

Professional Options Trading Masterclass Video Series

POTM

Video 10

Covered Call Collar Strategy

Covered Call Collar

Quick Explanation

The Covered Call Collar Options Trading Strategy is a strategy that can be applied when you already have a Long Stock position, and you don't expect the price of those shares to move much over a period of time. It can potentially return a profit from a stable stock price in a similar way to the Covered Call strategy. However, the Covered Call Collar Strategy also offers additional protection against the stock price falling, because it involves buying Put Options as well as writing Call Options.

In effect the Covered Call Collar has all the same applications (benefits and drawbacks) as the Covered Call Strategy except you also get more protection on the downside on your Long Stock position than you would by simply writing a Covered Call if indeed the Stock you are long does go down. The Covered Call Collar Strategy is a direct extension of the Covered Call strategy, which is used the same purpose i.e. you are Long a Stock and you expect the Stock price to remain neutral (no material rise or fall), but sacrifices some of the profitability of that strategy to also hedge against the stock falling in value. Therefore, you would use it when you wanted to earn money from your neutral outlook, but you wanted some protection against potential losses if the stock price dropped.

You will notice in the usefulness ranking that we have ranked the Covered Call Strategy as high for Retail Traders versus Medium for the Covered Call Strategy. This is because although as a Long Stock holder you do give up some of the Net Credit you would receive from writing Call Options (one side of the trade) and although your \$ upside is Limited on both sides of the trade, the \$ upside on the second side of the trade (Long Put) is only limited because the Stock can only theoretically fall to Zero. In reality if the Stock fell by an amount that is meaningful i.e. through the Strike price of the Put you are long the P/L gain on the Long Put position is meaning full enough to warrant a substantially better Hedge than just simply being Short a Call against the Long Stock position. This in our estimation makes the Covered Call Collar Strategy more useful to Retail Traders, especially those with Long Stock positions in their Pension that they are seeking to Hedge effectively.

- **Non-Directional Bet**
- **Neutral Strategy**
- **Simple**
- **One Transaction**
- **Net Credit (Upfront Payment Received)**
- **Max Risk (Limited)**
- **Max Gain (Limited)**

When to Use the Strategy

As explained above, the Covered Call Collar Strategy has the same benefits as the Covered Call Strategy in the previous section with the added benefit of downside protection by also being Long a Put Option. Remember the Covered Call Strategy had four main uses; -

Establishing a Covered Call has 4X main uses; -

1. Hedge against Long Stock Position that is positive P/L and collect Premium.
2. Hedge against Long Stock Position that is Negative P/L and collect Premium.
3. Hedge against Long Stock Position in a Dividend paying Stock that is going ex-Dividend very soon and collect Premium.
4. Getting a "better" execution price on an intended Long Stock Position.

In extension to each of these 4 benefits add on "Long Put" for downside protection. We will not repeat the 4X benefits here. Please at your own discretion remind yourself of these benefits from the Covered Call Strategy section and add on the benefit to each use a plus (+) "Long Put Option" to protect against a Stock Price fall. It is therefore a more complete strategy when being used for the purposes as a "Hedge" against a Long Stock position. The expectation is that if the Stock does indeed fall during the time period to expiration that the \$ losses experienced by the Long Stock holder on the Long Stock position will be offset or more than offset by the \$ gains experienced on the Long Put position. In each benefit above a Net Credit can still be received as long as the trade is structured in a way whereby the Credit received by writing Call Options exceeds the money spent (debit) on buying the Long Put position. It can therefore be a Debit or a Credit Trade however where possible you should seek to trade efficiently and spend less on the Long Put position than you gain from writing the Short Call position. After all, you are writing the Call Option because you expect the Stock not to go up. You are not Writing the Call Option because you expect the Stock to go down. You are writing it because you think it will neither go up nor down in price but remain neutral for a period of time. You are buying the Put Option because you think there might be an off chance that it could go down for reasons that you may not be able to see right at this moment in time. That's why it's called a "Hedge." It is therefore a more useful Hedging strategy than

simply writing a Covered Call because the strategy will protect against an unforeseen fall in the Stock Price and a Credit can still be received.

How to Use the Strategy

Putting the strategy into place is straightforward enough, with just two transactions required. You would write Calls on the relevant stock (enough to cover the amount of Long Stock owned) and buy the same number of Puts. You should use the same expiration date for both sets of options, which would typically be the nearest expiration date. You can, however, use a longer-term expiration date if you believe the stock will remain stable for a longer period of time.

The big decision you need to make when establishing the Covered Call Collar is which strikes to use. Generally speaking, you should write out of the money Calls at a strike that is only slightly higher than the current price of the stock you own. You can use an even higher strike if you wish, because this will enable you to potentially make more profits if the stock increases in price, but you will receive a lower credit and will make less if the price doesn't go up. The Puts that you buy should also be out of the money, and you should absolutely seek to spend less on them than you receive for writing the calls so you ensure that you receive a net Credit. Not receiving a Net Credit defeats the purpose of the Hedge and eliminates major advantage that the Covered Call Collar Strategy has over simply applying the Covered Call Strategy i.e. you are not only being paid to Hedge you are still being paid for a Hedge that is more effective than simply writing upside calls as a Covered Call Strategy against a Long Stock position. So, in effect you are being paid to receive the large \$ upside saving if the stock does indeed fall for whatever / unforeseen circumstances. Once you step over the line of NOT receiving a Credit but actually paying for the Hedge (Debit), then a major advantage of placing the Covered Call Collar strategy versus the simple Covered Call Strategy is eliminated. Getting paid and getting a superior Hedge is the motivation here i.e. to obtain a better more efficient Risk Reward profile on the Hedge.

