

NAPFA Advisor

Equity Collars: A New Investing Idea

NAPFA Advisor - July 2006

By: Kevin Adler, Editor

One roundtable discussion at the National Conference that turned heads was Tom Schwab's presentation about his equity collar investment strategy. Schwab, chief investment officer of Summit Portfolio Advisors (www.protectyourstock.com), led a roundtable about his firm's strategy for acquiring positions in individual equities, and immediately collaring them to mitigate the risk of the investment.

"This type of option contract is an innovative idea with many applications," said Schwab. I have seen some advisors who think it's designed only for the client who already had a concentrated position in a particular stock, maybe through stock options from his employer. But [at the NAPFA conference] we showed advisors how to use the collar starting from a cash position, too."

Schwab's equity collar approach begins with the acquisition of a stock. At the same time, the investor buys a put option with a strike price at or below the current stock price, which enables him to sell a specific number of shares at a named price for a limited period of time. The put option provides protection against downward stock movements below the put strike price. The investor also sells a call option with a strike price above the current stock price—probably much more above the current price than the put option is below the price. The call option commits the seller to provide the buyer with the underlying stock at the call strike price, if the owner of the call option seeks it.

The result is an investment in which a person holds a stock and has been able to limit the potential losses to a predetermined amount. Potential gains also are limited, but if the correct stock is chosen, those potential gains are many times greater than the potential loss. And that's where Schwab's expertise in selecting stocks comes in, a service he offers to his clients and to NAPFA members.

For clients who are seeking returns above the level of a bond, but who are extremely concerned about risk, this product might have application. "It's an equity alternative for older clients who don't want the risk...who have no time to make up for a poor investment," said Schwab. "And for younger clients who have plenty of time for market recovery, this approach may be a partial alternative for the traditional bond allocation."

Schwab added that for clients who see the potential for significant risk over the next 10 to 20 years, the equity collar makes sense. "Some time in the next 20 years, some type of event could trigger deflation in multiple asset classes, as happened in 1931," he proposed. "What if foreign investors choose not to roll over their US Treasuries, for example? If you are relying on a traditional asset allocation, all your asset values could decline at the same time? The equity collar largely avoids that problem."