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Collaring Peace Of Mind

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An equity collar strategy offers a different take on risk management.

Asset allocation and diversification are the principal risk management tools used by an advisor in a typical client portfolio.

But Thomas Schwab is one advisor who feels those tools don't go far enough in protecting clients. It's a lesson Schwab says he learned as an advisor at Smith Barney on September 11, 2001—and the days of panic and fear that followed on Wall Street.

"I realized that even when I was holding hundreds of stocks, I wasn't hedging against event risk like 9/11," says Schwab, founder and chief investment officer of Summit Portfolio Advisors LLC in Maui, Hawaii. "I went looking for something that would limit systemic risk."

Schwab, of course, wasn't the only investor who has been looking for safety since 2001. The terror attacks and the bear market sent most investors scurrying for safety, driving up demand for products that provide varying degrees of asset protection.
Among the offerings investors have flocked to are structured notes, index annuities, principal protected funds and other products that offer a level of downside protection.

Schwab, however, took a different route. He decided to use equity collars—typically used for clients in heavily concentrated equity positions—as a standard risk management device in all portfolios.

By purchasing a put and call option simultaneously with the purchase of every 100 stocks, Schwab puts a downside and upside limit on his client's positions. The end result is a guaranteed limit on losses, at the cost of an upper limit on gains. "You basically are putting a floor on how low these stock positions can go," he says.

The strategy is gradually gaining acceptance among both clients and advisors. Summit Portfolio Advisors, which Schwab founded in September 2005 with his son Joe, who is CEO, currently serves 30 clients with about $6 million under management. (Schwab's daughter Elizabeth joined the firm later and serves as president).

Schwab also generated some buzz when he gave a presentation on his equity collar strategy at the national conference of the National Association of Personal Financial Advisors (NAPFA) this past spring.

"I think he got a pretty good response," says Sidney Blum, who chaired the 2006 NAPFA conference committee. "A lot of our clients are looking for ways to reduce risk or to earn income that is somewhat less risky. His strategy of locking in a range of possible returns is appealing for certain clients."

Ron Miller, owner of Resource Management LLC in Waimanalo, Hawaii, says he intends to start using the strategy for his own clients. Miller, a retired dentist, started his advisory firm nine months ago and is serving 30 clients with nearly $10 million under management. After a visit from Schwab eight months ago, he invested his personal assets in Schwab's collar strategy, reaping an 11% return with a portfolio that limited losses to 5%.

Now he's planning to use it to diversify client portfolios. "As I get more familiar with it I'll probably recommend it for smaller portfolios that are risk-averse," he says.

Miller feels devoting part of a portfolio to the strategy is a good diversifier and feels it is a way to get "safe" double-digit returns. "Most people are concerned about the risk of the market," he says.

While other products also provide downside protection, Schwab feels his equity collar strategy has a leg up on the competition for two reasons: The firm's fees are simple and straightforward, and it allows for strategic stock selection rather than indexing.

The firm charges an annual asset management fee of 80 basis points. There is no account minimum, but the firm's minimum fee is $100 per quarter. (The firm is currently offering a 55-basis-point fee to advisors who bring in assets of $5 million or more).

As a general rule, Schwab says his clients portfolios are collared with a maximum downside risk of 10% and an upside potential of 20%. The range, however, is often tuned to suit the risk tolerance of specific clients. Portfolios are comprised of no more than 20 individual stocks, usually large caps with dividend yields and a diversified industry representation, with terms of slightly more than a year. A typical $100,000 portfolio will be comprised of ten stocks, he says. "Because the collar limits systemic risk, you don't have to be that diversified," he says.

Another factor in stock selection is ensuring the cost of the put option is cancelled out by the sale of the call option and/or dividend yields. In most cases, Schwab says, collars in a portfolio are zero-cost.

In one example, Summit bought 100 shares of Apple Computer Inc. on December 1 at $90.87, with a collar of $85 to $110, which provided downside protection beyond 6.7% and an upside limit of 20.8%. The cost of the put option was $9.20, while the sale of the call option brought in $9.00, for a net collar cost of 20 cents.

In that same portfolio, meanwhile, Cigna Corp., bought at $125.05 with a $120-to-$140 collar, results in a net collar credit of $1.00, plus assumed dividend income of 13 cents during the collar term. That results in a break-even deal if Cigna falls to $123.92 at the collar's expiration.

Schwab also notes the strategy is not strictly buy-and-hold and does include some active management. In cases where share prices rise or decline steeply, for example, Schwab may rewrite a collar to minimize losses or maximize gains.

"We are really trying to keep the collar cost as a neutral factor and we are just really trying to find where we can get the highest amount of potential return for the unit of risk we are taking," he says.

While the collar strategy seems well suited for older clients who are concerned about sustaining losses in their retirement nest eggs, Schwab feels other groups can benefit. He feels that young and aggressive investors could use collared portfolios as a substitute for some of their fixed-income allocations.

"We really see this as a bond alternative for clients who are longer term," he says. "If you think stocks are better than bonds, and don't need current income from bonds, consider putting money into this instead of bonds."

He bases this belief on a backtesting of the strategy that shows how, over time, a collar strategy will underperform the S&P 500 but still bring decent returns with a guaranteed range of possible outcomes.

When tested against data spanning 1926 to 2005, the collar strategy would have resulted in an annualized return of 9.0%, Schwab says, which is close to the 9.02% annual return that would have been achieved by a portfolio comprised of 52% S&P 500 stocks and 48% five-year Treasury notes. The annualized return of five-year Treasuries during the time period was 6.6%.

The key difference between the collar strategy and the 52/48 portfolio, Schwab says, is in the range of possible outcomes. During the studied time period, he says, the 52/48 strategy resulted in yearly outcomes ranging from 28.94% in gains to 23.65% in losses. The collar strategy range was fixed at between 20% gains and 10% losses.