DRS vs. Collars

Seeking a Sustainable Downside Protection Strategy

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Options-based strategies have been growing rapidly over the last decade, both in terms of available solutions as well as assets under management. As of May 31, 2018, there are 176 funds with over $20bn AUM in the Morningstar category "Options Based." So what makes this options-based strategy so popular?

As part of our ongoing comparison series, we will explore the following:

1. What are the drivers of returns in a collar strategy?
2. What are the risks in this strategy?
3. What role does a collar play within a portfolio?
4. How does a collar compare to the Defined Risk Strategy?

The Collar Strategy

With a collar strategy, the manager typically has a long underlying position in a portfolio of stocks. The manager seeks to protect against downside risk by purchasing an out-of-the-money put option. While it is certainly prudent to protect against downside risk, put options obviously cost money.

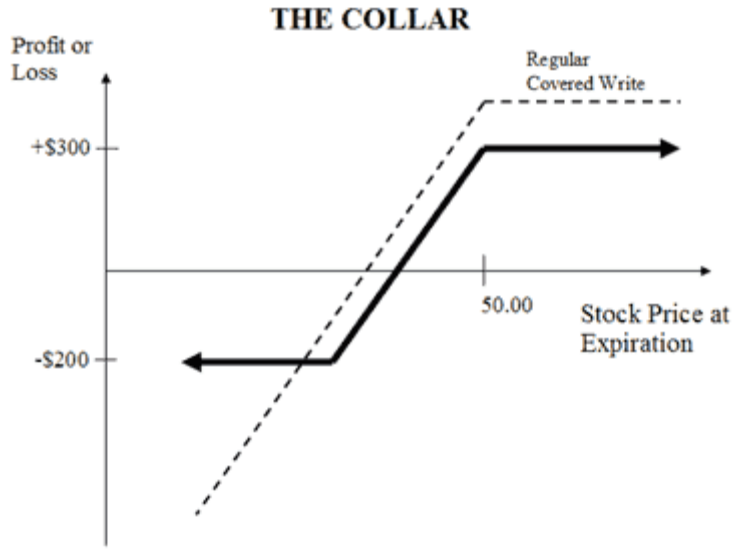
To help offset the cost of the put options, a collar strategy seeks to generate income by writing out-of-the-money calls against their market position. In effect, this caps the upside potential of a collar. This is the fundamental trade-off of a collar strategy: downside protection is purchased in exchange for selling away some of the upside potential.

Components

A collar typically has three components:

1. A long, buy-and-hold position in a market
2. Long, out-of-the-money puts to protect on the downside
3. Short, out-of-the-money calls to help pay for the puts

Below is a graph outlining the return profile of a covered call strategy.



Source: www.theoptionsguide.com

A "Protected" Covered Call

If the above chart looks a bit familiar, it should. The collar strategy is closely related to the covered call. In fact, two of the three legs of the collar are the same as the covered call: the long equity position and the short call position.

With the covered call strategy, we stated that one of the drawbacks is there is no downside protection. One way of thinking of collars is that they are essentially "protected" covered calls: using the premium they generate from the short calls not for income but to purchase downside protection.

Drivers of Returns

The primary driver of the collar strategy's returns is the movement of the market itself. Not only is the direction of the market important but the degree or magnitude of the market's move is also significant. It is often said that a collar is a moderately bullish strategy.

The key word is moderately. Since the core of a collar is a long position in a portfolio of equities, the holder obviously hopes that the market goes up. However, the risk is if the market goes up too much, the call options will go from being out-of-the-money to being in-the-money. Under such circumstances, the portfolio manager really only has a few options.

One, they could close out the trade and take a loss on the option trade. Two, the underlying asset could be called away and miss out on the gains. Or three, the portfolio manager could cross their fingers and pray that the market reverses direction and dips back below the strike price before being called. Either way, the collar has effectively sold off its upside potential in a sharply rising market.

