Hello, everybody. I'm Peter Lusk from the Chicago Board Options Exchange. I want to thank The Options Industry Council for having me here today. We are going to talk about one of my favorite trades, Equity Collars. Before we start talking about equity collars though, we've got a lot of attorneys and we got to satisfy them, too. So we're not using any commissions today and I also want to tell you that options can be a risky trade.

Now, as the outline goes, we are going to do a little review today, option basics. This whole thing with options is great. Repetition is a good thing. So those of you that are a little farther along, just stay with us. We're just going to help those that are just joining us as new option traders. We're going to go through equity collar basics. What it is. What makes it up? And then we're going to put out an example and take you through some various scenarios through the example. And let's get started.

This is your typical option string, alright? It reads like this: XYZ December 60 call at $2.50. Now, let me break it down for you. XYZ is the stock, just like if you had IBM but XYZ is our favorite stock that we are using in this example. December is the expiration month. Options expire unlike stocks although we've seen some stocks expire as recently as the last 12 months, right, with some of the turmoil in the marketplace. Now 60 is very important. That's what we call the strike price. That's the price per share of an option if it's exercised. Now, the call is the option type and, again, very important $2.50 is the price of the option. So when you are in your trading platform, you're going to see a price of an option looks similar to this, and our example, it's $2.50. But keep in mind that an option represents 100 shares of stock so this particular call option is price on a per share basis. So it reads at $2.50 but its $2.50 per share so this option would really cost you $250.

Now, some more option basics. Remember, if I'm an option buyer, I've got rights. I paid something for that option contract. So buyers have rights and sellers, they receive premium. They don't have any rights, but they've got an obligation, alright? So if I buy a call option, it gives me the right to buy the stock at that certain price which is the strike price at anytime during the life of the option. If I'm a put buyer, it's just the opposite. I've got the right to sell the stock at that strike price anytime during the life of that option and remember each option represents 100 shares of the underlying stock. Now, call sellers actually receive premium. They get paid and remember as an option seller, you can sell something you don't have. You can go right in the marketplace and sell an option contract. Now, a call seller has the obligation to sell if called upon to do so, alright? A put seller actually has the obligation to buy at that strike price if he is assigned or called upon to do so.

Now, let's talk about covered calls. When I teach options, covered calls are really the best place to start when we're talking about a new trader getting in the marketplace. This is a great little trade. Now, what's a covered call? Here it is. Let's just say that you've got 100 shares of stock, alright? It's kind of floundering; it's not doing a whole lot. Let's just say this stock is at 50. It's got a range that goes to 52 then it goes back down to 51 then 49. It's got its little charade where it just kind of hit its ceiling, you know? There is a way of generating income by selling a call option against the stock that you already own, alright? Now, here it is. Let me just give you a quick example. If I've got this stock and it's trading 51, my covered call, I'm going to go out into the marketplace and sell a call that will have a 55 strike, alright? So, again, I'm trying to generate premium. And look, if that stock doesn't go up to 55 and I don't get assigned and what happens with the call? Remember, if I sell a call, I've got the obligation to deliver shares, right? Now this is what happens, if I don't get assigned on that particular call option, I get to keep the premium and do it again. Covered calls can actually be a monthly business for those that own stock.

Now, let's talk about the protective put. Right now, we're setting up what this collar really is, but here is the protective put. Let's just say that I've got a stock and I'm worried about something. Earnings is something we're always worried about, isn't it? So this is what you can do. If you've got shares and you're worried about something, you can go out into the marketplace and you can buy a put option. With a strike price, it is somewhat of a safety net down below. Again, I'm just going throw out a number here. Let's just say that I've got a stock that's trading 50 bucks and I bought it at 20; I've had a nice run with it. I'm worried about the downside. What I'm going to do is buy a 45 strike put as a safety net. Remember, when I buy a put, what does it do for me? It gives me the right to sell the stock at that strike price. In this case that strike price would be 45.
So that’s just a little bit of a basic history, a little background on not only the covered call on the previous slide but the protective put.

