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The 12% Letter

The World's Greatest Income Secret

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I want to introduce you to an income secret that could easily give you all the money you need for the rest of your life.

Over the past 25 years of managing money for wealthy folks in California, I've used this secret to help people make a small fortune.

I can remember one client, for example, who started out with 2,000 shares of a company called Siebel Systems. By using this strategy, we were able to generate an incredible HALF-MILLION dollars in income in a single year.

This guy bought a vacation home in Tahoe with his earnings.

I had another client who simply needed to generate about $2,500 a month in income to cover his monthly expenses. We were easily able to do that for him using the income strategy I'm going to show you today.

I have used and continue to use this strategy myself, for my own account. Recently, for example, I used it to generate about $4,000 in free income on a stock called Devon Energy Corp.

The strategy I'm talking about is an "options" strategy – but completely different from any risky options trading you've ever heard about or tried before. In fact, what I'm going to show you is actually LESS risky than owning ordinary stocks.

The technique is called "selling covered calls," which is sometimes referred to as "covered call writing."

In short, covered call writing is the only income-producing idea that offers high returns and low risks when interest rates are rising. It's probably the best way to add extra income to your portfolio.

So what is covered call writing, and how does it work?

Although covered call writing involves the use of options, it is really quite simple. **In a nutshell, the strategy involves buying a stock and then selling someone else the right to buy it from you in the future.**

That's it. Think of it in terms of real estate…

Let's say you buy a piece of property for $200,000. You then turn around and sell someone the right to buy it from you anytime in the next three months for $210,000. For that right, you charge a premium of 4% or $8,000.

You pocket the $8,000 immediately. It's your money now. You are also obliged to sell the property for $210,000 if the buyer chooses to exercise his right.

This scenario has three possible outcomes…

1) **The property goes up in value, and the buyer exercises his right to buy**. In this case, you've pocketed the $8,000 premium, and you'll be selling the property for $210,000. Here, you'll have an $18,000 gain (9%) in three months, and you'll have to find another investment property to buy in order to continue the strategy.

2) **The property remains worth $200,000**. In this case, you keep the $8,000 premium. Since the buyer won't be willing to pay $210,000 for a property that's only worth $200,000, you'll keep the property, too. You've made 4% over three months, and you can sell the right to someone else for another three months, repeating the process.

3) **The property falls in value**. In this case, the $8,000 premium you received helps to offset the loss on the property. The buyer walks away when the right expires, and you're free to sell another right for another time period.

So if the investment goes up, then we sell it for a gain. If the investment stays the same, then we profit off of the premium. And, if the investment drops in value, then the premium helps offset the loss.

I know it sounds like a terrific strategy, but there are two major pitfalls…

First of all, if the investment collapses, the small premium you received by selling the option won't do much to alleviate the loss on your "safe" money. ***So you have to make sure that your investments are absolute bargains.***

If a stock drops 10%-20%, you can make up for the loss by selling the premium a few times. But you will not recover from a 50% loss with this strategy.

Unfortunately, a lot of people who try selling covered calls get sucked into buying expensive stocks because the call premiums are quite large and the theoretical returns can be huge. But that strategy carries a lot of risk, and it's not a good place for "safe" money.

We have plenty of opportunities to generate 15%-20% annual returns by selling calls on safe, cheap stocks. So we have no need to try to juice the returns even more by taking on large risks.

With this strategy, we'll be looking for low-risk stocks where the options can generate 15%-20% annual returns.

The other pitfall to covered call writing is that you sell off your potential for enormous gains.

Take our previous property investment, for example. We are obligated to sell the property for $210,000. That's a good gain, especially considering the extra $8,000 premium. But if the property jumps to $300,000, then we'll be kicking ourselves for selling at such a cheap price.

But here's the thing… The purpose of covered call writing is to generate income, not capital gains. It's the difference between buying a bond and buying a stock. Stock buyers look for capital gains. Income is secondary. Bond buyers want the income, and any gains are a bonus.

