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Equity Collar Can Help Avoid Investing Risks

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In the world of investing, there are many levels of risk.

Some people are comfortable with the volatility of commodities investing, while others opt for a more conservative approach.

If you're among the second group, you might want to consider putting a "collar" on your investment risk.

Thomas J. Schwab, chief investment officer for Summit Portfolio Advisors LLC, explains it this way:

"It's creates boundaries," Schwab said. "You buy the stock with a protective put option that protects you from losing an amount below a certain level."

A "put option" is a contract that grants the right to sell a specific number of shares at a specified price by a certain date.

Schwab said put options are more flexible than a stop loss, which is an order placed with a broker to sell shares of a security when it reaches a certain price.

"If you do a stop loss order there's a good chance the stock will trade down before it trades up, and then you get kicked out of the stock at a time when maybe you should be buying more," he said. "By comparison, a one-year put option gives you the ability to to wait and see, even if the stock goes bankrupt. With collar investing, you have the ability to exercise the put option at a stated price."

The stocks Summit Portfolio Advisors acquires for its clients are immediately wrapped with an inexpensive form of portfolio insurance, the "equity collar," that places boundaries around a stock.

While a stock is wrapped in the collar, any gain or loss is limited by the minimum and maximum price range of the collar, no matter how much the stock falls or rises.

Schwab used Avery Dennison Corp., a Pasadena-based maker of pressure-sensitive adhesive label material and office products, as an example.

At 9:55 a.m. Wednesday, Avery's stock was trading at $66.17. At that same moment, a collar trade could have been initiated, placing a lower boundary on Avery at $60 and an upper boundary at $75 for the next 430 days.

Based on assumptions for this illustration, if Avery closes above $75 Jan. 19, 2008, the gain will be 16.2 percent, or 13.8 percent annualized versus a loss of 6.4 percent or 5.4 percent annualized if the stock closes below $60.

"For someone who wants to hit a triple or home run on a stock, this is not for them," Schwab said. "But for someone who hopes for a decent return ... they might be a good candidate for collar investing."

Schwab said the prime candidates for collar investing are older Americans.

"This is good for people who want some exposure to the stock market but don't want to put themselves at risk if something goes wrong in the market," he said. "But younger investors could also use this to potentially replace their bond investments."

Summit Portfolio Advisors takes a unique approach to building its client portfolios, Schwab said. "We're not really picking stocks," he said. "We're not looking at the balance sheets of companies to see if they are a good or bad company. We're picking collar combinations."

Mitchell Kauffman, a certified financial planner with Raymond James Financial Services in Pasadena, said collar investing can be an effective tool. "I think it can be more a niche solution for a particular set of circumstances," he said. "A common one is the executive of a large publicly traded company who has a lot of company stock in his or her portfolio."

There could be significant tax consequences to selling the stock outright, Kauffman said, because a lot of that person's net worth is contingent on the stock.

Collar investing would "help them weather the storm," he said. "The big thing is where you get the trigger. We try to look at stock volatility and set the boundaries using historical performance."

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