TRANSCRIPT

A complete guide to using collars

Dan Passarelli: Thank you all very much for attending my session. I'm really excited, I hope you are too. We're going to talk about something really important to investors, a really, really useful tool called collars. And this is a, well it's a fairly complete guide to using collars. I'm going to teach you everything I possibly can in 50 minutes, so how about that, fair enough? OK, before we get started, I want to point out options are not for everyone, you should read characteristics and risks of standardized options before trading. You can get a copy of that by calling 1-888-OPTIONS. And I am fortunate enough to have had Fidelity invite me to be one of their guest speakers, I don't work for Fidelity, but it was very kind of them to invite me to share with you all I can.

OK. So most of you watching this webinar I think are probably investors of some varying sort. Maybe you are just getting started, and you've got a $5,000 account, and you want to start building the nest egg. Maybe you've worked your whole life and you've got a nice big fat nest egg, and you've got $3 million in the bank, and you want to figure out how to protect that capital. Well guess what? Options can be used to help protect those long-term holdings. And when I say long-term holdings, I mean I'm particularly talking

about generally stocks and ETFs, but we could also be talking about futures and holders, and you know, a lot of different long-term buy and hold assets. But here's the problem. A lot of people do it wrong. And a lot of people do it in such a way where you're basically guaranteed to not work, and you end up putting yourself in a worse position. So I want to kind of start out by sharing a conversation about protective puts, and then we'll move onto collars.

So a protective put is when I own a stock, and I decide to protect that stock by buying a put option. I buy a long, typically out of the money put option, and it — out of the money just simply means that the put that you would be buying has no intrinsic value. I mean the strike of the put is lower than where the stock price is trading. And this can, under some circumstances, be a great idea. It can, under some other circumstances, be an awful idea. So let's talk about this. What attracts people to buying puts? I've been doing this for 26 years, I've been in the options business. I've talked to thousands, tens of thousands, of traders. And I know why a lot of people use protective puts, because they have a stock position, maybe a concentrated stock position, like maybe they worked for XYZ company their whole life and they got a bunch of, you know, shares as bonuses, or whatever, you know, stock options that they exercised. And they want to protect that stock, and so they Google it, right? Or they watch a YouTube video, and they say OK, I'm going to buy a put. It

has, it limits your risk, but here's what the YouTube videos don't tell you. Here's what the articles that you Google, most of them don't tell you. That comes at a big cost.

We want to limit our downside risk and protect the stock we own, so we buy a put option. And mechanically, here's how it works. When you buy that put, what you're buying is the right to sell the stock that you own, so again, this is a two-part strategy, right? I own the stock and I own the put. The put gives me the right to sell the stock that I own at a specific strike, at a specific price called the strike price, and I have that right until the expiration date.

Let's say I own 100 shares of the SPDRs, SPY ETF, that's an ETF on the S&P 500, which in this hypothetical example is trading at $264 a share. So I buy a March 259 put at $4.63. So how do I do that? So imagine that maybe I bought SPDRs yesterday or last week, or 10 years ago, it doesn't matter when. But I own these share of SPDRs that are now at 264. What I would do is I would log in, if I want to execute this strategy, protect the puts, I would log into my Fidelity account, I would select the period of time that I want in this case I'm assuming it's March now, I put these slides together a while ago, it would probably be more something like, you know, September or something like that at this point. But I would go to the March expiration, I would look for the strike

price, which in this case is $259, that means if I buy at the right to sell my 100 shares of SPDRs at $259 a share, and I pay $4.63 a share to have that right until expiration.

So this can be, it can be a little tricky the first time you looked at this, and this is probably your view for some of you. The black straight line here is just simply owning the shares of SPDRs which are at $264 right now. And we know how that works. If it goes up I make money, if it goes down I lose money. That's easy. But if I buy this March $259 put at $4.63, I get the green line here. So there's a couple of important things that we need to consider here. First is that I have limited risk. And that's the whole point of this, right? The most I can lose in this case is $9.63, which comes out to about a 3.6% loss. And we're assuming that there's 46 days until expiration in this example. So now what?

