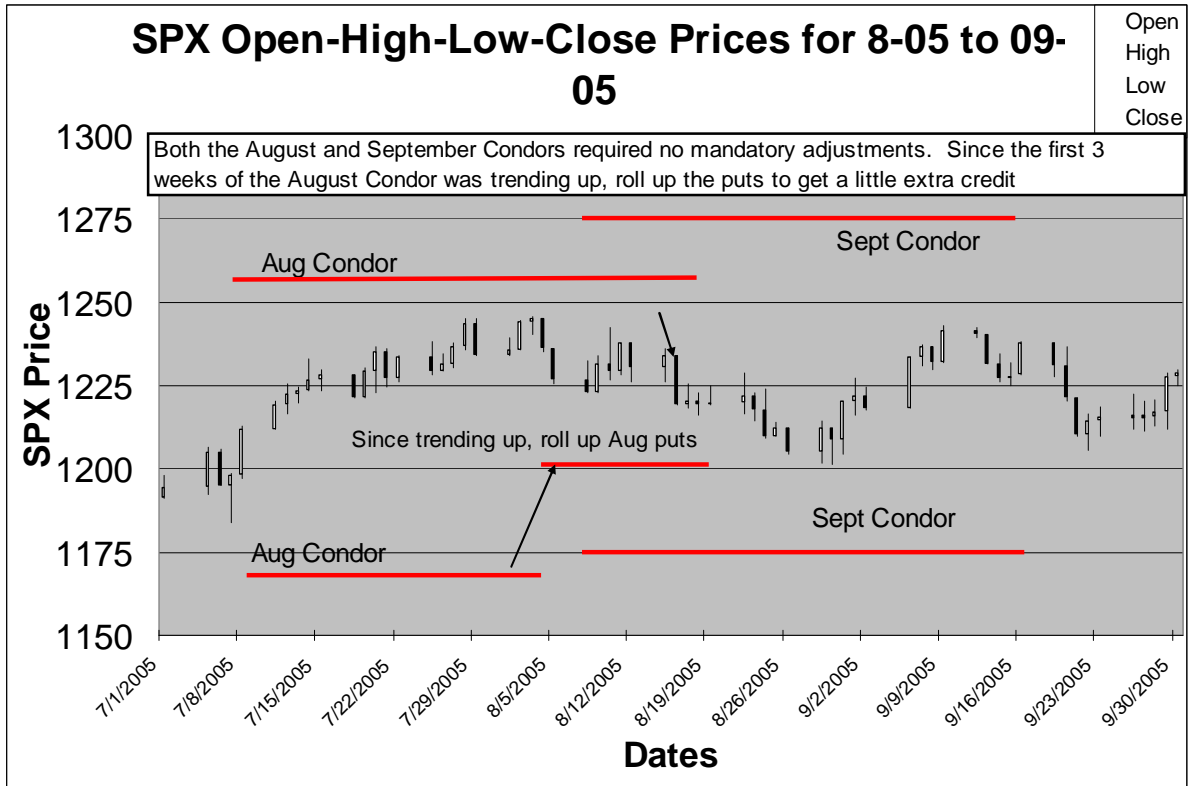


Chart 16. August trended up so we rolled up to get some extra credit. See how September was trading in a sideways range? No extra credit for that month.

