Competitive Advantages of Collaring a Spot Trade

This case study compares the revenue generated by (and profit/loss profiles of) a typical spot trade versus the revenue generated by the same spot trade combined with a popular option strategy that traders often implement around spot positions.

STRATEGY: This options strategy, called a long collar, is where a spot trader sells a call option with a strike price approximately equal to the anticipated increase in market price and buys a put option with a strike approximately equal to the market risk the trader is willing to assume. Long or short spot trades can be collared.

The premiums of the short call and the long put should be approximately equal (any difference between the call and put premiums would result in a credit or debit to the account's cash ledger). While the margin rate used in this example is only 3%, the benefits of collaring a spot trade improve as margin rates increase.

TAKEAWAYS: Apparent from the trade comparison on page two are several significant implications. Among them are the following key advantages in mission critical areas, each derived exclusively from implementation of the collar:

- **Margin & Leverage** – The collar reduces required margin, enabling a spot trader to place multiple collared trades. In this case, both the single spot trade and the 5 collar trades require the same margin to implement. The collar effectively increases the trader's leverage nearly 5 times, from 30:1 to 145:1.
- **Trader's Market Risk** – The collar creates an absolute maximum risk that is predefined and limited (without the necessity or risk of a stop order), and the trader is completely protected from even large gaps in the market price.
- **Dealer's Spread Revenue** – The collar increases the number of spreads captured by the dealer from 1 spot spread up to 5 spot spreads and 10 option spreads. Because option spreads are wider than spot spreads, the collar trade generates the equivalent spread revenue of 85 spot trades.

CONCLUSION: The advantages of option trading extend to both the trader and the dealer. The trader benefits from profit maximization and loss mitigation, as well as from a substantially increased ability to harness leverage beyond that of spot alone. The dealer benefits from a significantly higher revenue-to-margin ratio as well as from a marketing offer to its clients of a popular trading strategy for which competing spot-only dealers have no answer.

Trade Comparison: Spot vs. Collared Spot

LONG GBP/USD POSITION (September 25, 2019, ~10:30 AM EDT)

Current market price (approx.) =	1.2350
Future market price scenario:	
Future upside price =	1.2500
Future downside price =	1.2200
Dealer trade spreads (in pips):	
Spot spread =	0.5 pips
Option spread =	4.0 pips

TRADE COMPARISON	Spot	Collar
Spot positions:	1 lot	5 lots
Option positions:		
Short call | strike = 1.25 | expiry = Nov 15 | =	n/a	5 lots
Long put | strike = 1.22 | expiry = Nov 15 | =	n/a	5 lots
Option premium:		
Short call premium =	n/a	$ 7,300
Long put premium =	n/a	-$ 7,200
Net option premium from collar =	n/a	$ 100
Margin required:	$ 4,113	$ 4,235

ANALYSIS	Spot	Collar
Trade Profit/ Loss profile:		
Gain after a 1.5 point increase in the market price =	$ 1,500	$ 7,600
Loss after a 1.5 point decrease in the market price =	(1,500)	(7,400)
Maximum gain =	unlimited	$7,600
Maximum loss =	unlimited	(7,400)
Leverage ratio (approximate) =	30:1	145:1
Dealer Spread Revenue Analysis:		
Total spread revenue from trades =	$ 5	$ 425
Ratio of collar trade to spot trade revenue =		85:1
Revenue per $1k of margin =	$ 1.22	$ 100.35
Ratio of collar trade to spot trade revenue per $1k margin =		83:1

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