Well if when I put this trade on, SPDRs are at $264, if they fall... and they fall below $259 a share, and they're trading there at expiration, well guess what I can do? If they're anywhere below 259, let's say they're at 258.99, or they're at 220, I can sell them at 259. In this scenario, higher than where the market's trading, right? We're assuming it's below 259. So what's the most I can lose? Well the stock would fall from 264 to 259, so that's 5 bucks, plus what I paid for the put, which is $4.63. So I can lose 5 bucks on the stock, plus I've spent

$4.63, the most I can lose is $9.63, which is 3.6% of the share price. Now these are very realistic numbers. I actually... when I put these sides together a while back, I literally took real prices from my Fidelity option chain. So this is pretty darn realistic. Now, can the market move 3.6% in 46 days? Well sure it can. I mean, those of you who are watching this live, you've seen some of the swings recently, the market can move 3.6% in a week... in a couple of days, actually.

So, the question that you have to ask yourself is, do I like this part of the scenario? Do I like limiting my risk to the most I can lose is 3.6%? Well that's one of the two questions you have to ask yourself. The other part of this is we have to imagine a scenario of what happens if the stock rises? ETF rises, in this case. What happens if it goes up? Because we've decided not to sell our shares of SPDRs, we've decided to keep them, and buy a put to protect them. So make no mistake, protective puts, this is a bullish strategy. We think shares of SPDRs are going to go up, so what happens if they do? Well, we make money. But, we underperform because we have this expense. We've spent $4.63. So we always underperform the simple buy and hold strategy with no protection by $4.63, which — and 4.63 divided by 264, that's 1.75%. So the question is, am I willing to just give up 1.75% to be able to limit my risk to 3.6%. Now these numbers are only relevant in this specific example, they're

going to be different for every example that I could come up with. But that's what we want to ask ourselves.

Now 1.75%, I mean, is a lot. When you first start learning about investing, you'll hear people tell you that the S&P 500 goes up 10% a year, and I don't know if those numbers are really necessarily exactly accurate anymore, I suspect that they're not exactly accurate. But people throw around that figure rather frequently. You would expect the S&P 500 to go up 10% a year on average. Giving up 1.75% in six weeks is kind of a lot. And in fact, if I did that every six weeks, that strategy doesn't really work so well, does it? There's what, eight six-week periods in a year? Eight times 1.76, or 75, is — well that's more than 10%, isn't it? So if I just kept, you know, rolling every 46 days, every six weeks, it would be — well I guess it comes out to about 10% a year, right? It comes out to 10% a year to carry that position.

So I basically give up all my expected profit in this example to have the safety, to have the rights, I guess you could say, to cap my losses at 3.6%. Now raise your hand if that math makes sense. I don't see any hands going up, and that's not just because I'm, you know, in my office in Chicago. I think that's hard to justify. So when people trade protective puts, they have — they're forced to be rather selective, kind of pick their spots. OK, right now I want to protect this spot for the next six weeks, but every six-week period is not going

to be protected, I've got to decide which six-week period. And the fact of the matter is, if you've been investing for a long time, you know you can't predict which six-week period you're going to need that protection in.

So we have a dilemma. The put is very, very expensive. So we ask is there a way to overcome that expense? And the answer is maybe. One of the ways we can do that is by using a collar. Now in order to understand the collar, we need to understand two things. One is a protective put, which we just covered. The other thing is a covered call. So let's kind of take a little break from the flow into collars, and let's first make sure everybody understands what a covered call is.

