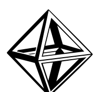
February 2009

The 12% Letter

The 65% Dividend Capture



Stansberry & Associates
Investment Research

The 65% Dividend Capture

Get in... Get Your Dividend... Get out

By: Tom Dyson

Today, I'm going to show you how to collect a special type of dividend I call "Type-2" dividends.

You may, for example, have the opportunity to capture a Type-2 dividend from gold bullion... trading on the stock market as an ETF. If you take the opportunity, you'll receive a payout of $35 for every ounce of gold you own.

If you own 10 ounces, you'll receive an instant payment of $350. If you own 20 ounces, you'll receive $700, deposited into your bank or brokerage account, instantly.

Unlike the way most large one-day dividends work - what I call "Type-1" dividends - you don't have to purchase your gold before a certain date and hold it for days or even weeks. Instead, at 9:30 a.m. on Tuesday morning, once the exact amount of the special payment is published, you decide whether you want to receive this immediate distribution.

If so, you'll simply call your broker or place your order online. Then, you'll get paid within minutes. All you have to do to confirm your payment is hold your gold for the next couple weeks.

Once those weeks pass - even though gold is one of the few investments that is up in 2009, I'll recommend you sell your ounces as soon as you've received your payment.

Why? Because there's another big special payment we can capture soon after. And here's the best part...

The Price Does Not Adjust

Collecting this payout from gold is a real-life example of a strategy I call "The Dividend Capture." I call it the dividend capture because you get in... get your dividend... and get out.

Before I go further, let me make this clear: Gold is only one example of a dividend we may capture. I'll be sending you a new capture every Monday evening in an e-mail. Each week, you can decide if you want to take advantage of it. If you choose to wait, you'll have another chance to capture another dividend the next week. That's the great thing about this strategy... we'll have tons of opportunities.

Truth is, my subscribers haven't captured a dividend on gold yet... because silver is offering even bigger returns. To learn how to capture payouts from gold and silver, keep reading this report. It tells you all you need to know. Then read the update I mail out every Monday evening. These emails are archived on the *12% Letter*'s website. My March 9, 2009 update has the details of the silver dividend capture.

Type-1 dividends are the dividends most average investors focus on. Normally, when you collect a large Type-1 dividend, the stock of the company that pays the dividend immediately drops in price by the exact amount of the dividend.

For example, when Microsoft paid its big $3-per-share dividend in 2004, the share price immediately dropped by $3. The market adjusted the share price to reflect that Microsoft was now $32 billion poorer.

Smucker's announced a special $2-per-share dividend late last year and the same thing happened… The share price dropped immediately after the deal went through.

But the beauty of Type-2 dividends is the underlying share price is NOT at all changed by the large dividend payment. In other words, the share price does not adjust down because of the income you receive. So the dividend is ALL profit.

And instead of requiring you to buy shares roughly a month before you receive any payout, Type-2 dividends allow you to buy shares and get paid immediately.

For our dividend capture strategy, we focus on Type-2 dividends, because it's much easier to get in… get the dividend… and get out. As I'll show, you can make up to 65% a year in profits by using this strategy and simply jumping from one Type-2 dividend to the next.

Let me show you how it works...

The Dividend Capture

Right now, the stock markets are riskier than they've been in 80 years. The world's biggest credit bubble just burst... and we're stuck in a credit crunch. The government is doing all it can to bankrupt the nation by spending trillions of dollars it doesn't have on rescue plans that won't work.

This could be the buying opportunity of a lifetime... or the stock market could fall another 50% from here. Regardless, the dividend capture strategy is ideal in this environment. You get in… you capture the payout… and then you get out without keeping your money in the stock market for more than a few weeks. If you're looking to repair the damage to your portfolio, this is the absolute best way to do it.

The technical name for the dividend capture strategy is "covered call writing." The truth is, we've been writing covered calls on safe blue chips since November 2008. But the new dividend capture strategy is even better. Here's an example:

ExxonMobil (XOM) is the world's largest company with a market cap of $373 billion and annual sales of $500 billion. It also holds the world record for quarterly profits, generating nearly $15 billion in the third quarter of 2008. Since 2004, ExxonMobil has made $180 billion in profits.

