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Insure Stocks as a Lower-risk Way to Invest

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By: Thomas Schwab

Just as you always insure your property, do you wish you could protect your stocks against unforeseen disaster that could turn that “dream home” stock into an unintentional money pit?

Well you often can and, depending on the stock, your insurance costs might be minimal or sometimes even zero. It's called an “equity collar.”

An equity collar places boundaries (or a collar) around a stock.

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

For example, on Jan 12th when Boeing Co.. was trading at about \$70 per share, a collar was available which protected Boeing stock below \$65 for over two years; the collar also limited the potential upside to \$85.

In the best case scenario, the investor could make about a 24 percent return (about 12 percent annualized) versus the worst case, where the investor could lose about 5 percent (about 2.5 percent annualized) – a reward to risk ratio of about 5:1, assuming current dividend rate and excluding commission expense.

Also on Jan. 12, attractive collars were available on several companies of local interest, including Amazon, Costco, Nordstrom, Microsoft, Starbucks, Washington Mutual and Weyerhaeuser. On any given day, hundreds of widely traded stocks are available with attractive collars.

One source to view a daily posting of collar opportunities is at www.ProtectYourStock.com and posted under Collar List.

When weighing the purchase of a particular stock, it might be worthwhile to see if collars are available for that stock and, if so, compare the benefits of owning the stock on a stand alone basis versus wrapped in a collar.

Also, investors may wish to build an investment portfolio from the ground up, by carefully screening through the pile of options for stocks with attractive collars as one criteria for purchase considerations. When stocks are purchased and wrapped with collars on the same day, the holdings are protected from day one. The equity collar is a defensive strategy, but it also enables investors to be more aggressive with their investment dollars to shielding them a bit from risks.

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.

Tax sheltered accounts (pension plans, IRA, IRA rollovers, etc.) are ideal places to use collars because many tax issues for this type of account are moot. If you are planning to use collars in a taxable account, be sure to check with your tax advisor and make sure your brokerage firm

provides good reports to assist you in your tax preparation.

As a general rule, you should always review any potential transaction with your tax, legal and investment advisors.

Diversification has long been the primary way to reduce risk in the stock market.

But Sept. 11 made investors aware that a single event can collapse even the most diversified portfolio.

If a catastrophic event should occur, the portion of assets that are protected with equity collars should retain the bulk of their value and provide a source of liquidity. Just as you always insure your house, consider doing the same for your stocks.

Thomas J. Schwab is chief investment officer for Summit Portfolio Advisors, LLC, a firm specializing in managing equity collar portfolios on a fee basis.

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