Equity Collars: A New Strategy

Investment discipline with limited risk By Louis D'Antonio

In a January 2008 *Journal of Financial Service Professionals* article, I examined the broader application for Equity Collars, a risk management tool that in the past has mainly been used to protect concentrated stock positions. The article, titled "Equity Collars as an Alternative to Asset Allocation," describes the benefits of equity collars as they may be applied to a wide array of client portfolios (not just those with concentrated stock positions) and challenges the generally accepted belief that asset allocation is the only way to manage systematic portfolio risk.

As most of you know, the collar is a strategy which uses both put and call options as a low cost way to protect a stock. Unlike many options strategies that are riskier than owning stocks alone, the option collar can substantially reduce risk of stock ownership. The strategy utilizes buying a put option to protect an equity position, which gives the right to sell the underlying stock at a stated exercise price. This provides the client with known downside protection. To offset the cost of the put, a call option is sold. With the call option, one must sell the underlying shares at a predetermined or exercise price. Hence, the term collar refers to the stated range set by the options (puts and calls) in which the return on the underlying stock investment can travel. With a collar, the client has a clear understanding of how much can possibly be gained or lost on a stock. There are no surprises.

With asset allocation, there is always the potential for surprise because possible outcomes are limited to what has happened in the past, not what may happen in the future. For example, most asset allocation models have 1931 as the worst year for stocks, yet some future year might yield even greater equity losses. Also, the financial planner must determine what meaning the historic descriptive statistics and the characteristics of the allocated return distribution provide relative to some future outcome. All outcomes have some probability of occurrence. With asset allocation, it is very difficult for the financial planner to determine what their clients' actual future return

Illustraton: Image Zoo

will be since all outcomes are possible and not bounded in any way.

Financial planners, and their clients, should be concerned with both the absolute level of return and of risk. Typically, diversification is used and it is believed that risk is reduced to acceptable levels in a prudent fashion. Unfortunately the probabilistic nature of the risk remains. The financial planner may truly believe that a 50/50 mix between equity and debt is prudent. However, using asset allocation alone, the planner cannot guarantee the investor that a loss greater than the desired minimum loss is not possible.

For example, over the entire 80-year period from 1926 to 2005, the S&P 500 averaged 12.3 percent. Yet, there were only four years during that 80-year period where the actual return on the S&P 500 was between 11 percent and 13 percent. In fact, the range of returns over the period were between -43 percent and +54 percent. With such a broad range of possible outcomes, it is difficult for the financial planner and client to interpret the historic data relative to their expected outcomes. Even if one uses confidence intervals, all outcomes are probabilistic and therefore possible. Receiving a loss of an unanticipated magnitude can be very problematic for the individual approaching retirement. However, given the volatility in the markets, an unforeseen downturn is possible.

NO SURPRISES

With the collar the range of possible outcomes is set. They are deterministic. The financial planner does not have to try to estimate what the "future" potential range might be using "historic" data. The collar allows the financial planner to express the risk nature of the investment in a concrete fashion. That is, "Can you deal with a possible seven percent loss?" "Will you be satisfied with a maximum gain of 18 percent?" There are no surprises beyond those parameters. There is no reliance on historic data and/or the planner's ability to interpret the historic data and forecast the future.

Within asset allocated portfolios non-market risk factors such as specific security risk, industry risk, and style risk are generally controlled by the principles of diversification. For example, if a portfolio contains only one stock, the investor has significant exposure to specific security risk, or the risk of severe loss if bad news comes out about that particular company. However, this specific security risk can easily be reduced by owning several stocks. The same is not true for systematic risk. If the stock market in general takes a sudden drop, such as what occurred after 9/11, even owning hundreds of stocks will not protect the client from market risk. Because this risk cannot be diversified away within the equity sector, financial

Equities Hedged with Collars

Thomas Schwab, who is the chief investment officer of Summit Portfolio Advisors in Denver, says that equity risk is normally controlled through portfolio diversification and asset allocation. He notes that asset allocation models rely on the historical correlation of asset classes that might prove to be overly optimistic. He feels that having a collar investing portfolio as one element in the asset mix might be an effective way to protect at least a portion of an investor's net worth in the event of economic calamity.

