The #1 Trade to Profit from Earnings Season

Cabot Options Institute

by Andy Crowder
The #1 Trade to Profit from Earnings Season

For years and years clients of mine asked if I could teach them how to effectively trade around earnings announcements. And for years and years I responded: No!

At the time, there were only 12 expiration cycles per year. Each expiration occurred on the third Friday of the month, so it made it hard to trade earnings announcements with any real precision.

But oh, how things have changed.

The advent of weekly options was a game changer.

Now we have the ability to trade earnings announcements with far more precision.

There are several strategies that I prefer to use around earnings: short strangles, short straddles, bear calls, bull puts and iron condors. But the strategy I use most often is the iron condor due to its risk-defined nature.

Implied Volatility

Professional and retail investors look to hedge and speculate around earnings. As a result, demand for options typically spikes. And with that spike in demand comes a spike in implied volatility (IV) in the expiration cycle that falls after a company announces. But most important is the spike in options prices due to the heightened volatility.

It's like clockwork. We know it's going to happen; we just don't know how high a company's IV will be from one quarter to the next. This is where a methodical approach is helpful. It gets you into trades that give you the best opportunity for profits and keeps you out of trades where the odds aren't in your favor.

The Law of Large Averages

Earnings season trades are binary, one-day trades. The price movement after an announcement either stays within the expected range or pushes outside of the range.

In most cases, each trade I place has, at least, an 80% probability of success. As a result, we know that as trade occurrences increase our win ratio should fall right around 80%. I traded this strategy successfully for over three years with more than 100 trades and guess what my win ratio was: yep, just over 80%. There is a reason why the Law of Large Numbers is, well, a statistical law, right?

But just because you have a high win ratio doesn't mean that you are going to be successful over the long term. I've known plenty of traders with high win ratios who still lose money hand over fist.

Risk management, as with any investment strategy, is a necessity. And because these are one-day trades, the only true way to manage risk is through using a disciplined and consistent approach to position size. Every one-day trader will have different levels of risk when using the strategy; I try to keep my position size between 1% and 5% per trade. By keeping my position size at reasonable levels I am able to endure sequencing risk and can focus solely on the end goal ... allowing the number of my trades to increase so the Law of Large Numbers has the ability to play out.
From there, I use the following five-step approach to trade earnings:

**Step 1**

The first aspect of placing a trade is knowing if the underlying stock of your choice has adequate liquidity.

Most traders don't realize, but there are only 3,200 tradable stocks with options. Only 11% out of the 3,200 stocks have medium liquidity and only 3% are considered highly liquid.

**With just a few exceptions, I only focus on the 3% of highly liquid stocks.**

At the end of each week during earnings season, I prep a list of the upcoming earnings announcements for the coming week.

**Step 2**

The next step includes looking at the IV rank and IV percentile.

*IV Rank – tells us if current implied volatility (IV) is considered high or low on an underlying security in comparison to all other IV readings over the past 12 months.*

IV rank is calculated by taking the highest IV reading and lowest IV reading over the past 12 months.

Current IV – 1-Year IV Low

1-Year IV High – 1-Year IV Low

For example, if a stock has an IV range between 40 and 80 over the past 12 months and the IV is currently 60, the stock would have an IV rank of 50%.

*IV Percentile – tells us the percentage of days that implied volatility (IV) has been below the current level of IV over the past 12 months.*

IV percentile is a ranking system from 0-100.

For example, if a stock has a current IV percentile of 80%, it simply means that the current level of IV is higher than 80% of all IV readings over the past 12 months.

Understanding the difference between the two and how to effectively use each measure is important, not only during earnings season, but also outside of earnings season.

When I am trading around earnings, I use both measures and typically want to see a reading around 50%, if not higher.
Step 3

Once I've found a candidate with an acceptable IV rank and IV percentile, I then move over to my platform to take a look at the expected move for the stock. For the most accurate reading I look at the nearest-term expiration cycle.