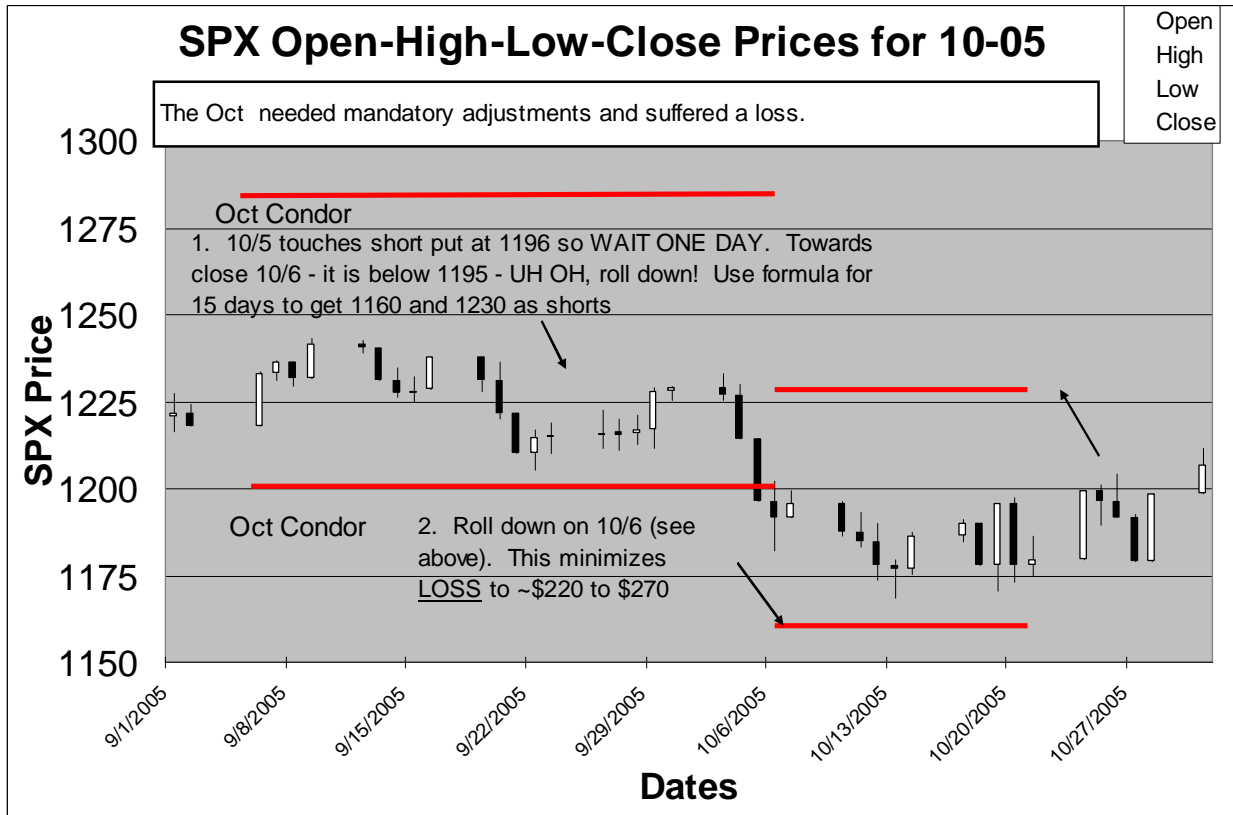


Chart 17. October showed a steady down trend. We followed our rules and waited one day on 10/6. The market was still below our short strike on the next day, so we do an adjustment using the remaining days for our time variable to choose new short strikes. Please note that the adjustment only minimized the loss. It could not change a loss into a profit unless we wanted to risk more margin – which we don't..