He points out that the conservative equity approach focuses more on collar selection than stock selection, which is why it is called Collar Investing. By selecting a diversified mix of stock/collar combinations, his company assembles a core portfolio for each client where potential gains for any holding substantially exceed potential losses. He says that when stocks are hitting new highs, lower risk collars might be selected to defensively skew the portfolio. Conversely, he notes that when stocks have plummeted, higher risk (and return) collars might be selected to more aggressively position the portfolio for a market rebound.

HEDGED CALL WRITING

To augment collar investing returns, Schwab says that he sometimes incorporates a second strategy on the managed portfolio called Hedged Call Writing, which potentially generates positive returns even if the stocks in the portfolio are not appreciating. He notes that both approaches use collars to protect the portfolio holdings but with hedged call writing an additional goal is to produce a positive return through the collection of call premiums whereas with collar investing, positive returns are derived from stock appreciation alone.

Schwab says he believes the inclusion of the hedged call writing strategy with the collar investing strategy may increase the portfolio's potential for a positive return, regardless of market conditions, and decrease the portfolio's correlation with other equity assets.

For more information visit *www.summitportfolioadvisors.com*.

planners diversify into other asset classes to reduce market risk. Unfortunately, diversifying to other asset classes moves money away from equities, historically the highest returning asset class. By comparison, the equity collar approach, because it places a floor on stocks, effectively manages systematic risk and allows the client to keep more money in the equity asset class.

Employing a collared stock portfolio (each stock purchase is immediately protected with a collar) can have different applications for different clients. For example, client A is 70 years old and has a $1 million portfolio consisting of a 40/60 mix of stocks and bonds. Client A is very nervous because if the market crashes, he may not have time to recover, but at the same time he needs stock exposure to support his lifestyle. Perhaps a partial allocation of the 40 percent stock piece to a collared stock portfolio might ease his anxiety but still provide stock exposure. Client B is a $1 million pension plan that carries a 80/20 mix of stocks and bonds. Client B has a long time horizon and does not need bond coupon income, but holds some bonds to hedge systematic risk. Perhaps investing the bond portion in a collared stock portfolio as a debt alternative may generate a higher return than bonds, but still hedge systematic risk.

In general, using equity collars is beneficial in reducing uncertainty and helpful in controlling systematic risk. In doing so, historical data is no longer relied upon to determine the probabilistic range of portfolio outcomes. By setting deterministic limits, possible outcomes are easily understood and client regret is minimized. As an alternative to asset allocation, the equity collar may provide comparable returns with additional attractive qualities beneficial to both financial planners and their clients. CPAWP

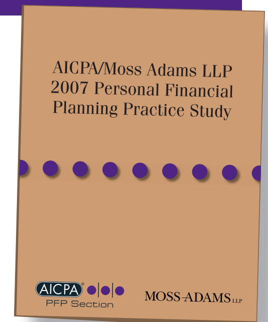
Louis D'Antonio is Professor of Finance at the University of Denver. He was previously a financial analyst with Goldman Sachs & Co. For more information about equity collars, visit www.collarinvesting.com.

PERSONAL FINANCIAL PLANNING

Must-have information for CPA financial planners!

AICPA/Moss Adams LLP 2007 CPA Personal Financial Planning Practice Study

Study Pricing
PFP Section Member **$76**
(20% discount off the AICPA Member price)
AICPA Member **$95**
Non-AICPA Member **$195**



The first study of its kind that analyzes and describes **best practices**, **benchmarking data**, **traits of the most successful CPA financial planning firms** and much more!

The study shows:

- CPA financial planning practices are growing faster than the financial planning industry
- What the most successful firms are doing to stand out from other firms
- How to enter this lucrative niche practice area

PFP Section members can access Web seminars that demonstrate how to put the study results into action.

Visit **aicpa.org/PFP** to view an executive summary of the study and learn more about PFP Section membership.

Not a PFP Section member yet? Join today!
In addition to a 20% discount on this study, you'll receive access to Forefield Advisor — plus PFP tools, resources, networking opportunities and more.

Call **1-888-777-7077**
Visit **aicpa.org/PFP**
Questions? E-mail **PFPinfo@aicpa.org**

1996-326
ISO Certified

AICPA®