For example, if a stock is due to announce earnings after the close on a Tuesday, I want to look at the expected move for the expiration cycle that Friday.

There is one exception: If a stock is due to announce on a Wednesday through Friday, I will take a look at the expiration cycle one week out.

Step 4

After I know what the expected move is, I move on to the historic price movements around the last 12 earnings cycles and compare them to the current percentage of the expected move. I also look at the Earnings Volatility Ranking (EVR).

EVR is ranked from 1 to 10, with one being the least volatile around earnings and 10 being the most volatile around earnings. Knowing if the EVR reading is high or low gives me insight into which strategy I will use.

Step 5

If my potential candidate meets all the aforementioned criteria, I swiftly move over to my strategy. I almost always use risk-defined options strategies like bear call spreads, bull put spreads and iron condors when I place earnings season trades. However, I like to use undefined-risk strategies like a short strangle or short straddle as well, particularly the short strangle as it gives me the highest probability of success.

Overall, I would say iron condors are my favorite strategy to use. If you are not familiar with the iron condor strategy, please make sure to read my report on this powerful, neutral-based options strategy.

The Strategy

The basic premise of my iron condor is simple. I place the range of my iron condor outside the range of the expected move.

For example, if Walmart (WMT) has an expected move between 140 and 155 I want the short strikes of my iron condor to be outside the range. In fact, I want a range as wide as I can possibly go while maintaining the ability to make a reasonable profit.

Moreover, I want my probability of success to be greater than 80% on both the call side and put side of my iron condor. I aim to make a return anywhere from 10% to 35% per trade.

Let's go through a trade example in CVS Health to clarify the components of a typical earnings trade. This is an older trade. No matter. The key is to focus on the mechanics of the trade....the step-by-step process.
Iron Condor Earnings Trade in CVS Health (CVS)

At the time of the trade CVS Health (CVS) was trading for 99.03.

The expected move is from 93.5 to roughly 104.5, for a range of $11.
Knowing the expected range, I want to, in most cases, place the short call strike and short put strike of my iron condor outside of the expected range, in this case outside of 93.5 to 104.5.

This is my preference most of the time when using iron condors.

If we look at the call side of CVS for the May 13, 2022, expiration, we can see that the 108 call strike offers an 89.78% probability of success and the 109 strike offers us a 92.30% probability of success. For this example, I’m going to sell the short call at the 108 call strike and define my risk with the 113 call strike. By choosing the 113 call strike to define my risk, I know that there is less than a 5% chance that I will take a max loss on the trade.

Now let us move to the put side. Same process as the call side. But now we want to find a suitable strike below the low side of our expected move, or 93.5. The 90 put strike, with an 84.67% probability of success, works as our short put strike. The 90 put strike defines our probability of success on the downside. I’m going to define my risk by choosing the 85 put strike with a 92.74% probability of success. This means we have less than a 7.5% chance of taking a max loss on the downside.

We can create a trade with a nice probability of success if CVS stays between our 18-point range, or between the 108 call strike and the 90 put strike. Our probability of success on the trade is 89.78% on the upside and 84.67% on the downside.

I like those odds.
Here is the trade:

Simultaneously:

**Sell to open CVS May 13, 2022, 108 calls**

**Buy to open CVS May 13, 2022, 112 calls**

**Sell to open CVS May 13, 2022, 90 puts**

**Buy to open CVS May 13, 2022, 85 puts for roughly $0.53 or $53 per iron condor.**

<table>
<thead>
<tr>
<th>Spread</th>
<th>Side</th>
<th>Qty</th>
<th>Symbol</th>
<th>Exp</th>
<th>Strike</th>
<th>Type</th>
<th>Link</th>
<th>Price</th>
</tr>
</thead>
<tbody>
<tr>
<td>IRON CONDOR</td>
<td>SELL</td>
<td>-10</td>
<td>CVS 13 MAY 22 (Weekly)</td>
<td>108 CALL</td>
<td></td>
<td></td>
<td>.53</td>
<td></td>
</tr>
<tr>
<td>BUY</td>
<td>+10</td>
<td></td>
<td>CVS 13 MAY 22 (Weekly)</td>
<td>113 CALL</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>SELL</td>
<td>-10</td>
<td></td>
<td>CVS 13 MAY 22 (Weekly)</td>
<td>90 PUT</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>BUY</td>
<td>+10</td>
<td></td>
<td>CVS 13 MAY 22 (Weekly)</td>
<td>85 PUT</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Our potential return on the trade: 11.9%**

Our margin requirement is $447 per iron condor.

