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## Collared option plays assuage market risks

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The scream machine between Capitol Hill and Washington – and the market volatility it is causing – has equity investors lurching between joy at the return of the markets one minute and regret when the morning's gains are lost by lunchtime.

One would think that investors would be looking to buy some insurance, or a derivative, to protect those gains.

Off-forgotten zero-cost collars, a not so familiar option strategy, are made for such nerve-wracking times. Lisa Goldberg, executive director of Analytic Initiatives at MSCI Barra, sees value in the options strategy now.

“What if instead of paying the premium I sell an out of the money call, which just covers my cost of an out of the money put. So I fund my insurance by selling to people interested in this big upside,” she said.

Money managers, though, may resist putting on the protection, preferring to trust their market timing abilities instead or because they're under pressure from customers who don't want to pay extra management fees.

But, “the first obligation of a portfolio manager”, contends John C Broddock, a managing partner of investment banking boutique Broad Oak Advisors, “usually is to protect the principal”.

In prior years, some reticence to buying such “insurance” on portfolios could be explained “because markets didn't crash that often”, noted Goldberg. Since that's all changed, the zero-cost collar strategy makes some sense.

The risk that the share price will fall is protected by a put contract. The closer the put price is to the current stock price, the more the put will cost. A call is then purchased in order to preserve a specified percentage of the future appreciation of the stock (or a portfolio's value). Upside gain beyond that point would be lost to the buyer of the call. The longer the option term, usually one to five years, the greater the upside portion the investor can keep.

In addition to freezing gains, once “collared” the stock may be used as collateral toward lower interest bank financing. There are also tax advantages to be gained by using a collar to avoid having to sell a stock, for example, in cases where shares may appreciate after being held for only a short while.

The options are secured over-the-counter from counterparties that take their compensation by adjusting the cost of the puts and calls. The term “zero-cost” is more of a theoretical concept in that respect.

But the transactions are open to a degree of market risk in that some OTC contracts can be difficult to value and can be subject to gouging. Assuming attractive fees can be obtained, the collar still can be a bargain when compared with potential market losses.

The art of the deal is to set the call price so that it equals the value of the put, hence a “zero-cost” collar around the stock. Both the put and the call are typically out-of-the-money. The further out, the lower the collar cost will be. However, the spread between their exercise prices will also widen, which typically raises the cost of the collar.

More sophisticated investors may refer to listed options or have their own models for valuing offers. Broddock, author

of the book *Derivatives Demystified*, suggests that investors and managers (with minimum portfolios of US\$2m) head off such onslaughts by drafting a simple “terms sheet”, in the plainest language possible, such as forgo all but 20% move up and allow a 10% drop in share value.

However, Broddock says investors may want to hold off on using the strategy in the short term, particularly if the US debt ceiling debacle gets resolved and markets rally. But in the longer term, the strategy may pay off.

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