

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

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

PART 4 – Summary Expected Profit and Conclusions

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SPX Iron Condor System Observations for All 2003, 2005 & 2006 Trades

We show the various profits on a \$5000 base when we allow shaving, no shaving and if we roll up puts or roll down calls when the index has been trending during the month in order to get a little more profit. We assume that you use a broker that specializes in options so that they only hold the margin on one side of the trade since the index can only crash through one side of the trade. Most brokers will hold margin on both sides of the condor (call and put). The numbers below use a \$2000 to \$2500 margin on a single side. Since the time period is 40 days, there is about a 10 day overlap where we put on the next month's trade on the 6th of the month while we are still waiting for the prior month's condor to expire. That is why we need \$5000. If you decide to do 30 day condors with no overlapping, you will only need half of the \$5000 and your ROI will be higher but with smaller credit per trade.

Profit	2003	2005	2006
No Shaving and No Rolling (Min Profit)	\$2505	\$1320	\$375
No Shaving but Rolling	\$2605	\$1585	
Shaving and No Rolling	\$3430	\$2065	\$930
Shaving and Rolling (Max Profit)	\$3630	\$2330	

Table 6. SPX Iron Condor Profit Results for 2003, 2005 and 2006

SPX Iron Condor System Summary

Prepare for 2 to 3 losing months in which the loss, due to our adjustment rules, usually equals the month's planned credit. For example, if you planned to receive a \$250 credit, if we have to exit a losing position, it is usually with a \$250 loss – not the full \$2000 loss. We don't wait and "hope" for a retracement that may never come.

SPX results: 47% ROI for 2005 and 72% ROI for 2003 if shaving and rolling up during trending months are done! This is on the total account. It is interesting to see that the trending year, 2003, had much more profit than the non-trending year. You would think you would have more losers in the trending year. Actually, 2003 was following the 'bad' down-trending year of 2002 – which had high IV. This translated into higher credits per condor until IV decreased to its current levels. Some people think that 47% ROI is not too good. Actually, it is very good considering it is your total account! Here are the many benefits to using this system:

1. **NO OVERNIGHT SURPRISES:** No earnings slam, takeover surprise, accounting irregularity, stock analyst downgrade or other event you have no control over that can happen overnight when the options markets are closed and ruin an individual stock trade.
2. Minimal adjustments and monitoring is required. You could even have <http://finance.yahoo.com> send an alert to your cell phone when the SPX hits a trigger. You can do something else with your life other than watch a price chart all day!
3. The SPX is considered a long term investment by the IRS. It is taxed at a rate of 60% long term gain and 40% short term gain. See a tax specialist to reap this additional benefit of paying less tax on your profit.
4. The SPX is highly liquid. It is not too difficult to get one third shave off the spread.
5. The SPX is cash settled, unlike stock settled indices. You save commissions by not needing to close the trade at expiration if you are in range. You just receive the cash.

Warning – SPX Iron Condor System Is For Non-Directional to Slightly Trending Market

As the heading states, this system is fine for non-directional and slightly trending markets. The 2003 up trending year backtesting results showed that. However, there are many senior financial analysts that believe that the stock market may be in for a sharp crash in the near future. This is due to the very large fundamental problems of U.S. national debt, U.S. personal debt, import/export trade imbalance, and so on. Starting on May 11th until at least June 13th, the market has been in a large correction. This sudden drop exposed a hole in our system rules. The ‘wait one day’ rule caused further losses when caught in a rapid correction. Therefore, we need to add an additional rule:

If a short strike is crossed by more than 5 points intra-day, then just GET OUT!

Our foremost goal is to **preserve precious capital**. Any over-focus or hope of trying to get the current month’s condor credit needs to be replaced with a long-term 12 month perspective that allows losing months with no condemnation. I backtested this rule for 2005 to Jun 2006. There would have been no extra early exits (i.e., whipsaws) due to this rule. For the June condor, on May 17th – we would have exited using this rule instead of using the wait until the next day rule. This would have saved some money – at least \$300 of the \$750 loss.

Another important point is to understand that backtested results and real results are not the same – especially concerning order execution. On May 17th, the market was in a panic and the SPX dropped over 20 points. When I tried to close my trade, a market order to close still took FIVE MINUTES to execute! I called the trade desk in Chicago and they explained that because SPX is still an open outcry trading pit – as compared to a fully automated exchange – there was a big delay due to the flood of orders! This is something you do not see in backtesting, but must be prepared for.

I do not want you to get locked into a system no matter what the market is doing. As the market changes, we need to change our systems. If the market becomes directional (like a crash), then non-directional systems like this SPX Iron Condor system will need to be abandoned. Note that if you did not have to get more credit, then the June loss of \$200 plus large May loss only left a net profit of \$375 for 2006. Maybe then the Elliott Wave Down system (long puts) will finally work. It will be up to you to decide to change the strategy, but I believe there will be enough economic signs for us to know the general time of when a crash may come. If we are too early, or if the crash doesn’t come, then all we did was reduce profit. That is better than sustaining a large loss.

