Welcome to the ***Leveraged Investing Club Limited Downside Letter*** for December 21, 2014.

In this week's ***Limited Downside Letter***, we look at a stock that I haven't written puts on in several years but which may now be offering a compelling opportunity.

T – AT&T

From Morningstar:

AT&T is the second-largest U.S. wireless carrier, serving 99 million traditional customers and 14 million "connected devices" such as e-readers. The firm is also the local phone company in 22 states, serving about 27 million phone lines, 17 million Internet users, and 6 million television customers. In addition, AT&T provides phone and data services, such as Web hosting and data transport, to larger businesses nationwide. In May 2014, the firm agreed to acquire DirecTV in a roughly $65 billion transaction.

The Fundamental Case for T

Late last week, Tim McAleenan, wrote a bullish piece on T (AT&T) on Seeking Alpha based on the opportunity afforded by the stock's relatively low valuation and high dividend.

In my opinion, Tim is one of the best financial writers writing today. He's not just adept at identifying attractive long term investing opportunities, he's also adept at articulating the underlying principles involved in long term investing success.

Case in point – he's made the case on multiple occasions of the power of reinvesting high yield dividend income from stocks that are trading at low valuations into more of the same.

When you have a structurally and sustainable high yield dividend paying stock (such as **T, GSK, BP**, or various tobacco stocks) and you reinvest those dividends into more of the underlying shares, you get the best of both worlds – above average current dividend income plus decent dividend income growth in the future.

In the case of low dividend growth **T** (the company just announced its 31st consecutive annual dividend increase last week – although the increase went up by just 2.2%), the bulk of the decent dividend ***income*** growth comes from reinvesting the dividends into more of the 5.55% yielding shares.

In the SA article, Tim summarizes his case thus:

> *The reason why AT&T is attractive is as follows: The telecommunications giant has lowered its dividend payout ratio from the 80%-90% range in the early 2000s to only 72% today. The P/E ratio has become more attractive, shifting from the 20x earnings range earlier in the 2000s to around 13x earnings today. And the profits are growing at a rate of 2%-3% annually, which when combined with the dividend and modest P/E expansion, ought to be enough for long-term 10% returns from here. The attractive part is that more than half of it is being supplied by the dividend alone.*

Put Writing Opportunity?

The pertinent question for us, of course, is does this situation translate into an attractive put writing opportunity?

I have successfully written puts on both **T** and **VZ** in the past, although not in quite a while.

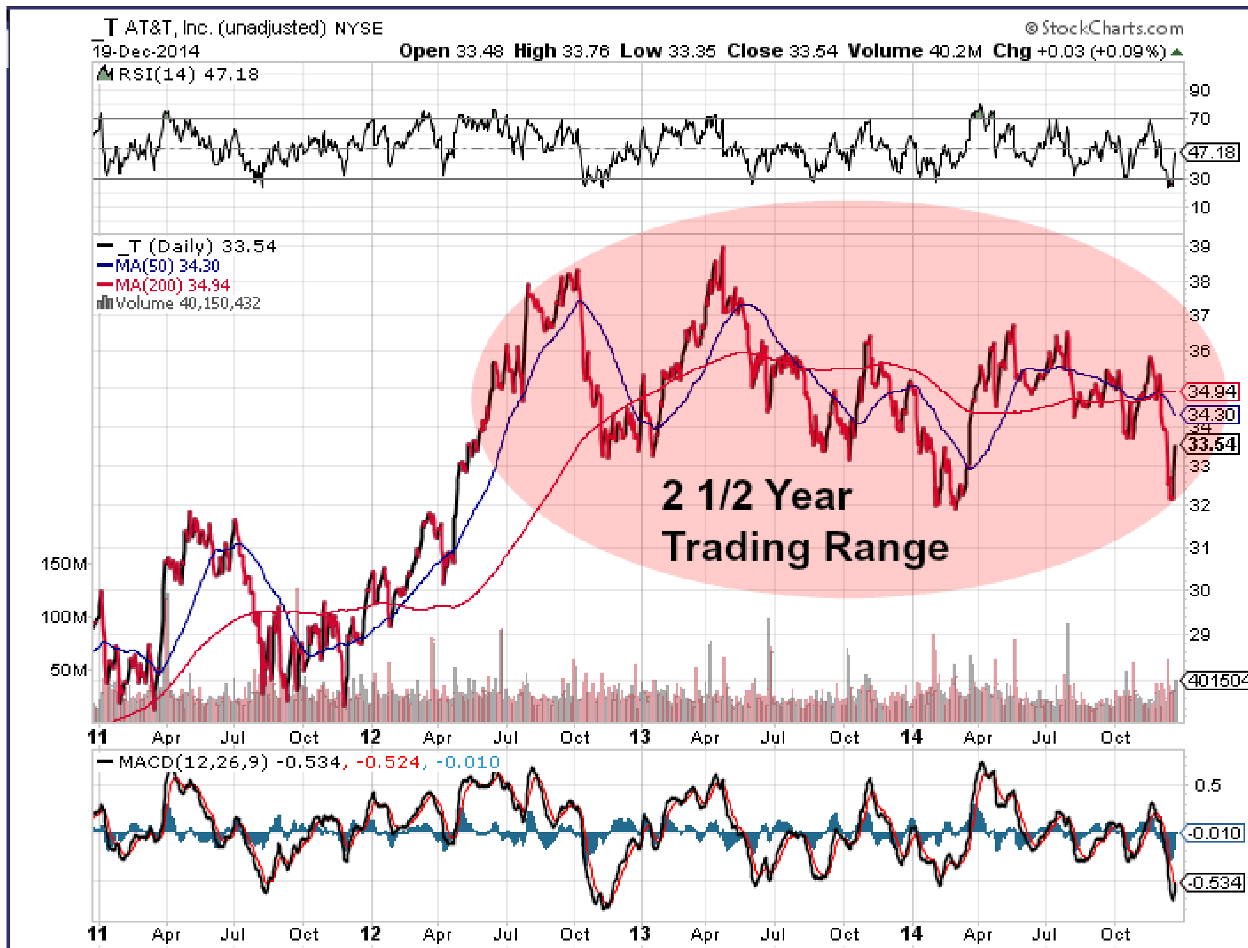
While both can provide potentially attractive opportunities, there have also been various drawbacks.

