USING AN EQUITY COLLAR TO MANAGE CONCENTRATED RISK

Whenever owners of concentrated stock positions have obtained their shares at a cost well below the stock's current fair market value, an equity collar may be the answer. Although the gain has yet to be realized, many shareholders wish to preserve the value of the shares without entering into a taxable liquidating transaction. To secure share value, the owner could simply purchase protective put options, but put premiums make this an expensive proposition.

What is an equity collar?

An equity collar is a hedging technique designed to protect a stock from downside price risk, at little to no out-of-pocket cost to the shareholder. Here's how it works: the shareholder purchases protective put options on the shares he or she owns while simultaneously selling covered call options on those same shares. The protective put places a price "floor" on the shares, while the call creates an upward "ceiling." The options are typically purchased and sold so that the strike price is "out of the money" in relation to the current price of the collared shares. The sale of the call option contracts results in the collection of a premium, which is then used to offset the premium costs associated with the purchase of the put options. Thus, these hedging transactions are often referred to as "zero-premium" or "cashless" collars.

An example: Mr. Stevens owns a large, highly appreciated position in CBA, Inc. It is June, the end of CBA's quarter, and Mr. Stevens is concerned that there may be short-term pressure on the share price; on the other hand, he believes that CBA's long-term prospects remain very strong. Because he'd realize a large taxable gain if he sold them, Mr. Stevens would like to structure a zero-premium collar for his CBA shares, which currently trade at $50 per share, for the next three months.

CBA September $55 call contracts trade at $2 each, and CBA September $45 put contracts also trade at $2 each. Mr. Stevens sells the calls and receives a $2 premium per contract while simultaneously purchasing the puts at $2 per contract. The premiums he receives for the calls offset the cost of the protective puts, resulting in a no-cost hedge. During the term of the collar, $45 represents the protective floor at which Mr. Stevens can sell his stock regardless of how low the price drops; $55 represents the ceiling up to which Mr. Stevens may participate in appreciation of the shares. If the stock trades above $55, the shares may be called away and Mr. Stevens will receive $55 per share regardless of how high the actual market price is.

Points to consider

As a protective hedge, an equity collar is best suited for shareholders with significant gains in their shares who feel that, while the price of the stock may be neutral or slightly bearish in the short term, the stock's long-term outlook remains bullish. Many shareholders also use collared shares as collateral to obtain loans, as lending institutions are more likely to lend larger amounts against protected assets.

An equity collar can be very effective in protecting the value of a concentrated position, but it must be structured properly to achieve a zero-cost outcome. It may become necessary to purchase back the call option at a higher premium to avoid having the shares called away and unintended tax results. Consult with your financial advisor to learn more about this strategy and whether it may be appropriate for you.

Please note that options are not suitable for all investors. Typically, commissions are charged for options transactions. Please contact your financial advisor for a copy of the Options Disclosure Document (ODD).

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