Now, here we go. This is what we’re here for today. Let’s talk about the equity collar. Now, you’ve got these shares of stock. You’re looking for some sort of protection. What we’re doing is we’re going combine the covered call and the protective put, these two strategies, and what that is… that basically equals our equity collar. We are going to choose strike prices to protect us not only on the downside with the put but on the upside. And the beautiful thing about this is this: Look, if I sell a call, I collect premium, don’t I? Well, when I buy a put, I’ve got to pay premium. But here’s the deal. The premium that I collected on the sale of the call can actually finance down below the purchase of the put.

Now, who might use a collar? Good question. You know, my dad, he’s 79 years old, long time stock trader, doesn’t want to know anything about options even though his son works with him, right? Well, we sat down at the kitchen table one day and I told him about this collar strategy, which again is the combination of a protective put and a covered call, and I told him about the protection that he could have with this particular strategy. And you know what, he got it. He got the benefits.

Now, let me take it through an example. Currently in the marketplace, if I’m on my trading platform, now this is what I’m going to be looking at. Right now already I know that I’ve got XYZ stock and its trading $62 a share, right? Let’s just say this is my dad again. He had this great run. He bought this stock at 18, right? So all the way up to 62. But he’s nervous about something. What’s he nervous about? A lot of things in the world, right? In this case, what he’s doing now with my help, of course, is this: He’s choosing 2 points to get out of this stock trade. Now remember, each option contract represents 100 shares of stock. So he’s exit points are these: He’s going to go ahead and buy the protective put down below which is a 60 strike put and remember if I buy a put, it gives me the right to exercise that put and get out of that stock at the price of 60, right? Okay. Now, the other portion is the covered call portion. I’m going to sell it out-of-the-money call. 65 strike call. So my two exit points are 60 and 65.

Now, here’s the beautiful thing about this is the sale of the call will actually help finance the purchase of the put. If I was nervous about things down below just like the protective put, I can go ahead and buy the put, right? But every time I’m nervous, just like a Cub fan, nervous all the time, right? You can’t keep throwing money at your stock position. Now this looks like a beautiful deal, right? Remember, I’m buying a put for $250, selling a call for $250. It doesn’t always work out that way, alright? You might have to put this spread on for a debit. And when you’re doing these collars, don’t get all caught up in the fact that “Hey, I don’t want to pay for this insurance.” Just check out the pricing. Your exit points are the most important thing, alright?

Now, here is our example. I’ve long 100 shares of XYZ at 32, alright? That’s when I got into this trade. Bought the stock at 32. It’s currently trading $62 a share. What am I going to do? Well, I bought the put at $250. I sold the call at $250. It was a zero cost insurance solution for me with options, wasn’t it? Now I’ve got this downside protection, right? If I have to exercise this put, I’m good to go, right? If this thing gaps on the open, this stock gaps on some bad earnings play, earnings news, this thing goes down to 48, I’ve got that put. That put is my friend, an old saying from the pits, right? I’m an old pit trader at the CBOE and look, puts are your friend. If that stock does gap down to 48, I can get out of this stock at 60. Because remember, when I buy a put, it gives me the right to sell the stock at a strike price. The strike price that I sold, my exit point, is 60. And my upside profit potential is still intact, isn’t it? If the call is assigned, of course, I’m out of a position. Remember, I’ve got a 100 shares represented by the put. A 100 shares represented by the sale of the call. So whichever one gets hit, I get assigned on the call, I’m out of my position or if I exercise my right on the purchase of the put, I’m also out of a position.

Alright. Let’s take you through the basic scenarios of what goes on here. Here you go. XYZ is below 60 bucks, alright? XYZ actually closes at $55 a share. Now, my dad’s got this 60 strike put. It’s in the money and it’s in-the-money by how much? At expiration, it’s in-the-money by $5 and what’s our in-the-money amount? Our in-the-money amount is what we call intrinsic value. Alright? The other part of this collar, which is the 65 strike call, has no value. It goes out worthless, doesn’t it? And it’s not assigned.
But here’s the deal now. With this stock below 60 and it actually closed at 55, I’ve got choices. I can sell the put. Maybe I’m bullish now. Okay? I could sell the put and keep my shares or I can exercise the put and sell shares at 60 which was really my intention all along, wasn’t it? It was to get out if something happened, if something crater below.