As I write, Exxon is trading around $74.50 a share. Let's say you buy 100 shares of Exxon for $74.50. At the same time, you sell one ExxonMobil call option contract with a $75 "strike price" and a maturity date five weeks away. What you're doing is giving someone else the right to buy 100 Exxon shares at $75 a share in five weeks. (One option contract always contains options on 100 shares, so you can only sell one option per 100 shares.)

In return for this privilege, the option buyer will pay you upfront cash. As the markets currently stand, you'll get $3.05 per share. The 100 shares you bought cover your potential liability to the call option owner, so the cash you receive becomes a simple "one-off payment."

This strategy results in one of these outcomes:

1. At the end of five weeks, if Exxon's stock is above $75, you have to sell your 100 shares to the option buyer at $75 a share. This means you make $0.50 per share on the stock position. (You paid $74.50 for the shares). Even if this stock somehow doubles, you have to sell it for $75. But that's OK, you still made a $50 profit ($0.50 times the 100 shares you bought). Plus, you get to keep the $305 cash you collected up front ($3.05 times the 100 options you sold) for selling the options.

In this case, you made $305 in guaranteed income in five weeks. That's a 43% annualized yield. Plus, you made a small gain (0.67%) in the stock.

2. At the end of five weeks, if Exxon's stock is below $75, the option will expire worthless. You keep the $305. That's a 43% annualized yield. Plus, you keep your 100 shares of Exxon's stock and whatever profit or loss the shares are showing. You make a small gain in the stock if it's above $74.50 or a loss in the stock if it's below $74.50. Because of the premium, our downside is also limited here. We'll only lose money if Exxon's shares fall more than $3.05.

Don't worry if it sounds difficult. Once you see exactly how it works, you'll realize it's absolutely the easiest, safest way to collect income.

Let's go through another example…

Annaly (NLY) is a mortgage real estate investment trust (REIT). All of the company's assets are short-term debts (less than 10-year duration), fully backed by the U.S. government. So although it trades as a stock, you are really buying a basket of debts. You aren't taking on any stock-market risk whatsoever – as Annaly's assets have fixed principal amounts. And you aren't taking on any credit risk either, since all of Annaly's assets are fully backed by the U.S. government.

Annaly is a $14.50 stock. Let's say you buy 100 shares of Annaly at $14.50. At the same time, you sell one Annaly call option contract with a $15 "strike price" and a maturity date five weeks away. What you're doing is giving someone else the right to buy 100 Annaly shares at $15 a share in five weeks. (Again, one contract contains options on 100 shares, so you can only sell one contract per 100 shares.)

In return for this privilege, the option buyer will pay you upfront cash. As the markets currently stand, you'll get $0.70 per share. The 100 shares you bought cover your potential liability to the call option owner, so the cash you receive becomes a simple "one-off payment."

This strategy results in one of these outcomes:

1. At the end of five weeks, if Annaly's stock is above $15, you have to sell your 100 shares to the option buyer at $15 a share. This means you make $0.50 per share on the stock position. (You paid $14.50 for the shares.) Even if this stock somehow doubles, you have to sell it for $15. But that's OK, you still made a $50 profit ($0.50 times the 100 shares you bought). Plus, you get to keep the $70 cash you collected up front ($0.70 times the 100 options you sold) for selling the options.

In this case, you made $70 in guaranteed income in five weeks. That's a 50% annualized yield. And Annaly has a 14% dividend yield. Add it all together and you get a 65% annualized dividend yield from

this safe basket of bonds. Plus, you made a small gain (3.4%) in the stock.

2. At the end of five weeks, if Annaly's stock is below $15, the option expires worthless. You keep the $70. Including the dividend, that's a 65% annualized yield. Plus, you keep your 100 shares of Annaly's stock and whatever profit loss the shares are showing. You make a small gain in the stock if it's above $14.50 or a loss if it's below $14.50. Because of the premium, our downside is also limited here. We'll only lose money if Annaly shares fall more than $0.70.

In *The 12% Letter*, we've been selling calls that expire in six months time against our stocks (not the five weeks I'm using in the dividend capture strategy). This may seem more comfortable to you, but I urge you to give the dividend capture strategy a try. Our gains will be bigger (for example, if you'd sold Exxon calls that expired in July, you would make 17% instead of the 43% mentioned above). They'll be faster (a few weeks versus six months). And they'll be safer because we'll only be in this volatile market for a few weeks at a time.