One is the relatively low levels of implied volatility in recent years. The stock rarely offers the 15-25% annualized returns I target on my cash-secured put trades, except during periods involving the ex-dividend date (in which **T's** relatively high dividend yield gets priced into corresponding near and at the money puts).

But even then, the potential returns are often at the low end of that 15-25% annualized range, and sometimes still slightly below it.

Naturally, the non-dividend related expiration cycles have much lower premium levels, which can make any potential rolling, adjusting, and repairing afterwards inconvenient.

A second challenge can be seen in the following chart:



For the last 2½ years, **T** has been trading in a range from the low $30s to the (mostly) mid $30s.

So while there have been time periods – involving the dividend cycle – to generate 15-25% annualized returns, the challenge has been to identify those periods that correspond with **T** also trading at the lower end of its range.

On a stock with higher levels of implied volatility, a potential $2-$3/share price drop over 30-45 days is usually no big deal, and it's not like a similar situation with **T** would be impossible to repair (far from it, in fact), but, in my experience, it would be a bit of a nuisance.

I'm also not a huge fan of the capital-intensive telecom model that seems to require ginormous debt levels and constant capex spending.

If we ever do see a rising interest rate environment, I would expect the company's (currently) ample free cash flow to be pressured two-fold: there would be less of it since the cost of servicing all that debt would increase, and consequently, there would be an incentive to divert more of the free cash flow into tackling the debt.

In short, over the last 2-3 years, I've pretty much been able to find better put writing opportunities.

That may be changing.

I've actually been monitoring **T** for a while now but, again, in recent weeks, other trade ideas have won out (e.g. **KO**, **KMI**, and **BAX**).

T was on my short list last week, but **KO** won out.

But this week, **T** has beaten out **AFL**, as I feel that **T** is now presenting a pretty attractive opportunity for writing cash-secured puts.

Limited Downside Review

Remember the rationale for our trades and this letter – when we write puts, we're looking for limited downside situations, ideally multiple reasons why a stock in question is unlikely to trade lower, or lower by much in the near term.

Here then is "limited downside" case for **T**:

- Friday's close @ $33.54 doesn't nail the bottom and strong support level at $32 where the stock recently bounced, but **T** is still trading near the bottom of its 2½ year range
- As Tim pointed out in his SA article, **T** is trading at an historically low valuation
- Additionally, the 5.55% yield on the stock (based on last week's closing #s and the new dividend payout) should further serve to support share price

The Choices

The timing for a trade is also attractive with the **upcoming ex-dividend date on January 7th** that dovetails nicely with **T's** current valuation and share price.

Additionally, T is expected to announce **quarterly earnings sometime around January 23rd.**

I'm personally looking at 3 potential ways to trade this situation (**T** trades weekly options, but to keep things simple, I'm only focusing on the regular monthly options):