As with the above explanation of the Covered Call Strategy, the 4X main uses were explained on when to use the strategy. We will not repeat them in this section. Please remind yourself of these 4X main uses above and add into the outcome a Long-Put position that is purchased as an Out of The Money (OTM) Put Option to protect against a down move in the Stock and the price of that Long Put option is lower than the Credit received by writing the Out of The Money Call.

Break Even

Break-even point is when **Price of Underlying Security = Starting Point + (Net Premium)**

In the case of the Net Premium being a Credit in the above calculation Net Premium is a minus figure i.e. we must subtract the net credit received figure from the starting point (reference price) of the underlying stock when the Covered Call Collar was established.

In the case of the Net Premium being a Debit in the above calculation Net Premium is a plus figure i.e. we must add the net debit paid figure to the starting point (reference price) of the underlying stock when the Covered Call Collar was established.

It is therefore much more preferable to receive a Net Credit from the Covered Call Collar Strategy in order to have a break even that is lower than the reference price.

Profit Calculations (Maximum Upside)

Leg A = Write Call Option, Leg B = Long Put Option

Maximum profit is made when **Price of Underlying Stock = Strike of Options in Leg A**

Profit is also made when **Price of Underlying Stock > or = Starting Point but < Strike of Options in Leg A**

Profit, per share owned is **(Price of Underlying Stock – Starting Point) + (Price per Option Leg A – Less Price Per Option Leg B)**

It should be noted that there's a school of thought that says that any profit made from an increase in the price of the underlying security would have been made even without applying the covered call, and it shouldn't be included in the profit calculations.

Risk Calculations (Maximum Downside)

The biggest possible loss occurs if the price of the underlying security should drop to exactly the strike of the puts options bought in Leg B. The calls would expire worthless, and so would the puts. You would keep the net credit. However, the shares you own would have dropped in value and that loss wouldn't be completely covered by the net credit. If the shares drop even further, then the losses wouldn't get any greater. Although the stock would continue to fall in value, the puts would start to increase in value and offset that fall. The potential losses can be summarized as follows.

Maximum loss is made when **Price of Underlying Stock = Strike of Options Leg B**

Maximum loss, per share owned is **(Starting Point – Strike of Options in Leg B) - (Price per Option Leg A – Less Price Per Option Leg B)**

There's also the risk that the Covered Call Collar can potentially cost you profits, if the stock rises above the Strike of the Call Options written in Leg A. Should the stock rise above the Strike, then the Calls written in Leg A could be assigned. You could be obliged to sell the stock you own at the strike. This would still represent a profit, but you could have made a larger profit if you had just kept hold of your Stock and not used this strategy. Although you can always close the Short Call Options position created in Leg A. The Covered Call Collar or indeed the Covered Call Strategy is clearly NOT an ideal strategy to use if you think there is a chance that the underlying security will increase significantly in price.

Strategy Example

- You own 100 shares of Company X stock, which is currently trading at \$50. We shall refer to this price as the Starting Point (Reference Price)
- You believe that the price will not move much, if at all, over the next few weeks and you want to try and profit from this / bank some Net Premium whilst also protecting your downside.
- You Write Out of The Money (OTM) Calls with a strike of \$52 and the closest expiration date are trading at \$1. You write 1 call options contract (each contract contains 100 options) and receive a credit of \$100. This is Leg A.
- Out of The Money (OTM) Puts with a strike of \$47 and the closest expiration date are trading at \$.50. You buy 1 call options contract (each contract contains 100 options) at a cost of \$50.
- You have created a Covered Call Collar and received a net credit of \$50.

Profiting

The maximum possible profit will be returned when, at the time of expiration, the price of the stock has increased to the strike of the calls written (\$52). When this happens, the Calls you have written will be At The Money, and will therefore expire worthless. The Puts you have bought will also expire worthless.

Therefore, you would keep the net credit made at the time of applying the strategy (\$50) + the shares that you own have increased in value by \$2 per share and you will have also made a profit of \$200 on the Long Stock position. This would give you a total profit of \$250.

There's also the risk that the Covered Call Collar can potentially cost you profits if the stock rises above the strike of the options written in Leg A. In the above example, should the stock rise above \$52, then the Calls written in Leg A could be assigned. You could be obliged to sell the Stock you own at the strike of \$52. This would still represent a profit, but you could have made a larger profit if you had just kept hold of your stock and not used this Covered Call Collar Strategy. Although you can always close the Short Call Options position created in Leg A.

Losses

The biggest possible loss occurs if the price of the underlying security should drop to exactly the strike of the Put Option bought in Leg B (\$47). The Calls would expire worthless, and so would the Put, so you would keep the net credit. However, the Long Stock position you own would have dropped in value (by a total of \$300), and that loss wouldn't be completely covered by the net credit received. If the shares drop even further the losses wouldn't get any greater. Although the stock would continue to fall in value, the Put Option Contract would start to increase in value and offset the \$ losses incurred by the Long Stock position.

1. **Please Note:** One other key advantage of the Covered Call Collar is that, at the time of applying the strategy, you can calculate exactly what the maximum return and the maximum loss will be as both profits and losses are limited. However, the profits on the Leg B side of the trade (Long Put) are only limited in the sense that the Stock can only go to Zero. Meaning there is a major hedging advantage by using the Covered Call Collar Strategy versus simply using the Covered Call Strategy. This why we rate the strategy as High Usefulness for Retail Traders for the Covered Call Collar Strategy versus Medium for the Covered Call Strategy. It is also a simple strategy to deploy with only 2X very straight forward transactions.