Placing the Trade

There are two parts to a covered call trade. First, you buy the stock. Then, you sell a call option against the stock. Each Monday in my weekly update, I'll tell you about a new dividend capture. I'll tell you the stock you need to buy and the exact option contract to sell against it. I'll also tell you what date to sell your stock and alert you when that date arrives.

Right now, for example, I'm watching a dividend capture in a medical device company called Conceptus (CPTS). Conceptus will pay $925 for every 500 shares. I'm also watching investment company State Street Corp. (STT), a Carolina property management firm called Highwoods Properties (HIW), and Cleveland iron-ore firm, Cliffs Natural (CLF).

I'll keep you updated each Monday on the best opportunities through an e-mail I send out after the market closes. All you have to do is check your inbox Monday evening. Then, on Tuesday morning, call up your broker and have him execute the trade.

If you are keen to get started right away, look up the most recent dividend capture. You'll find it in my most recent weekly e-mail archived under "E-mail Updates" at *The 12% Letter* website.

Please note, small movements in stock prices generate very large moves in option prices. If the stock price makes a large move before you get to jump into the recommendation, you can either wait for the next recommendation (there will be plenty), or you'll need to pick your own call option contract to sell. It's easy. Sell the contract with the strike price around 5% above the current trading price of the stock and with the maturity date

Your Broker Needs to Approve You

If you've never traded options before, you'll need to tell your broker before you can begin. He'll want to establish your eligibility and suitability to trade options. Brokers need to make sure their clients don't lose money trading options because they don't understand how options work. Ask your broker to show you the forms. You can fill them out online. They are just a formality and should take less than 10 minutes to complete.

Finally – and most critically – you must read and sign what's called an "Option Disclosure Document" with your stockbroker. This form makes sure you know the risks associated with option trading.

Once you've been approved, you're ready to begin.

between one month and two months into the future.

Before you get started, read the report on covered calls my colleague Jeff Clark wrote for me. It's called the "World's Greatest Income Secret." It's posted on *The 12% Letter* site under "Special Reports."

Next, call up your broker and discuss this strategy with him. Your trading commissions pay him to help you with trades. So use his help. Tell him you want to set up a covered call on the company I recommend in the e-mail update. Then, tell him which call option to sell. He'll know exactly what to do.

Whatever you do, please don't enter this strategy until you understand exactly what you are doing. Read the December 2008 and January 2009 *12% Letter* issues on covered call writing. Discuss the strategy with your broker. Search the Internet for more explanations if you need. Finally, you can ask me questions by sending an e-mail to www.stansberryresearch.com/secure/twp/feedback.asp.

Remember: You must sell one option contract for every 100 shares you buy of the stock. This is very important. You must match one option contract to every 100 shares of the stock. Otherwise, you will not be fully hedged. This also means you must buy at least 100 shares of the stock I recommend to follow this strategy.

Frequently Asked Questions

Q: These yields are so large. Why haven't I heard about this strategy before?

A: Right now, we're seeing incredible volatility in the stock market. Volatility increases the price of options because it makes it more likely option buyers will have the chance to exercise their options at a profit. So when volatility rises, option sellers increase their prices.

Options have never been more expensive than they are right now. Similar options today sell for five or six times more than they did in the calm markets of 2005 and 2006.

By using the dividend capture strategy, we're making the high volatility work in our favor and generating a safe, high-yield income stream.

Q: Where does one find the ticker symbols for the covered calls?

A: Covered calls have two ticker symbols: the symbol for the stock and the symbol for the option. You can find each stock symbol and option symbol on Yahoo Finance. Type the company name into the box on the top left-hand-side of the website and click on "get quotes." Then, click on "Options" underneath "Quotes" in the left column.

You can also find the premium, strike price, and maturity date of each option on Yahoo Finance. The options are organized by month of maturity. Click on the month you'd like to explore. Yahoo will present you with a list of strike prices for all put and call options trading on your company at a given maturity month. (Options always expire on the third Friday of the month.)

Here, you'll find all the data you need to choose an option, including prices and symbols.

Once you have an idea of the option you want to buy, call up your broker and ask him to help you set up the trade. You can refer to my most recent e-mail update to find out which dividend we're capturing.