A covered call is when I own stock, and then I sell a call. Right? Now I'm not saying I own a call and then I sell it to try and make a profit. I'm saying I have no position, and I sell a call short. Typically this is an out of the money call where the strike price is higher than the current stock price. So the idea, because I'm selling something short, I'm actually collecting a premium, right? So I'm actually getting a credit, that's sort of the opposite of what we did with, when we bought the put. When we bought the put we had an expense. Here we have a credit. So that already sounds pretty darn favorable. But there's a

tradeoff there. The tradeoff is that we limit our upside. So here's how this works.

We want to generate income by generating that credit, and because we know that we're limiting our upside, and I'll show you how that works in a second. We need to be OK with that. We need to be OK limiting our upside profit potential, which we may or may not want to do. So here's the gist of it. When I sell the call, here's how I limit the upside. I have the obligation to sell that stock that I own, again, two part strategy, own the stock, short a call. That short call gives me the potential obligation to sell the stock that I own at the strike price, and I have that obligation until the expiration date. So it works like this.

I own 100 shares of SPDRs, again, same example, we're pretending we did not do the protective put for the moment. SPDRs are at 264, so I sell one of the March 268 calls at 4.20. So this is a higher price than where the stock's trading. So basically, I have something like this. Again, the black line is just simply owning the call, the buy and — or excuse me, owning the ETF, buy and hold strategy. The green line is owning the ETF and being short the 268 call. So you can kind of see how this works here, right? If SPDRs are above, if they rise, if they're above the strike price of 268 at expiration, I limit my outset. If

they're below the strike price of 268 at expiration, then I don't necessarily limit my upside. In fact, I actually outperform the buy and hold strategy. Four dollars and 20 cents is about 1.6% of $264. I outperform buy and hold strategies by about 1.6% if the stock is below the strike price. If the stock is above the strike price, the best case scenario is I can make about 3.1%, right? Because the shares would go up from 264 to 268, so I'd make $4, plus I get to keep that $4.20. So I kind of have a conceptually similar tradeoff as I do with the protective put, but it's a little different. Here, I'm taking in a premium of about 1.6% every 45 days, and I can conceivably roll this every 45 days and just do it again, do it again, do it again, and collect roughly 1.6% every six weeks.

If shares of SPDRs fall, I can still lose money, but I'll lose 1.6% less than I otherwise would. Shares of SPDRs rise, then I will make money, but the most I can make is, what was it, 3.1%. So covered calls can be tricky, and they sound really, really attractive, and they are. In my Fidelity IRA, I trade covered calls in a similar strategy called cash secured puts every single day. I have those positions on every single day.

So it's critical to understand covered calls and protective puts in order to understand the main strategy that I want to share with you today, which is called the collar. And if you understand covered calls and protective puts,

understanding collars is very, very easy. So a collar is a strategy that can help you protect long stocks at a very, very low cost. It's an investor-oriented strategy, but like all options strategies, they come with a tradeoff. So here's what a collar is. It's simply a combination of a protective put with a covered call. So I'm long stock or an ETF, I buy my protective put, but I finance that put by selling a covered call. So I have one option that I have a cash outlay, I'm paying, you know, kind of a lot to protect myself, but I'm financing that high expense by selling a call and by bringing in a premium to offset that. Make sense?

So the end result is, I have the limited risk of owning that protective put because I own the protective put, and the tradeoff is that I limit my reward. Now that sounds like a potentially big tradeoff because, you know, in my covered call example, previous to this, it kind of changes once we do it as a collar, you know, the most I could make was 3.1%. You know, you may or may not be OK with that. So you basically end up having two choices, which I'll talk about in just a few minutes. Choice one is well, if you don't like that tradeoff, you can just not do the collars. Choice B is you can take a little bit of a more active management philosophy, and do some managing, adjusting, and rolling to try and get rid of the limitations that collars afford you. So we'll address that in just a few minutes. Let's go over exactly how these collars function.

Rationality, we want to limit our downside risk on a stock or ETF we own, and we want to — and we do that by buying the protective put, and we sell the covered call to finance the put. So we'll have the right to sell the stock at the strike price, and we'll also have the potential obligation to sell the stock if the stock's above the call strike price. All right?

