10.8 COLLAR OPTION STRATEGY

Explainer Video

> "A COLLAR OPTION STRATEGY IS A TRADING AS WELL AS A HEDGING STRATEGY WHICH INCLUDES BUYING A PROTECTING PUT AND SELLING A COVERED CALL OPTION TOGETHER. THIS IS A STRATEGY WITH LIMITED PROFITS AND LIMITED LOSSES."

This strategy is used when one expects a decrease in price. Here, the upside as well as the downside are limited. The exposure is limited on both sides.

It can also be understood as a combination of both Protective Put and Covered Call Strategy.

The Steps involved in forming a Collar Option Strategy are:

1. Own an Underlying asset (stock/ index)
2. Buy a put option (Strike price below market price i.e., ITM) to provide protection against downside risk.
3. Finance put option premium by selling a call option (Strike Price above the Market Price i.e. OTM)

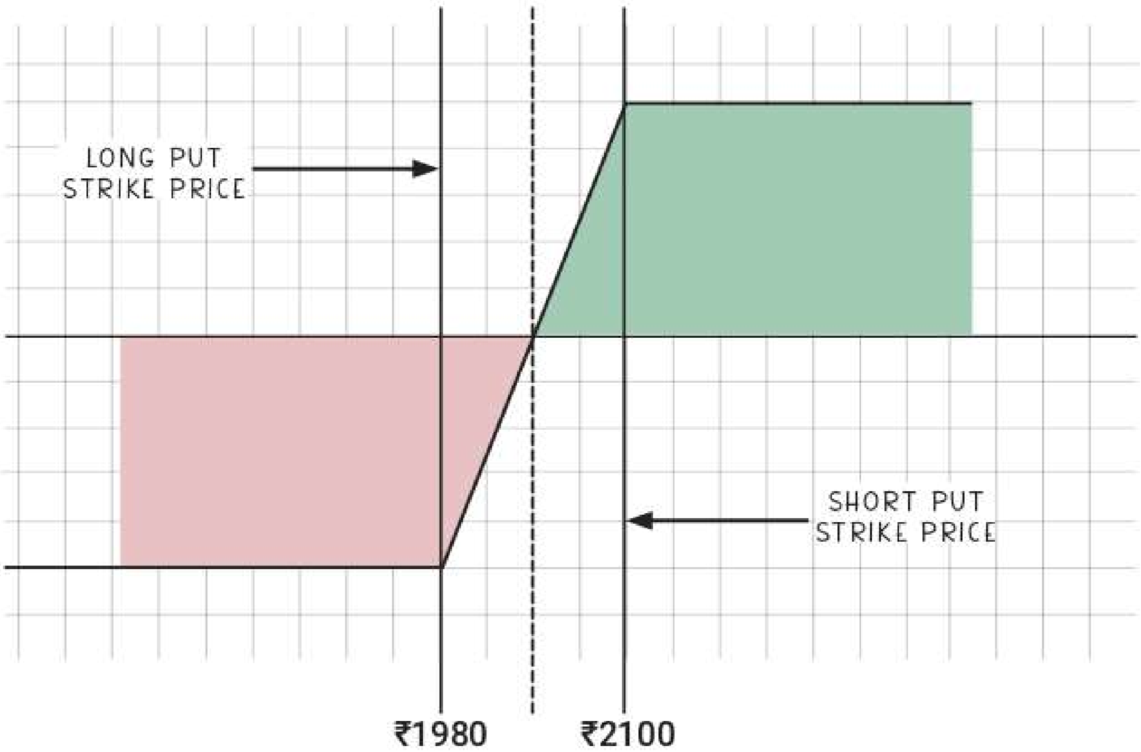
Alternatively, we may:

1. Short an underlying asset in cash or futures market (Stock/ Index)
2. Buy a Call Option with strike price above the Market price i.e. OTM to protect against a large increase in price of the underlying asset.
3. Finance the purchase of the call option by selling a put option with strike price below the market price. This would help us with a short position on the collar.

For instance, we own stock at ₹2000. To create a collar option strategy, we buy a put option at a Strike Price of ₹1980 at a premium of 30.

To finance the put option premium amount, we sell a call option at a Strike Price of ₹2100 at a premium of ₹10.

So, our total cost of having this protection has come down by ₹10.
Total cost now = ₹30 – ₹10 = ₹20.



The maximum profit that we can have under this strategy is ₹80 from current position and maximum loss is limited to ₹40. We can see that the maximum profits and losses are limited under this strategy.

This setup helps us limit our downside as well as our upside. Also, it reduces our premium cost involved in creating this protection for our position. Essentially, we are creating collars around the position to cap our exposure to potential profits and losses as the market price moves. These are very commonly used to hedge positions.