COLLAR STRATEGY: OPTIONS TRADING

Current Market Environment

In the current market environment we can see a need to look outside the square when it comes to our investing. We are in a challenging market and have been since the start of the GFC. We are no longer in the mid 2000's when we experienced one of the strongest bull markets in history. For many people, investing was as simple as purchasing a stock and watching it go up. We now need to be clever in the way we invest and look for other opportunities however, as buying and holding stock is unlikely to provide decent returns. We can see that in this current market we need to look for strategies that perform in sideways markets, have downside protection against shocks (eg Japan), and have the flexibility to adapt when conditions change.

Collar

A collar is a strategy that looks to benefit from a sideways moving market by generating a monthly income while at the same time having protection to insure against any 'shocks' within the market. A collar incorporates stock, call options for income, and put options for protection. Knowledge of options is important for understanding how a collar works. This article does not cover the basics of options and assumes most people have general knowledge in this area. A collar can be optimized in different ways however a textbook example of a collar strategy looks a bit like this;

Step 1 – Buy Stock

As with all investing you need to look at holding good quality blue chip stock. For a collar this will normally be stock within the top 50.

Eg: You purchase 1000 ANZ @ $24.00

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Step 2 – Buy Put Option

One of the crucial components of a collar is that you purchase a put option for protection. Most people will insure their assets, for example if you own a home you will purchase house insurance or car insurance if you own a car. So why not insure your assets you have in the stock market? A put option is a way that you can insure or protect you stock holding. With a collar you generally look to purchase a put option for expiry in six months time.

Eg: You purchase a $22.50 ANZ put option for expiry in September 2011 for $0.85 – Cost: $850

Step 3 – Sell a call option

The third part of the collar strategy is selling a month to month call option to generate income. As you have protection in place for six months you therefore have six months to generate a monthly income.

Eg. You sell a $24.50 April call option for $0.60 – Income received: $600

Now you may be thinking why would I use this strategy as the cost of the protection is more than my income? The key point to remember is that our put protection is a once off cost for 6 months, while our call options for income are on a month to month basis. So after six months, a collar strategy will look something like this.

Please note: I have used simple assumptions for this table; however it shows what you are looking to do with a collar.

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Month	Put Protection Cost	Monthly Income
1	$850	$600
2	0	$600
3	0	$600
4	0	$600
5	0	$600
6	0	$600
Total:	$850	$3600

Net result: $2750 or 11.45% (Remember you have a $24,000 position)

If you look at ANZ over the past 12 months the stock has been going sideways and a buy & hold strategy would not have given you a good return. It is this exact reason why you need to look outside the square with your investing.

Why a Collar?

After examining the current market environment we can see a need to look beyond our normal buy & hold strategy. We need to look at strategies that perform in sideways markets, have downside protection (against shocks eg Japan), and have flexibility to adapt when conditions change.

So why a Collar?

- Income generation – perfect for sideways markets
- Outperforms a buy/hold strategy, in most market conditions (except a strong bull market)
- Low risk – we have limited downside
- Attractive returns
- Downside protection – against any external shocks
- Ideal for all account structures (including SMSF's)

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