

The Right Collar

Equity derivatives can keep risk-averse clients comfortable while their wealth stays in the market.

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By Suzanne McGee

March 1, 2007- In the first decade of the 21st century, the biggest challenge for many financial planners is how to address the most significant legacy of the final decade of the 20th century: a sudden increase in risk aversion among clients in the wake of the stock market bubble and the bear market that followed.

High-net-worth clients can't live without stocks, they agree. Even as they approach retirement, it's no longer wise to forfeit the best source of long-term double-digit returns. Not only are clients likely to live another two or three decades, making it important to maintain a growth-oriented portfolio, but many of their nest eggs were damaged by the slump of early 2000, and only an allocation to stocks gives them a chance to recover some ground. "It almost doesn't matter whether the risk is real or perceived--it is something we have to deal with anyway," says Kevin Gahagan, a principal at Mosaic Financial Partners in San Francisco.

How, then, can advisors maintain an equity-rich portfolio for clients queasy about taking on even an iota of additional risk? For some, the answer lies in equity derivatives, ranging from straightforward exchange-traded stock options to complex and customized structured notes offered by investment banks to high-net-worth investors.

Whether advisors turn to an online brokerage or an investment banker to pull together the components, the basic strategy is the same, Gahagan says. "It's about how much you're willing to pay--either outright or through future potential gains that you're forfeiting--in exchange for downside protection," he says. "There's no shortage of people offering these vehicles; the question is which is appropriate."

The granddaddy of the group is the equity collar. Equity collars give investors the certainty that they'll lose no more than a predetermined amount on a stock or index holding, while enabling them to capture a percentage of the upside over the structure's life.

To set up an effective collar, the advisor purchases a put option, which gives its owner the right to sell the underlying stock to the counterparty at a predetermined price, on or before a specific date. To help finance the cost of the put, the advisor then sells a call option, which requires the client to sell the stock if its price meets or beats the strike price by a predetermined date. Ideally, the income from selling the call comes close to the price of the put, and investors are left with a collar that gives them, say, 25% of the stock's potential profit over a one- or two-year period while ensuring that they won't have to swallow a loss of more than 10%. And all at a low or no cost.

Traditionally, advisors and private bankers have used collars to address the problem of concentrated wealth. "Many people underestimate how hard it actually is to preserve their wealth," says Rhian Horgan, global head of equity derivatives for JPMorgan Private Bank. Concentrated wealth contributes to that problem when a particular stock's growth doesn't keep pace with the broader market.

Selling is an option, but it's unpalatable to many clients. Some inherit concentrated stock positions at a low cost basis and don't want the big tax hit a sale would create. Others have a sentimental attachment to the stock of a company they founded or led; some depend on dividends for their annual income; still others may insist on retaining voting control of a company.

"Collars and a growing array of other products can address those concerns," Horgan says. The upside, she adds, isn't just cutting risk. "If you put a collar in place, you can borrow against the stock and invest in a more diversified portfolio," she says. "If you put a collar around a concentrated position, its value to potential lenders will increase."

GETTING IT RIGHT

The cost-benefit analysis of traditional collars may be easy to explain to clients, but that doesn't mean putting one in place is a snap. For starters, it means having an in-depth discussion about the issues surrounding the individual stock, as well as the client's approach to risk.

"You have to explain that if the stock rallies, the person who bought the call option will likely call the stock away, and they'll have to give it up and face paying the tax," explains Sidney Blum, a veteran fee-only financial advisor in Evanston, Ill. "And you have to be careful how you structure collars," he adds. "If the collar is too tight, the IRS could decide that because you've taken all the risk out of the investment, you have effectively sold it already."

In one case, Gahagan structured a series of collars for a patent attorney who had made a modest investment in a client's start-up business. The business ultimately was acquired, and the attorney hung on to the stock in the acquiring company until it was worth \$20 million. Then he began planning to relocate to Lake Tahoe.

The collar was effective on two fronts. "He was able to protect his downside and defer the stock sale until he had completed the relocation, protecting him from being taxed on the sale," Gahagan says. But the client refused to collar the entire position. "The stock slumped, but he was happy we had collared so much and didn't complain about not shielding the rest."

COLLARING IT ALL

Some advisors are pushing the concept of the equity collar into uncharted waters. Thomas Schwab, who runs Maui-based Summit Portfolio Advisors, structures entire portfolios based on equity collars. He builds a portfolio of a dozen or so stocks primarily on the basis of whether their put and call options are trading at valuations that make it possible to cover the cost of the put completely with the profits from the call, and where the strike prices on both offer an attractive risk-reward scenario.

"There are close to 1,000 stocks that have (long-term) options available with a lot of liquidity," he says. Schwab's job, as he sees it, is to screen those stocks, looking for companies that have decent fundamentals and the right market price/strike price combinations. The remaining challenge is making sure the resulting portfolio is sufficiently diversified, even if it includes only 15 stocks.

Schwab believes his approach is the wave of the future, particularly for retirement-bound boomers who worry about stock market risk even while they fret about long-term growth. He left Smith Barney, where he worked as a broker for nearly 30 years, in 2005 to open his new firm and now manages some \$10 million in client assets.

There are risks, of course. While it's possible to establish effective collars on an array of large-cap U.S. stocks, those opportunities are scarcer when it comes to smaller or foreign stocks, Gahagan explains. "You're taking an opportunity cost if you try to make this strategy your entire portfolio," he says. "You'd be ruling out parts of the market that may represent big potential gains; look at what small-cap stocks and some international markets have done in the past few years." While Schwab says that it's possible to collar American Depositary Receipts, analysts generally agree that ADRs don't provide enough diversification in international markets.

The challenge facing wealth managers today is how to offer more complex, derivative-based strategies that can protect equity-rich portfolios. But advisors may want to move slowly: If they're looking for a quick and easy solution for their high-net-worth clients' risk aversion and asset dilemmas, they may be disappointed.

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