Folks who write covered calls are bond buyers.

If you like the prospects of a stock and believe it could easily double or triple, then you shouldn't sell options against it. All you're doing is capping your profit potential and guaranteeing that you'll be out of the trade before it explodes higher.

To put it another way, you should only sell calls against stocks that you wouldn't mind selling at the agreed upon price. If it moves higher after you're out, then who cares? You met your objective and moved on.

Let's look at an example…

Back in August 2007, I recommended a covered call position on Sun Microsystems (Nasdaq: JAVA). The company had just reported stellar earnings – the third time in three quarters that it trounced analysts' expectations. It was sitting on a pile of cash, and the fundamentals were all quite favorable.

So at a little less than $5 per share, JAVA qualified as a safe, cheap stock. And the option premiums were also quite large. For example, the January 5 call options were bidding 55¢.

Here's the trade I recommended…

Buy shares of Sun Microsystems (Nasdaq: JAVA) at about $5 per share, and
Sell the SUNW January 5 calls (SUQAA) at about $0.55.

Quite simply, we bought the stock at $5 per share and then sold to someone else the right to buy the stock from us at $5. For that right, we got 55¢ per share. So our net cost of this trade was $4.45 per share ($5 for the stock less 55¢ received from selling the call).

These options expire on January 18, 2008 – which was just a bit more than five months from the date of the recommendation.

If JAVA had traded for more than $5 per share at that time, then we would have been required to sell the shares for $5. Since we got into the trade at a net cost of $4.45, we would have a 55¢ gain, which works out to a little better than 12% in a little more than five months.

In fact the stock traded for less than $5 per share when the options expired. We held on to the stock (and the 55¢ premium) and can continue selling options against it.

The only way we could have lost money on this trade is if JAVA had traded for less than $4.45 on option-expiration day in January. JAVA reached its low point of the past 52 weeks when it hit $4.40 per share, and that occurred almost exactly one year ago – well before the turnaround of the past three quarters. So, I think the odds of losing money on this trade were fairly remote.

This was an excellent opportunity to write a covered call. It's a low-risk way to generate a 12% return in a little more than five months. You won't find a bond with that combination.

If we end up having to sell our stocks because they're trading above the option strike price, then we'll just take our profit and move on to another position. Remember, the objective is to generate 15%-20% annualize income on a conservative portfolio of low-risk common stocks.

I think we'll actually do much better than that.

The trick, of course, is to keep the risk to a minimum. And we'll do that by picking the right stocks. By focusing on conservative, value-oriented stocks we'll eliminate a lot of the volatility that can wipe out several months worth of gains overnight. We'll also avoid the temptation to chase the highest-yielding covered call positions, as those tend to be the trades that are most likely to blow-up.

Understand that this is different than the way in which most people approach covered call writing. Most people start by looking for options that carry the fattest premium and then find a way to justify owning the stock. That's why most people have a tough time generating consistent income through covered call writing.

Start with the proper stock selection. Once we've nailed that down, then you can move on to finding the right options to sell. Ideally, you'll be selling options that expire within three to five months, generate 15%-20% annualized returns even if the stock goes nowhere, and offer the possibility of additional capital gains on the stock.

I know this sounds like a tall order, but I've been doing it for years. The opportunities were somewhat limited back in 2005 and 2006. But with the recent increase in stock market volatility, the call-option premium is higher now than at any time in the past four years. That gives us an ideal environment for covered call writing.

To take advantage of this situation all you need to do is contact your broker and make sure that your account is approved for covered call writing. In most cases, you'll just need to fill out and sign a one-page form called an "Options Disclosure Document."

Remember, we're not buying options here. That's a strategy for traders and speculators. Most options expire worthless – so we're taking the other side of the typical options investment. We're *selling* covered calls. This is the lowest-risk form of options trading. In fact, it's less risky than just buying stocks outright.

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