

Inside Information

Collaring Returns

By Bob Veres (www.bobveres.com)
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If you could lock in a chance to make three times more than you could possibly lose, would you do it?

Last month, I reported on a new investment methodology called "insulated beta" which made use of options contracts to tame the volatility in a portfolio (both upside and downside, but allowing for more upside than downside) with a high degree of precision. While I was working on that article, I was mulling over another strategy that seems to me to be at once old as the hills and very new.

Meet Tom Schwab, a former Smith Barney broker who founded and serves as chief investment officer of Summit Portfolio Advisors, LLC in Maui, HI. Schwab is one of many investment managers who uses options to create "collars" for their client portfolios--and his methodology will be explained in detail shortly. But he is also more of a passive than an active proponent, in the sense that instead of looking for hot stocks, he thinks the investment marketplace is reasonably efficient, and that most stocks are fairly priced. So he looks for inefficiencies where others haven't thought to look: in the prices of put and call options on individual stocks.

In fact, Schwab has a system that automatically scans all the various potential long and short positions available on the stock market, and when he can find a collar that offers three times more potential upside than the worst case downside, at essentially zero cost, he pounces. "So far, year to date, we're a little bit ahead of the market with a beta of around .25," he says. Then he adds: "This isn't a strategy that will beat the market long-term; we say that we expect the returns to come in somewhere between stocks and bonds, but with a lot less volatility than you'd experience in the stock market.

How does it work? Each unit of Schwab's portfolios have three moving parts: he purchases a stock, buys a put option and sells a call option. In a recent transaction, he bought China Mobile, a cell phone company in a market where there is ample room to grow, also selling a call option and buying a put, so that the price of the put was offset by the money received from the buyer of the call option. The put gives him the downside protection; it puts a floor under the losses in this position. The call option gives the other party the right to take all gains in the stock, over the next 600 days when the option expires, above a certain level. The software is designed to find the most asymmetrical possible combinations at zero cost. "I think in that transaction, our downside risk over the next 600 days is 4%, and the upside is 18%," says Schwab.

Another example is Apple Computer. Schwab has apparently been buying the stock for his clients for years, and recently saw a situation where he could buy the stock at 180, buy a put with a strike price at 170, and sell a call option which gives somebody else the right to any gains above a 200 strike price--any gains if the stock exceeds that price. The put costs \$10, the call nets \$10, so Schwab describes this as essentially a zero-cost transaction.

Of course, various things can happen with this position. If the stock goes down to \$100, the client is out \$80 on the stock itself, but the call position is worth \$70. If the stock goes up to \$200, the client is ahead \$20 on the stock and the put expires worthless. If the stock goes up above \$200, the client is still up \$20; the call option is now in the money and will take any further upside. Heads you win \$20, tails you lose \$10.

One interesting problem with this strategy is that when the market goes down and herd mentality gets restless, it's hard to find these attractive put/call combinations, because people are willing to pay more for downside protection (the costs of buying the puts goes up) and are not quite so expectant of big future gains above some hypothetical strike price (buyers aren't willing to pay as much for the calls). So Schwab has adapted the strategy to more bearish situations, recollaring stocks that have gone down in value.

"We actually bought Apple in the 80s and rode it all the way to around 180," says Schwab. "When the stock got back down into the 120s, we were way, way under. It was essentially dead money; it wasn't going to climb out of that hole. So we were able to close out the positions, and there was a small loss, and we found an attractive collar on Apple that was around 120; we closed out the put and call that we had in place and bought a new put and sold another call." The new band of possible returns was between 110 and 150.

As you might imagine, this is happening with a lot of stocks in Schwab's portfolios these days, positions that are being liquidated and recollared. But not all of them are offering attractive collars, which suggests to Schwab that the market is going to roar back any time soon. So he's adapted the strategy so that it controls the downside over longer time horizons, and then generates income from the portfolio. How? By selling call options with relatively near-term expiration dates, and pocketing the premiums. "In this market, if you sell many shorter-term options, you can make more money than if you sell them over longer time periods," he says. "And more importantly, it keeps us liquid, so that we can take advantage of more advantageous collars as the market becomes more optimistic and they become available again.