Now, here’s the scenario of selling the put. XYZ closes at 55, right? I’m going to go ahead and sell the put back out in the marketplace and keep my shares and I get to keep the 5 bucks, alright? That wasn’t my original intention, but these are things you can think about. Maybe there was an earnings announcement that came out and this company is now positive for the next quarter. You’ve heard it all before, right? But here’s what happens, if I go out in the marketplace and I sell that put back out, it reduces my cost-basis, doesn’t it? I got into this stock a long time ago at 32, less the $5 I collected by selling that put back out into the marketplace, so look my cost-basis has now been reduced by that $5 I collected on the sale of the put. So my cost-basis is now at $27. And now, I’ve still got that unlimited profit potential from my original 100 shares of XYZ. Well, if that’s what I didn’t want to do, that’s okay. Remember, we’ve all got choices in life. We got choices when we trade options as well. In this case, remember, my original intention of putting the collar on was to possibly use that put and exercise it and get out of this particular trade that I’ve had a good running.

So I’ll take you through this now briefly. The investor, like my dad, he’s going to exercise that 60 strike put. What does 60 mean? Well that’s the strike price, right? If I buy the put, which I did in this case, I’ve got the right to sell 100 shares at 60, alright? So here we go. XYZ shares were originally purchase at 32 and I got off them at 60 with the sale on my put which represented 100 shares, right? See the put offsets the shares of stock. So my profit is $28 or $2800 actually. Okay? So my downside objective was met.

Now, if XYZ is between 60 and 65, guess what happens to the options? Well, the collar expires. No value on the collar. Remember, we put it on for no cost and there’s no profit either. Basically, both the 60 strike put and the 65 strike call that I sold go out worthless.

Now, we established this again for even money, right? If I did it for a credit, I will be able to keep the credit or if I put this trade on for a net debit, I would lose the cost of the debit which is what I would pay for insurance basically. Alright?

Now, if XYZ is above 65, the call is assigned. Alright? Let’s just say that XYZ closes at 68. Remember, when I sell a call option, I don’t have any rights. I collected premium. What do I have to do if I’m assigned? I have to sell 100 shares. So I’m short 100 shares at 65, right? And I’m long 100 shares with my original purchase of stock and I’m out of a position. So here’s the result. XYZ purchased at 32, I sold it at 65 with my covered call portion of this collar trade for a $33 profit. So my upside objective was met. I sold the shares and I’m out of a position. And remember, you got to be ready for anything. If that stock soared up to 70 or 72, I can’t partake in it, can I? I’ve got to get out at 65 because that’s the exit point that I chose by selling the call.

Now, I always like the pictures. This looks a little bit busy but it’s not that bad, alright? Take a look at the perforated line and just remove everything else that you’re looking at. That perforated line is our long stock that we bought a while back at $32 a share, right? Now, take a look at the exit points. We chose the call strike. See the cost strike price with the arrow going down and then all the way down below you can see on the bar the 65, that’s our exit point up on top. So if this stock ran, I’m out of the game at 65. If the stock goes lower, I’ve got the right to be out of the game at 60 with the protective put portion that I purchased.

Now, the money part is what we’re all… well, this is what we’re all about, right? So look at the left bar, you see the 3300? That’s what I would make. That would be my profit if I got out at the 65 strike call where my profits are capped; I make 3300 bucks on the run of this stock. If I get out a little bit lower and the stock got hit, got hurt a little bit, I make 2800, don’t I? A difference of 500 bucks.

Now, the equity collar is just a wonderful strategy especially for the stock investor. Now all these strategies that we go over time and time again are all great. Keep them in your hip pocket. Know when
to use them. This is a great strategy when you’re worried about something. Remember, we talked about the protective put? You can’t keep throwing money at a protective put every time you’re worried about something. So consider the collar which is the sale of the call which helps finance the protective put portion of this particular trade.

Look, I want to tell everybody thank you so much especially The Options Industry Council for having me here to talk to you. Thanks so much and by the way, don’t be afraid to go on the OIC website. It’s a wealth of information. So thank you so much for watching. And we hope to do this again sometime soon.