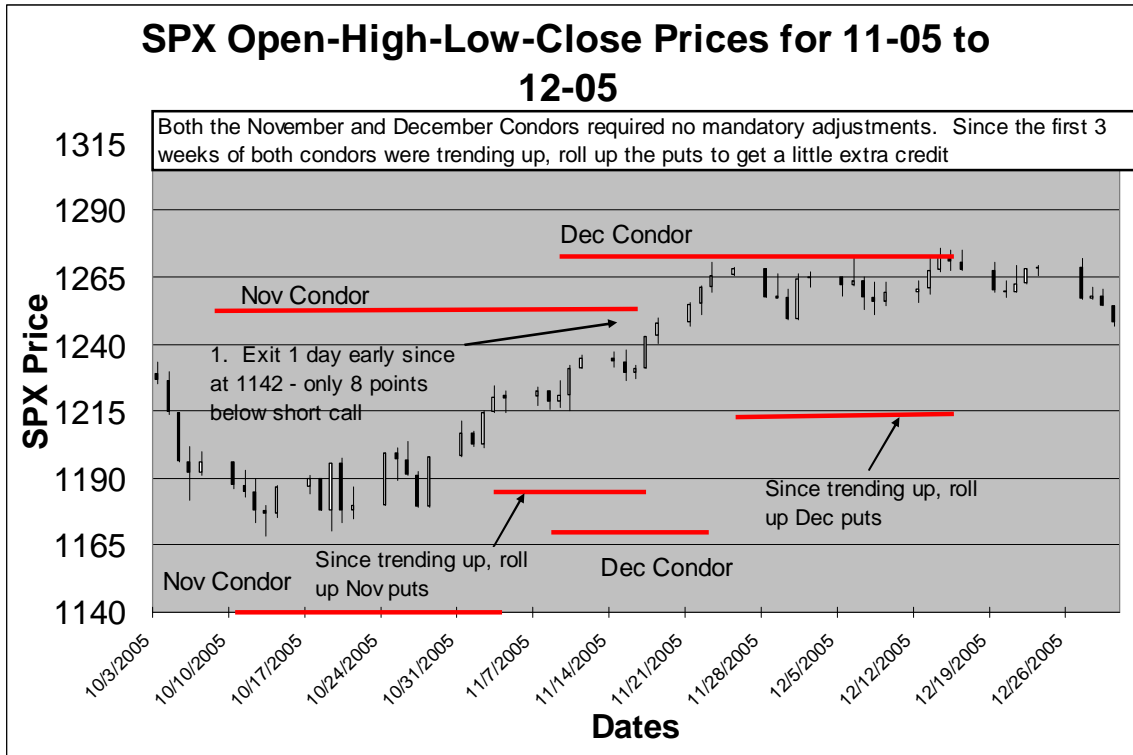


Chart 18. After the October drop, both November and December rebounded. This allowed us to roll up the puts on both months and recover some of the loss from October. Again, we should have a long term focus based on making many trades and accepting the few that lose.

SPX Iron Condor System Raw Results for All 2005 Trades

Here is the table showing key attributes of each of the SPX Iron Condor System trades taken in 2005. The columns are defined as follows:

1. Expiration and Entry are the expiration date for the month we want the trade and the date we enter the trade in order to receive the credit. When there is an adjustment, this column represents the day the adjustment was made.
2. SPX Short Call and Sigma Short Put are the values of the SPX that represent the short call and put strikes that the entry rule formula recommends.
3. SPX Credit and Credit No Shave represent the amount of credit we receive when we place the trade when we shave one third off of the bid/ask spread and when we just trade at the natural.
4. The SPX legs are the actual strikes taken for the trade based on find short strikes closes to SPX Short Call and Short Put and with a guide of no more than \$5000 margin risk.
5. Margin is the actual margin for the trade. In order to get a 'good' credit, sometimes one side of the trade may have a different margin than the other.
6. Profit and Profit no shave are the actual profit we make when we close the trade – with shaving one third of the bid/ask and without. Losing trades are in **RED**.

Table 3. SPX Iron Condor Trades Taken Every Month for 2005 Expirations

| Expiration | Entry Date | SPX Short Call | SPX Short Put | SPX credit | Credit No shave | SPX legs | Margin | Profit | Profit no shave | Comments |
|------------|------------|----------------|---------------|------------|-----------------|-------------------------|--------|--------|-----------------|--|
| 1/21/2005 | 12/13/2004 | 1256.4 | 1127.1 | 275 | 235 | 1250/1275, 1125/1110 | 4000 | 275 | 235 | No problems - right in the middle |
| 2/18/2005 | 1/10/2005 | 1252.584 | 1122.956 | 190 | 120 | 1250/1275, 1120/1100 | 4500 | 190 | 120 | Are we too wide? We're risking 2500 to make \$200! |
| 3/18/2005 | 2/7/2005 | 1264.03 | 1143.014 | 190 | 140 | 1260/1275, 1150/1130 | 4500 | 190 | 140 | The 1140 was not available - also - the credits were very bad - had to move up |
| 4/15/2005 | 3/7/2005 | 1298.091 | 1152.253 | 85 | 55 | 1300/1325, 1150/1130 | 4500 | | | Wow - what happened to spreads! - IV dropped as index rose Dec to Feb?? |
| 4/15/2005 | 3/7/2005 | 1298.091 | 1152.253 | | | 1300/1325, 1150/1130 | 4500 | -15 | -35 | ADJUST - CLOSE - 1 day before expiration, we are at a \$35 dollar loss because of bad spread - plus we are close to the bottom strike. This option is one in which we can't do anything on expiration Friday - so close out! Big drop to 1142 on that Friday. |
| 5/20/2005 | 4/11/2005 | 1228.453 | 1135.38 | 275 | 220 | 1225/1245, 1125/1110 | 3500 | 275 | 225 | What if we rolled one of the sides that you think won't be touched 2 weeks before exp? E.G., we think our top is too high so roll down to 1200/1220 |
| 5/20/2005 | 5/6/2005 | 1228.453 | 1135.38 | 335 | 285 | 1200/1220, 1125/1110 | 3500 | 335 | 285 | ADJUST -Rolled down with 2 weeks left - got \$60 more. |
| 6/17/2005 | 5/9/2005 | 1216.27 | 1129.342 | 455 | 345 | 1215/1235, 1135/1120 | 3500 | 405 | 295 | Amazing how the credit varies from .75 in Apr to 3.45 (and we risked more margin in Apr) |
| | | | | | | | | | | Exited 1 day before exp when SPX at 1210 - only 5 points from short call |