To see how this works, suppose you have a stock which is trading at \$135. You buy it at the market price, and buy a put option that expires in 18 months, with a strike price of 125. Your potential downside is \$10 a share over the next year and a half, plus the cost of the option itself, which happens to be \$11.50. Then Schwab will sell a covered call that expires in six weeks, at a strike price of \$135, giving the other party any gains that the stock might experience in the next six weeks, and collecting \$4.50 in the process. Assuming he can do something like that 12 times, the portfolio will bring in roughly \$54 a share over the next 18 months. If the stock essentially stays where it is, you're ahead roughly \$42 a share, with downside protection if things turn ugly. Of course, if the stock were to rise dramatically, you've given up those gains in exchange for the income equivalent of a 31% 1.5-year return.

The goal with the collars is not to earn outrageous returns. "We're trying to create a strategy that has a low correlation to the market, where we can make money if the market is not moving," says Schwab. He estimates that his portfolios have an R-squared (correlation to the market) of about 8.0, and a beta of .25. "On a risk-adjusted basis, you could call that generating alpha," he adds.

"The advantage of the collar," says Schwab, "is that you really know how much risk you are going to take, how much you can win and how much you can lose. There are a lot fewer surprises with this strategy than if you were relying on the asset allocation history."

Schwab offers asset management services to the planning profession, and has done presentations at NAPFA (his most recent speaking engagement was at NAPFA National), but only recommends that you use his services in the IRA rollover part of client portfolios because of potential tax consequences. "Under the tax straddle rules," he says, "if you hedge a stock with a derivative, you cannot age it. I think you have to assume that if you were doing this in a taxable account," he adds, "it would all be short-term gains and losses. Add the bookkeeping issue on the tax accounting for the options transactions, and it's just a lot cleaner if it's done in a tax-deferred account."

Schwab makes it very clear that this is not a free lunch, that the collar techniques he uses are not exploiting inefficiencies in the marketplace. "A collar investor has to forfeit potential gains in

exchange for the downside protection from the put," he says. But I'm not so sure. By shopping the marketplace and looking for advantageous combinations of puts and calls, Schwab does seem to be adding value to the process.

Later in the conversation, when we were talking about the Black Scholes option pricing model, Schwab pointed out that the theoretical price of an option is not necessarily what the marketplace offers. "Right now, there is a lot of fear," he says, "so the puts are overpriced relative to the long-term volatility of the market, historically. There seem to be things that the markets see, that the model doesn't see." Schwab admitted that even though he may pounce on a collar that offers a much higher upside than downside, there DOES seem to be information (expectations? forecasts?) embedded in the price. The question is whether those are rational, and whether a rational shopper looking for bargains can take advantage of little inefficiencies caused by investors whose decisions are colored by fear or greed. If you believe that, then Schwab may be adding value above the implementation of a low-risk strategy. If you don't, then the strategy is basically what you get.

Cost? Summit's maximum fee for managing a client's portfolio is 80 basis points, and it drops depending on how many client dollars you're giving Summit to manage. Schwab also notes that the equity collar positions are marketable securities, which can be sold at any time, so a client isn't locked into working with him for any specific time.

<http://www.summitportfolioadvisors.com>)

Outsourcing equity management to Summit is yet another possible way for advisors to make sure their clients don't lose significant money in the early years of their retirement, when their portfolios are most vulnerable to bear market returns. And once again, we all know there is a market for this kind of service; how else can you explain the popularity of equity indexed annuities?

Bigger picture, I think this is another example of specialized managers who are offering more sophisticated investment management than advisors could do on their own. The more of these kinds of managers I turn up, the greater the case for outsourcing the portfolio management work and focusing on the financial planning value that you add to your clients' lives.