

For Further Protection, Consider Insuring Stocks

[Denver Business Journal](#), December 16 - 22, 2005

by Joseph M. Schwab

Why not insure your stocks?

Just as you insure your home, car and other property, do you wish you could protect your stocks from unforeseen disasters?

Well, often you can, and depending on the stock, your insurance costs might be minimal or even zero. You can do it with an "equity collar," which places boundaries (or a collar) around a stock for a fixed period of time. While a stock is wrapped in the collar, any loss or gain is limited by the minimum and maximum price range of the collar, no matter how much the stock actually falls or rises.

Here's how it works. Using Google (NASDAQ: GOOG) as an example, at closing time on Dec. 12, you could have purchased at least 100 shares of GOOG at \$412.61. If you decided to purchase or already owned Google, you then could have executed an equity collar (covering at least 100 shares) that would protect GOOG below \$410 for the next 768 days. The collar also would have limited your potential upside to \$500 during the same time period.

Excluding commissions, your potential payoff on this investment could be as much as \$87.49 (plus 21.2 percent for 768 days) per share versus a potential loss of \$2.51 (-0.6 percent) per share. And with Google trading at \$412.61, your incremental cost for insuring GOOG at \$410 for 768 days is actually less than zero, a net credit of 10 cents per share.

This collar gives you a reward to risk ratio of 34.9-to-1.

An equity collar places boundaries around a stock with listed options. A "put" option is bought to limit the risk (the lower boundary), and a covered "call" option is sold to reduce costs (the upper boundary).

A put option protecting GOOG below \$410 was purchased for \$69.30 per share, and a call option limiting the upside to \$500 was sold for \$69.40, for a net credit of 10 cents per share.

Though investors have used the principles of diversification as the primary way to protect a stock portfolio, 9/11 made us aware a single event can at least temporarily collapse the value of even the most diversified stock portfolio.

If a catastrophic event were to occur, the portion of a stock portfolio that's protected with equity collars should retain the bulk of its value and provide a source of liquidity.

An equity collar portfolio can be built in two ways. Traditionally, equity collars are placed around a previously purchased stock or stock portfolio to protect the pre-existing holding.

A second approach is to build a collared portfolio from the ground up, screening for stocks that are both attractive investment opportunities and offer favorable collars at a low cost. Each stock in the portfolio is immediately protected and the cost of protection minimized.

The equity collar is a defensive strategy, but also enables investors to be more aggressive. It may

allow them to make a greater asset allocation to stocks because the collar allows them to be in the stock market without taking the market's full risk.

Investing in stocks with collars may be a solution for investors who are stuck in money market funds and short-term bonds but are seeking higher returns. Tax-sheltered accounts (pension plans, IRA, IRA rollovers, etc.) may be an ideal place to use collars because many tax issues for this type of account are moot.

The fact is, retirement investment accounts are often a person's largest asset, second to their home. If you're planning to use collars in a taxable account, be sure to check with your tax advisors and make sure your brokerage firm provides good reports to assist you in your tax preparation.

You should always review any potential transaction with your tax, legal and investment advisors.

Equity collars are available on many stocks and come in a wide variety. A recent review showed interesting longer-term (more than one year) collar possibilities for a number of Denver-area companies, including Ball Corp., EchoStar, First Data Corp., Janus Capital, Molson Coors Brewing and Newmont Mining, which can be viewed at www.ProtectYourStock.com.

The stock market represents one of the best ways for you to invest for the long term, but it just makes good sense to protect all your assets, including your stocks. Just as it unwise not insure your home, it's also shortsighted not to protect your stocks, especially if the cost of protection is low.

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