Conclusion

Wow! We covered a lot of trades and analysis.

An insight to be gained from this system is that it is not the **PAST** history and the optimized system rules that are based on **PAST** data that make you a successful trader. It is how you react to how **PRESENT** overall market trends influence your individual trade that makes you successful.

The update to include the first half of 2006 for this system showed the need to adjust your system based on statistical analysis and new market conditions. A hole in the SPX Iron Condor system was exposed during the sharp mini-crash of May-June 2006. A new rule was added to close that hole. Because of the potential change from a slightly up trending to a strong down trending market in May and June, 2006, this Iron Condor system is not as profitable as it was in prior years.

The point is to not be surprised by these losses. There are other systems that have a higher probability of profit need to be in your arsenal of trading strategies. The Elliott Wave system and the IV-based Calendar system are other strategies to consider for this current market. You can purchase those reports separately or together in a single book from <http://www.breakthroughbacktesting.com>.

Finally, there are options trading systems that are pretty mechanical in the sense that there is not much subjective judgment required and yet still make a good profit over a year's time. Many professional traders consider 24% to 30% a year on larger accounts (i.e., greater than \$100,000) to be a good year. Of course, this depends on how much you are willing to lose (i.e., risk). Those are the numbers you should get used to as a reasonable expectation. If you do higher than that, good for you – but don't expect that and don't get depressed if you don't exceed those! I truly hope that this book helps you succeed in your trading!

Steve Burke

Bibliography and Required Reading

You should read and follow this list of books and web sites in order to transform your thinking into that of a successful trader. It is not exhaustive. I believe you can be a self-learner in which by spending about \$400 to \$500 on these books plus your time, you can save thousands on seminars.

1. **Elliott Wave Principle – Key to Market Behavior, Frost and Prechter. 1978.** John Wiley and Sons. This book gives a solid covering of the history and techniques of Elliott Wave training that some people spend a few thousand dollars to learn on a seminar.
2. **High Probability Trading, Marcel Link. 2003. MacGraw Hill.** This book gives a new person a comprehensive overview of technical analysis, systems trading, trading psychology, trading with a plan, understanding proper entry and exit, money management, position sizing and other dynamics of the stock market that option traders need to understand.
3. **Option Volatility and Pricing, Sheldon Natenburg. 1994. MacGraw Hill.** The classic readable book that shows how option values change not only with stock price, but with time, volatility, and other factors that pure stock traders don't worry about.
4. **Options as a Strategic Investment. Lawrence McMillan, 2002. Penguin Putnam.** This is the standard reference book for almost all option strategies. Some people say use this as a reference every now and then. I say bite the bullet and read the whole thing. You need to be at least familiar with all of the options strategies (calendars, condors, backspreads, diagonals, etc) that are available.
5. **Come Into My Trading Room. Dr. Alexander Elder. 2002. John Wiley & Sons.** Excellent book on the psychology of a trader and how he relates to the market. Many insights into market dynamics like 'head fakes' and how market makers and other big investors manipulate the market to a certain degree. The main focus is on systems trading, recording your trades and learning from them, and strict position sizing.
6. **Options Trading: The Hidden Reality. Charles Cottle. 2006. RiskDoctor Inc.** One of the most complex but important options book on the market. Written by an experienced market maker. This book makes the more complex issues of options trading understandable with 3D graphs showing the relations of the various option Greeks to each other and how various trades are affected by implied volatility skew and much, much more.
7. **Trading in the Zone. Mark Douglas. 2000. Prentice Hall.** Probably the premier book on trading psychology. Although my book focused on validating trading systems, Mr. Douglas's book focuses on the equally important issue of confronting the fears, greed, hope and other emotions we let mess up our trades.
8. **Inter-market Analysis – Profiting from Global Market Relationships. John Murphy. 2004. John Wiley.** We live in a world in which large investors move – or cycle money to whatever investment vehicle gives the best return: from stocks, to bonds, to commodities to currencies. The relationships between these markets are really important for traders to appreciate as the relationships affect market trends – and therefore our individual trades.
9. <http://www.optionetics.com> has an extensive set of discussion boards grouped by option trading topics such as Beginners, Spreads, Advanced Strategies, etc. You can learn more

from other experienced traders by reading the discussion threads than in \$70 books or in expensive seminars.

10. **KELLY BET FRACTION.** Here is an Optionetics article that briefly defines Kelly Bet Fraction and how it can be used for options trading:
http://www.optionetics.com/articles/archive/article_archive_full.asp?idNo=12061 .
11. <http://www.optionplanet.com> has free or very inexpensive (\$100 to \$200) classes given around the United States on beginning to advanced option trading. You can see if a class is being given in your area and sign up on that web site. They are the education arm of <http://www.thinkorswim.com>.