Then, call up your broker and say "I'd like to open a covered call position on ABC Corp. Please sell the (month) 2009 $X call option against my position."

Q: If you sell an option with a $15 strike price that expires in July, and the stock is already close to $15, is there any way to close the position and get the gain now instead of waiting until July?

A: No. Holding the option to maturity is the only way to keep the premium. If you decide to close the trade early, you must give the premium back (by buying back the option you sold).

Q: I don't fully understand options like your covered call strategy. Can you refer me to any online sites that can help explain things in simple terms?

A: Options are complicated instruments. They can confuse even the most seasoned traders. Let me give you a simple explanation...

Options are opportunities. You can either sell these opportunities to someone else and collect a fee for selling them... or you can buy them yourself and pay a fee for the privilege of owning the opportunity.

There are two types of options: put options and call options. Put options give the owner the opportunity to sell a financial instrument at a certain price on a certain date. Call options give the owner the opportunity to buy an asset at a certain price on a certain date.

For example, an XYZ Inc. $10 January call option gives the owner the opportunity to buy XYZ Inc. stock at $10 in January. If XYZ Inc. stock is trading at $20 come January, then this option is a very valuable asset... It's like buying $20 for $10. Meanwhile, the seller of the option must sell this stock at $10 per share to the option owner. So he has sold $20 for $10, losing $10 per share. If he already owned the stock, then he must sell it for $10. If he didn't already own it, he must enter the market and buy it at $20.

To learn more about options and the covered call strategy, read the special report "The World's Greatest Income Secret." It's posted on *The 12% Letter* site under "Special Reports." Also, if you're confused, please talk to your broker before placing a trade.

Q: If I sell covered calls on a stock that is at its lowest price in years, like now, won't I be losing money on the options as the stock price and option price increase in value?

A: If the stock price rises, the value of the option rises. But we aren't planning to buy back the calls, so that's not a factor.

In a covered call strategy, the best-case scenario is the stock price closes one cent below the strike price on the day the option expires. That way, you keep both the option premium and the shares (which are showing a modest capital gain). Even if the shares trade for more than the strike price and the stock is called away, you keep the premium and profits on the stock up to the strike price. In both cases, you're booking a winner.

In our worst-case scenario, the stock tanks by more than the premium we receive for selling the option. That's the only way to record a loss. In that case, the options would be close to worthless. And then we can sell more calls to recoup some of the loss on the stock.

Q: The options for the covered call you recommended are selling at nowhere near the prices you mentioned in your e-mail. What's going on?

A: Small movements in stock prices generate large moves in option prices. If the stock price makes a large move between me publishing and you reading the information, then you'll need to pick your own call options to sell. But don't worry, it's easy.

With our dividend capture trades, sell the contract with the strike price around 5% above the current trading price of the stock and with the maturity between one month and two months into the future. If you're not comfortable picking your own option, just wait for the next recommendation (there will be plenty).

Q: Can covered calls be written on stocks held in an IRA account?

A: It depends on your provider… but most brokers let you trade options inside your IRA. Profitable option trades generate capital gains taxes. I recommend you trade your options inside your IRA if you want to defer these taxes.

Q: Will your strategies using covered call options take into consideration a possible inflation?

A: When the market starts to worry about inflation, covered call strategies will be the best way to generate income. I expect inflation will increase option premiums.

Q: In the "S&A Guide to Options Trading," this strategy is listed as one of the most risky. Any comments?

A: A covered call strategy is "risk averse." For example, an ExxonMobil covered call is less risky than a plain vanilla stock position in ExxonMobil. When you sell the call option against your position, you at once reduce upside potential and downside risk. You sell the upside potential to the option buyer. But the premium you receive reduces any potential loss.

"The S&A Guide to Options Trading" refers to the buying and selling of naked options. Naked options are option contracts without corresponding stock positions or hedges. These are leveraged derivatives. If you're wrong, you'll lose everything. If you're right, you'll multiply your money. Naked options are the most risky financial instruments available to retail investors.

Q: How do I "roll over" option positions?

A: If you let your options expire by holding them to maturity and then sell more, you're "rolling over" your position. If, on the other hand, you get "called away" – which means at maturity, the stock price has closed above the strike price of the call option you sold – then you'll sell your stock to the person who bought your options. In this case, you'll have to start the trade from scratch. Buy more stock. Sell more options.

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