Of course, the benefit to the collar strategy is when the market goes down. If the market goes past the put strike and if the collar was implemented correctly, the strategy should be protected from losses beyond a certain point.

That is why the strategy is called a collar: The range of returns is meant to be "collared" with limited downside but also limited upside.

Risks

The first risk is the most obvious one: that a collar strategy has sold off its upside potential. This is more of an "opportunity cost," where gains beyond a certain point are forgone. However, there are additional risks to a collar. As always, the devil's in the details.

Paying the Price for Puts

One risk has to do with what's known as the skew of option pricing. In layman's terms, skew refers to the fact that the prices of put options are usually significantly higher than the price of call options. If a collar strategy is buying high-priced put options and hoping to offset the cost by selling low-priced call options, the collar might not be generating premium to fully pay for the put.

This leaves the portfolio manager with some difficult choices.

- The P.M. might accept that the cost of maintaining the put might not be fully offset by the short calls. In such a case, the gap between the income generated off the call and cost of the hedge will be an enduring drag on the portfolio performance.
- The P.M. might seek to offset the cost of the put by selling multiple calls. For every put owned they might sell two, three, four or more calls to generate enough premium to pay for the put. This creates a leveraged bet, and if the market goes past the call strike, this approach can get very painful very quickly.
- The P.M. might seek to buy or purchase cheaper puts by moving the protection further out-of-the-money. While the cost of the hedge would be reduced, so would the degree of protection. Essentially, the investor would be on the hook for a larger tranche of losses before the protection kicked in.

Potentially Expensive Protection during Bear Markets

The other major risk to a collar strategy is the cost of maintaining it through a prolonged bear market. When collars are established, the protection is usually short-term in nature with the puts going out three months or so. Sometimes more, sometimes less, but three months is typical.

What happens to a collar strategy during an extended market downturn after its initial hedge is cashed in? If the collar is to be maintained, new put options will need to be purchased. But in a protracted bear market like the dot-com crash (2000-02) or the Global Financial Crisis (2007-09), buying new puts every quarter can become prohibitively expensive. The price for short-term protection skyrocketed in such environments and, in some cases, maintaining a collar might be impossible thus leaving the underlying unprotected from downside risk.

Role Within a Portfolio

There is no "silver bullet" strategy that works well in every situation. Every strategy has environments it works well or works poorly. Collar strategies tend to work best in either modestly upward markets or short-term, minor corrections of 5%-10%.

In the case of the former, the collar will enjoy modest gains without too much upside called away. With the latter, the short-term put offers some protection, and hopefully the sell-off isn't too steep or too prolonged. A case can be made for having a portion of one's portfolio in such a strategy.

However, if one expects to capture most of the upside in a strong bull market or if one is looking for bear market protection, a collar is not likely to be the best fit.

How Do Collar Strategies Compare to the Defined Risk Strategy?

The Defined Risk Strategy shares a few similarities with collars, in the sense that it has a core, buy-and-hold, long position and purchases options to protect on the downside. However, there are some key differences between these two strategies.

Where the collar has short-term puts, the DRS has long-term downside protection on the equity with a LEAPS put option. With a LEAPS put option, if and when we're in the midst of a bear market, the DRS won't be forced to purchase expensive puts for short-term protection or, as would be the worst case for the collar strategy, be left without protection.

Another difference is in the way they generate income. While the collar strategy seeks to generate income by writing calls, the DRS does so via the simultaneous sale of both calls and puts in a market-neutral fashion. This provides the potential for more premium and better opportunity to offset the cost of the put option.

All this leads to a very different return and risk profile than collar strategies: The DRS may provide better protection in down markets with more opportunity for upside potential.

About the Author

Marc Odo, CFA®, CAIA®, CIPM®, CFP®, Client Portfolio Manager, is responsible for helping clients and prospects gain a detailed understanding of Swan's Defined Risk Strategy, including how it fits into an overall investment strategy. Formerly, Marc was the Director of Research for 11 years at Zephyr Associates.

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