Risk and Return of Equity Index Collar Strategies

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Equity index collar strategies are often perceived as a way for investors, at little to no cost, to exchange some upside exposure for reduced losses on the downside. That perception may be accurate if one considers only the net dollar cost of the strategy’s initial option trades, but the authors of this paper contend that it fails to account for the significant drag the collar may impose on returns.

To make their case, the authors decompose the equity index collar’s returns, seeking to show that it is expected to have lower returns than its underlying index, primarily because it earns less equity-risk premium. Additionally, they write, collars that are net long volatility exposure may further reduce expected returns because they pay out volatility risk premium.

The authors then compare the collar to other ways of obtaining equity exposure with reduced downside risk. Their analysis attempts to show that not only has the collar strategy historically performed poorly relative to these alternatives, but investors should expect it to continue to potentially underperform in the future.
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