So you can imagine, I'm going to kind of give you a little foreshadowing on what the next slide is going to be about, you basically limit your market exposure to a narrow range. If it falls too much, my exposure's gone, if it rises too much, my exposure's gone. So this can be very, very attractive, potentially. So here's how this works back in our example, we're going to use the exact same numbers, so it's really, really easy to understand. I own 100 shares of SPDRs at 264. I buy the same March 259 put at $4.63, and then I also sell that same March 268 call at $4.20. So let's just look at the option components here for a moment, if I'm paying $4.63 for the put, but then I'm collecting $4.20 for the call, I'm basically paying just a debit of 43 cents for this option position, for the collar that I'm adding to my stock position, right?

So this is what I was talking about. What's my exposure here? Well my exposure is I own the stock, but I basically only own it between $259 and $268. Because if at expiration the SPDRs fall below $259, guess what? I can exercise

my put and sell it at 259 bucks. If at expiration SPDRs are above $268, well then I will get what they call assigned, and I'll sell my stock, or my shares, at $268, and I'm out of the position.

So what's the most I can make or lose? Well, SPDRs can only fall five bucks. If I can lose $5 on SPDRs falling to 259, if they call any farther below that, that's OK by me, I'm going to sell them 259. But I've also spent 43 cents a share. So the most I can possibly lose on this is $5.43 a share. What's the most I can make? Well if SPDRs rise up to 268, I can make four bucks, right? Because they would rise from 264 to 268, so I'd make 4 bucks. But I spend 43 cents a share, so the most net that I can make is $3.57. Right? If they rise any more than that, my upside exposure is capped as the same. So I can lose 2%, which is less than the 3.6% that I could lose if I just did the protective put. Right? Now wait, why can I lose less on the collar? I've got more going on here. Why do I lose less? Well because my expense is less. It's not $4.63 anymore, it's only 43 cents. Now I can only make 1.35%, I can only make that 3.57, which is actually a little less than what I would make if I just did the covered call. Why? Well because where previous, where just doing the covered call, the $4.20 I collect is a new asset to me, it's cash put into my account, it's a credit. I'm basically spending that credit to finance the put. This strategy is really about

the put and the only reason we do the call is to finance the put, to make that protection really, really inexpensive.

Now between the two strike prices, where I actually have market exposure, it's basically the same as the buy and hold strategy. It's, you know, I've got a very, very, very, very small extra cost of 43 cents a share, and on a $2.64 position, I mean that's kind of nothing, you know? So I'm very, very OK with that, I mean that's the whole purpose that I do this collar. I mean basically, here's what I've done: The only reason I would do this collar is if I want to hold the shares because I like this in the long-term, but I think in the short-term, it's probably not going to rise too much, and I'm afraid it's going to fall off. Everybody see how that works?

Now, I've used the same strikes that I used before in the protective put and the covered call examples in the collar, just to make it simple. But there's nothing special or magic about those strike prices. I can change them, you know? I could use the 259 puts and the 268 calls, or I could use different strike prices, you know? I can change the strike price of the call, I can change the strike price of the put, I can change them both. And when I do, that's sort of an, it gives me a lot of choices. It enables me to change, you know, how much downside risk am I willing to absorb? If I choose a higher put strike, then I

won't lose as much, because if the SPDRs fall, I can sell them at a higher price if I use the higher strike put. But what's the tradeoff there? The put's more expensive. So then I would have to sell a lower strike call to bring in a bigger call premium to finance that more expensive put, which then limits my upside exposure.

The thing that people often have a problem with though is that upside exposure being limited. So, is there a way that we can overcome that? Well yeah, I'll talk about that on, oh I think it's the next slide here.