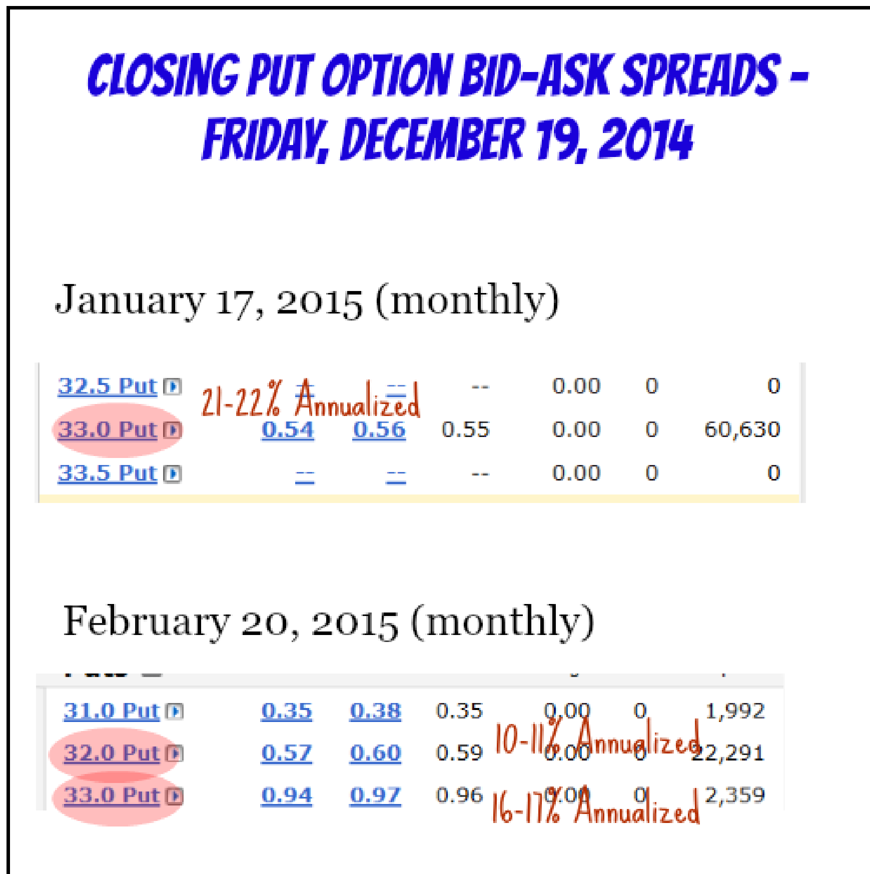
1. **Write the January 17th 2015 $33 put**
2. **Write the February 20th 2015 $33 put**
3. **Write the February 20th 2015 $32 put**

Based on last Friday's closing numbers, a fair estimate for the rate on the January $33 short put would be in the 21-22% annualized range; the February $33 short put would be in the 16-17% annualized range; and the February $32 short put would be in the 10-11% annualized range.

As far as the calendar goes, and what's impacting the price of the puts, as mentioned earlier, the ex-dividend date is elevating the January $33 puts (and, by definition, the February puts as well).

Additionally, the February puts are also impacted by the upcoming January 23rd (estimated) earnings release – normally you wouldn't be able to lock in a 16-17% annualized rate on **T** going out a full 2 months.

Here's a graphic that may make it easier to visualize the choices:



CLOSING PUT OPTION BID-ASK SPREADS – FRIDAY, DECEMBER 19, 2014

January 17, 2015 (monthly)

32.5 Put	--	--	--	0.00	0	0
33.0 Put	0.54	0.56	0.55	0.00	0	60,630
33.5 Put	--	--	--	0.00	0	0

February 20, 2015 (monthly)

31.0 Put	0.35	0.38	0.35	0.00	0	1,992
32.0 Put	0.57	0.60	0.59	0.00	0	22,291
33.0 Put	0.94	0.97	0.96	0.00	0	2,359

I’m personally leaning toward selling the February $33 puts (even though that requires I hold the position open during the next earnings release).

As you know, I’ll often sacrifice higher annualized ROIs over the short term if I can lock in what are still great annualized returns over longer periods.

And, of course, going out farther generates more overall premium which serves to lower the breakeven on the trade more than it would with the nearer dated option.

So in a worst case scenario where I’m assigned against my will, the trade would still result in my owning **T** at an adjusted cost basis that rivaled traditional stock investors who nailed the recent bottom in the stock in the low $32s.

Realistically, of course, it’s highly unlikely that I couldn’t further improve the trade and lower the potential/worst case scenario cost basis even more.

Other Items

Finally, three other quick comments.

First, as always, another option would be to write the February $32 put and either accept the lower rates (10-11% annualized – below my personal threshold, but still not bad considering the strong technical support at $32/share) or else wait and see if the stock pulls back a little from here and try to get better terms.

Second, Tim’s article is worth considering when it comes to reinvesting the proceeds of your overall accumulated booked option income.

Constructing a quality income-producing portfolio relies on the same core investing principles regardless of how you generate your investible funds.

So perhaps there is a place for a stock like **T** in your own long term portfolio. Despite the **T's** significant debt levels, this is a company that still produces an incredible amount of free cash flow.

And third, I've previously referenced Tim's personal blog (The Conservative Income Investor). If you haven't already, I highly recommend you check it out and subscribe to it – again, I consider Tim to be one of the best and most insightful financial writers out there.

He publishes blog posts more frequently than he writes new SA articles, and the blog posts give him the flexibility to cover core investing principles in a way that's not entirely possible on SA.

Reminder - I'm not a licensed financial advisor and I'm not officially advising or recommending any specific trade - I'm simply sharing with you with as much transparency, honesty, and detail as I can what goes into my own trade selection and thought process. Only you can decide whether any specific trade I discuss is right for you.