Again, the goal of selling the CVS iron condor is to have the underlying stock stay below the 108 call strike and above the 90 put strike immediately after CVS earnings are announced.

Here are the parameters for this trade:

- The Probability of Success – 89.78% (call side) and 84.67% (put side)
- The maximum return on the trade is the credit of $0.53, or $53 per iron condor
- Breakeven level: 89.47 – 108.53
- The maximum loss on the trade is $447 per iron condor. Remember, we always adjust if necessary, and always stick to our stop-loss guidelines. Position size, as always, is key.

**Trade Result**

After CVS’s earnings announcement the stock opened up around $97--almost in the middle of our stated range. We immediately were able to take a one-day profit of roughly 9%. Again, our approach to earnings is to take the high-probability approach, aiming for singles and doubles knowing the Law of Large Numbers will work in our favor over the long-term.
Quick Summary

Earnings season offers some tremendous profit opportunities.

During each earnings season I will provide weekly tables on the highly liquid stocks you should be focusing on. Moreover, I will provide additional research and trade ideas several times throughout the week.

As always, if you have any questions, please feel free to email me at andy@cabotwealth.com.
About the Expert

Andy Crowder is a professional options trader, researcher and chief options strategist of Cabot Options Institute Earnings Trader. Formerly with Oppenheimer & Co. in New York, Andy has leveraged his investment experience to develop his statistically based options trading strategy which applies probability theory to option valuations in order to execute risk-controlled trades.

His proprietary strategies have been refined through two decades of research and real-world experience and has been featured in the Wall Street Journal, Seeking Alpha, and numerous other financial publications.

As a professional options trader, Andy has helped thousands of option traders learn and implement his meticulous rules-driven options trading strategies through highly attended conferences, one-on-one coaching, webinars, and his work as a financial columnist.

He currently resides in Bolton Valley, Vermont and when he’s not trading, teaching and writing about options, he enjoys spending time with his wife and two daughters, backcountry skiing, biking, running and enjoying all things outdoors.

About Cabot Wealth Network

Cabot Wealth Network, established in 1970, is a trusted independent source of advice for individuals striving to take control of their investments and find the best stocks. Its investment advisory services deliver high-quality advice to more than 200,000 individual investors and investment professionals in 141 countries. Headquartered in historic Salem, Mass., Cabot Wealth employees take great pride in providing intelligent investment advice and timely, personal service without the hype and fabricated claims. Cabot is a member of the American Association of Individual Investors, Better Business Bureau, Specialized Information Publishers Association, and the Salem Chamber of Commerce.

This special report is published by Cabot Wealth Network. Cabot is neither a registered investment advisor nor a registered broker/dealer.

Neither Cabot nor our employees are compensated in any way by the companies whose stocks we recommend. Sources of information are believed to be reliable, but are in no way guaranteed to be complete or without error. Recommendations, opinions or suggestions are given with the understanding that readers acting on the information assume all risks involved.

We encourage readers of this report to consult with an independent financial advisor with respect to any investment in the securities mentioned herein. Any opinions, projections and predictions expressed in this profile are statements as of the date of this publication and are subject to change without further notice. Past performance may not be indicative of future results.

© Cabot Wealth Network. Copying and/or electronic transmission of this report is a violation of the copyright law.

P.O. Box 2049 • Salem, Massachusetts 01970 • 1 (800) 326-8826 • cabotwealth.com