Now as far as that 43 cents goes, you know, that brings our cost down by about 90% on the benefit of being able to have that put. Sometimes, collars can be put on at no cost. Sometimes you can even put them on at a small credit, depending on which strikes you choose. Now, I was using a 46-day collar here. When we use collars, it's very, very common for people to use them by buying much, you know, much longer term puts, and selling much longer term calls. Sometimes using options with six months or even a year until expiration, and still having a very, very low cost. I mean, limiting our loss to, you know, 2% or 3.6% in six weeks is, you know, whatever. I mean can the market move that much in six weeks, yeah, but if you could limit your loss to 3 or 4% over a year period, that starts being a lot more attractive.

So, let's look at a one-year collar. Let's say I own 100 shares of SPDRs at 246 again, and there's about a year until January expiration. So I could buy the January 247 puts at 18.45, and sell the January 290 calls at 13.72, which is a total debit of $4.73. Now, there's a couple things to note here. Because I'm looking at a one-year choice here, instead of a six-week choice, I know the market can move more in a year than it can move in six weeks. So I'm going to choose a lower strike put, which is going to be more expensive actually for two reasons. One is because well, it's going to be more expensive for one main reason, I guess, now that I think about it. It's going to be more expensive because there's so much more time until expiration, 12 months instead of six weeks. So that's going to, you know, options with more time until expiration are more expensive. I mean granted, we're choosing a lower strike, but because there's so much more time until expiration, we still have to pay a lot more for it. And because it's a lower strike, the market can fall a lot more, and so we have a little bit more downside exposure from pure stock price action.

Selling the January 290 calls in the covered call example we used before, we were selling it, as I recall, as the 268 strike. So we're actually giving ourselves more room to the upside, which we really want to do, you know? I mean saying, you know, I don't think the stock will move more than four bucks in six

weeks might be somewhat reasonable. But saying I don't think the stock will move more than four bucks in a year is kind of silly, you know? That's not realistic. We need to give ourselves more room for the upside, so we choose a much higher call strike.

So the debit here is 73 cents, which comes out to... I don't know, that must be about 3 point something, 3.7, 3.8% in a year, that's pretty reasonable, right? I mean if I'm a typical year, and I can make 10% on average, again, throwing that number out, if I'm expecting to make 10% on average holding this, I'm good spending 3.7, 8% a year for protection.

Now let's compare the collar to the put. If I just buy the put, that's $18.45. That's a lot. So I'm able to spend just about, almost what, 20-some percent on the collar instead of what I would pay for the put, I'm able to abate, you know, 70-some percent of my cost by doing the collar instead of doing the, instead of just buying the put outright. So you can start to see how there's an advantage to doing these long-term. Now one other thing that I want to talk about is the options provide protection, I've still got this cost, and I still give up the upside. So is there a way to offset, to — well is there a way to not have such a limitation to the upside? Because again, the only reason I'm doing a collar is because I think there is still some upside potential. If I thought there's no way

in heck this stock is going up, it's going to crash, I wouldn't be messing around with a put or a collar, or anything. I would just sell the stock or ETF, right?

So because my whole rationale for either of these strategies, protected put, or the collar, is that I think the stock or ETF is going up, if I'm going to mess around with the collar, selling the call to finance the put, what I really want to do to get really, really good at this, I've got to get pretty good with managing the trade, right? So what I end up doing is when the stock or ETF goes higher, I do what's called an adjustment or a roll to be able to effectively change the strike of that call. Basically what I do is I buy the call back, maybe at a profit, maybe at a break even, maybe at a small loss, and then I sell a higher strike call to give myself more room to the upside. Now that's one of the strategies that I talked about in our MTM smart income system, and to get really, really good at using collars, you'll want to be able to do adjustments on the call side.

But that being said, try it on your own, if you have a long-term investment that you don't want to sell, that you're concerned about downside risk, and that you want the downside protection, and that you're willing to give up some upside, and maybe willing to try some rolling strategies, you know, once you get a little more acclimated, you get, you know, pretty good at this, a collar can be a very, very suitable way to do that.

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