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Financial Matters

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Stock market investors seeking protection against disastrous downturns might consider a form of insurance known as an "equity collar." An equity collar puts constraints on a particular stock in a person's portfolio. The collar not only limits how low the stock can fall but also how high it can grow.

With an equity collar, a minimum and maximum price range gets established for a specified period of time. Any potential loss or gain is limited by the collar, regardless of how much the stock actually rises or falls.

Jim Citro, associate vice president/investments for A.G. Edwards in Quincy, said equity collars are not for everyone. He said they make the most sense for investors who have a large position in one particular stock and face some "significant exposure" if the stock were to make a big move downward.

"The risk of loss is more significant than the benefit of the stock going up," Citro said. "If you've got \$5 million of net worth in a stock, and you would lose it, that's a more dramatic situation than if that \$5 million were to grow to \$6 million, for example." An equity collar involves the simultaneous purchase of a "put" option and the writing of a "call" option. The put option is a contract to sell the stock if it falls below a minimum price. A call option is a contract to offer a stock for sale if the price rises above a maximum price.

Ordinarily, buying a "put" option costs the investor a certain amount of money per share, while writing a call option earns the investor a premium per share. When both are purchased at the same time, the premium can offset some or all of the cost of buying the put. In effect, this makes the upfront cost of the equity collar minimal or sometimes even zero.

Consequently, this system provides cheap insurance if a stock should go down. However, it limits how far a stock's value can rise if the price were to make a sudden and significant move upward. Citro said an equity collar might make sense for an investor who is more concerned about "protecting the downside than the opportunity for the upside." Another important consideration, he said, is if the person doesn't want to pay much to protect the downside. "If those two things are in place, then a collar is a reasonable option," he said.

He said investors can always buy "put" options to protect themselves against a sudden drop in a stock's price.

"But you have to pay for them on an ongoing basis," he said. "The advantage of a collar is that by selling the call - by giving up some of the upside - you receive a premium which offsets, in part or all, the cost of protecting the downside. Ideally you can get it where the net cost is zero or near zero."

Thomas Schwab, chief investment officer for Denver-based Summit Portfolio Advisors, is a big proponent of equity collars. He feels they are a viable option not only for people with strong positions in one particular stock but also for other investors looking to be more aggressive with stocks while still protecting themselves against a major downturn in prices.

"For investors with substantial amounts in money market funds, the collar may enable a greater asset allocation to stocks because the collar allows investors to be in the stock market without taking the full risk of the market," he said.

The pullback in technology stocks several years ago, which caused billions of dollars to be lost in high-tech stocks, made many investors jumpy about getting back into stocks. But Schwab said the risks can be minimized when equity collars are used.

Schwab likes to use Google stock as an example of how an equity collar could work "with very little downside risk."

On Dec. 14, he said, Google was trading for about \$416 per share. He said an equity collar could have been purchased that day to protect the investor if the stock were to drop below \$410 during the next two years. The collar also limited the upside gain to a maximum of \$510 per share over the two-year period.

In that example, the investor could potentially earn about \$94 a share in a best-case scenario or lose roughly \$6 a share in the worst-case scenario.

This example, however, does not include any commissions or fees that might be involved in managing the account.

"Most important, the collar may be one way to lessen investor anxiety about the stock market - and perhaps allow them to make better decisions for securing their financial goals," Schwab said.

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