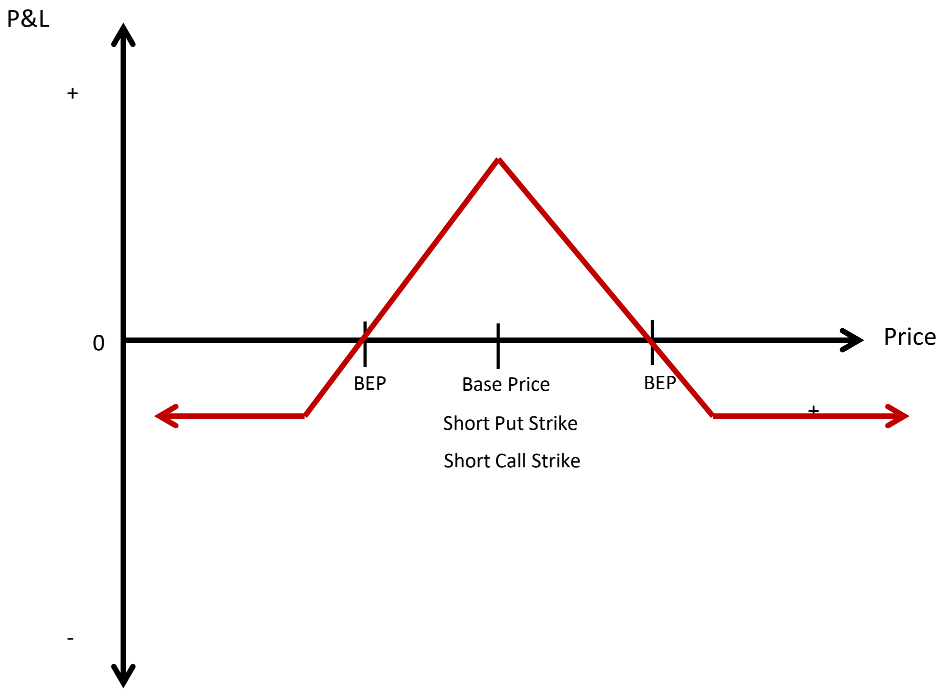
Iron Butterfly Setup

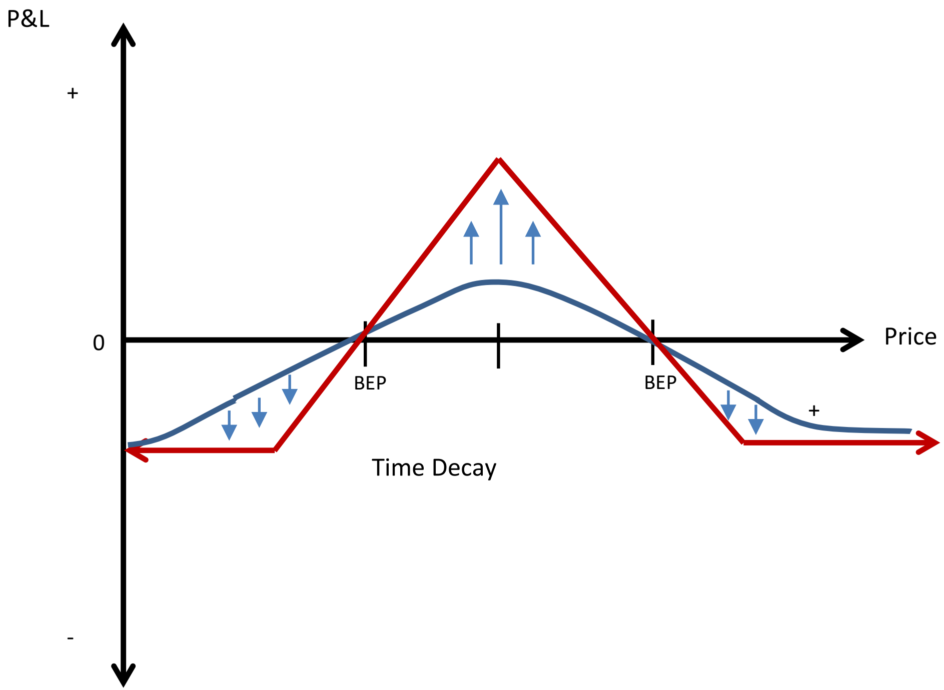
Iron Butterfly P&L Diagram

P&L Diagram Iron Butterfly



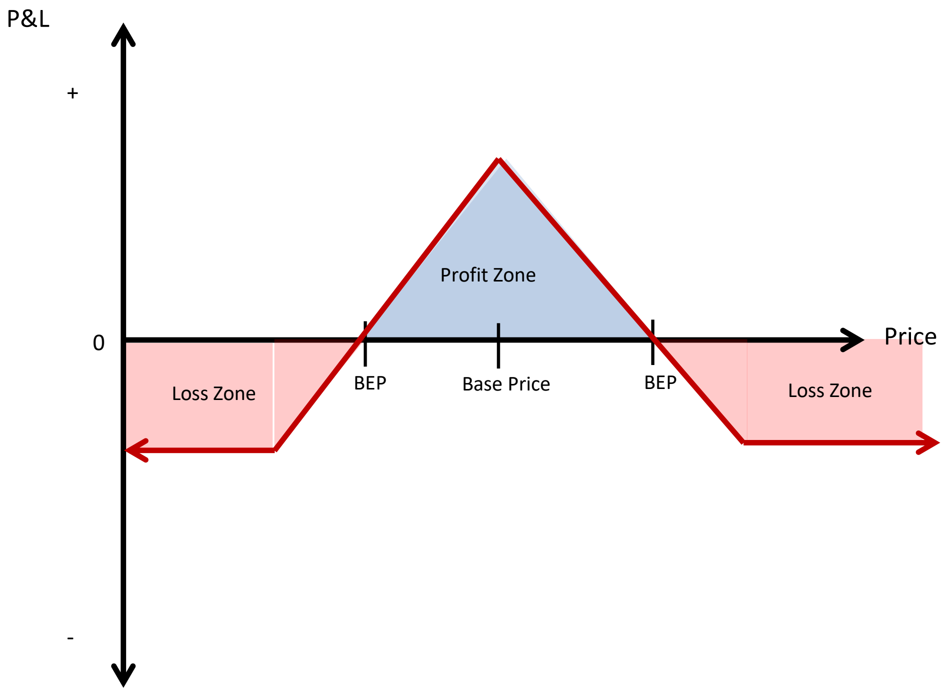
- Selling (Short) simultaneously a Call and Put of the same strike, the strike price being ATM or near ATM.
- Hedges are set up by buying (longing) calls at a higher strike than the sold call and put contracts at a lower strike.
- Iron Butterfly is in effect a Short Straddle with Hedge Positions as a max cap for losses.
- Through this strategy you are betting that the price will more or less stay the same through the period you hold the option combination.

P&L Diagram Iron Butterfly



- Should the price move significantly, you are risking a loss and your amount of loss is capped depending on how far the strike of your bought hedges are.
- Breakevent point (BEP) is any of the short strikes after consideration of net credit received. (Say if price goes above your call, BEP is call strike plus net credit received. Should the price be below your strike, BEP is put strike minus net credit received.)

P&L Diagram Iron Butterfly



- This is a premium/net short strategy. Goal is to keep as much of the premium received upfront.
- Following factors improve your break even point:
  - More credit/Premium from options sold ATM or near ATM
  - Only one side loses.
- Used in expectation that price will not be volatile.
- Theta decay is highest with ATM or near ATM options. This works to the favor of the net option seller.

Points to Ponder

- Max win is limited to premium received. Max loss is capped via bought hedges.
- Close to expiration, your profit will be at it‘s peak, if the price of the underlying is at or close to ATM of the short strikes.
- Works well when implied volatility is high. On a high IV market options can be more expensive due to the risk expectation of the market.
- In short this strategy is highly dependent on the base price (if it more or less stays there in your range) and IV decline (sell on a high IV and once IV is low all being the same you can buy back cheaper).
- Works well with small trading accounts since: 1) Margin requirements are limited, 2) only one side can lose and 3) losses are limited by the hedge positions.
- Can be used for earnings play since you bank on high IV crash and at the same time cap your losses.