| Expiration | Entry Date | SPX Short Call | SPX Short Put | SPX credit | Credit No shave | SPX legs | Margin | Profit | Profit no shave | Comments |
|------------|------------|----------------|---------------|------------|-----------------|-------------------------|--------|--------|-----------------|---|
| 6/17/2005 | 6/3/2005 | 1216.27 | 1129.342 | 515 | 405 | 1215/1235, 1170/1160 | 3000 | 465 | 355 | ADJUST -Trended up - so roll up puts to 1170/1160 for .80 cents more. Plus I reduced margin |
| 7/15/2005 | 6/6/2005 | 1239.944 | 1153.613 | 320 | 240 | 1240/1260, 1150/1130 | 4000 | 320 | 240 | Check up on 7/1 showed trend reverse to be same as 6/6 start - so no adjust. This was nice - let it expire. |
| 8/19/2005 | 7/11/2005 | 1254.454 | 1170.983 | 280 | 200 | 1255/1270, 1170/1155 | 3000 | 280 | 200 | Notice how margin varies. This one did not threaten either strike-even with this up climb |
| 8/19/2005 | 8/5/2005 | 1254.454 | 1170.983 | 345 | 265 | 1255/1270, 1200/1185 | 3000 | 345 | 265 | ADJUST -July had a straight up trend, roll up the puts. Right now I roll to whole numbers like 1175 (before) and 1200 - now |
| 9/16/2005 | 8/8/2005 | 1276.528 | 1177.472 | 310 | 250 | 1275/1300, 1175/1155 | 4500 | 310 | 250 | At the peak, IV is low - smaller credits - need bigger margin |
| 9/16/2005 | 9/2/2005 | 1276.528 | 1177.472 | 345 | 285 | 1250/1265, 1175/1155 | 3500 | 345 | 285 | ADJUST -On 9/2, August was trending down, so roll the calls down. Just a .35 credit after shaving - however, WE REDUCED MARGIN BY \$1000 |
| 10/21/2005 | 9/12/2005 | 1285.746 | 1197.811 | 265 | 185 | 1285/1300, 1195/1180 | 3000 | | | 10/7 - the 2 week to expiration mark - also was when spx dropped almost to bottom short. |
| 10/21/2005 | 10/5/2005 | | | | 75 | 1240/1255, 1185/1165 | 3500 | | | Puts down 10 points, Calls down 45 points. The best I can do is minimize loss to \$65 |

| Expiration | Entry Date | SPX Short Call | SPX Short Put | SPX credit | Credit No shave | SPX legs | Margin | Profit | Profit no shave | Comments |
|------------|------------|----------------|---------------|------------|-----------------|-------------------------|--------|--------|-----------------|---|
| 10/21/2005 | 10/6/2005 | | | | | 1240/1255, 1170/1150 | | | -220 | -270 ADJUST -Proper rule was to wait one day and adjust at the close! . Formula used, it said 1158 and 1235 for 14 days left- but I choose rounder numbers of 1160. Hovered by 1170 all expiration week so exit on Thurs 10/20 with either a \$220 or \$270 loss with SPX at 1177. |
| 11/18/2005 | 10/10/2005 | 1248.376 | 1143.906 | 310 | 245 | 1250/1270, 1140/1125 | 3500 | 200 | 135 | Even though this climbed, the prior decline increased IV to make wider strikes with good credit- See this? |
| 11/18/2005 | 11/4/2005 | 1248.376 | 1143.906 | 345 | 280 | 1250/1270, 1180/1165 | 3500 | 245 | 180 | ADJUST -Trending up since 10/20 - so roll up puts 40 points to get a credit. Exit 1 day early on 11/17 since at 1250 - only 8 points from short! |
| 12/16/2005 | 11/8/2005 | 1272.363 | 1173.63 | 250 | 180 | 1270/1285, 1175/1160 | 3000 | | | We lose a lot on rolls due to bid ask spread - even if we shave 1/3, we still lose 2/3rd. |
| 12/16/2005 | 12/15/2006 | | | | | | | | | Actually follow the rules. It never closed above 1270 until 2 days before expiration on 12/14. |
| 12/16/2005 | 12/15/2006 | | | | | 1270/1285, 1225/1200 | | | -145 | -215 ADJUST-CLOSE -Then wait one day, it is still above, in this case we need to close the trade 1 day before expiration on 12/15 |