3 Life Changing Benefits of Value Investing with Options

An Introduction to Leveraged Investing

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INTRODUCTION

Before we get into the 3 life changing benefits of value investing with options, we first need to take a look at a couple of items and issues.

First and foremost, we need to address value investing itself.

ABOUT VALUE INVESTING

It's important to note that there is no single definition or official school of value investing. But as I see it, the most successful investors – Warren Buffett, Benjamin Graham, Philip Fisher, Marty Whitman, John Neff, Peter Lynch, and many others – have, at some level, all been value investors.

To be sure, they all developed and customized their own unique approaches to the discipline, but the objective has always been the same – the acquisition of high quality assets at attractive (or better) prices.

In fact, that's a key point – when it comes to value investing, the process itself is not important. It's the end result that matters. However you go about acquiring your high quality assets is really up to you.

And when it comes to building and compounding wealth – and in this report, we're specifically talking about the shares of high quality businesses – the process itself is far less important than the end result of the attractively priced acquisition itself.

So why is that end result so important?

Conventional wisdom tells us that the secret to success in the stock market – or anywhere for that matter – is to buy low and sell high.

While that may be a formula for generating positive returns, it's not necessarily a formula for building wealth.

Because, this is what all successful value investors understand – and why they're value investors in the first place – the purchase price is far more important than the selling price.

That may not seem to make a lot of sense on the surface, but it's actually a very profound principle. Because the less you pay for your investments, the higher the rate all future and compounded returns will be, even to the point where modest gains in the future can still represent outsized gains for you.

Case in point – imagine Investor A buys shares in a $50 stock and that stock pays $0.40/share in quarterly dividends (or $1.60/share annually for a 3.2% dividend yield).

One year later, the shares are trading @ $55/share and Investor A has collected $1.60/share in dividends. Investor A has earned 3.2% in dividends plus unrealized capital gains of 10% from the rise in the share price.

Now let's look at Investor B who bought shares many years earlier when the stock was trading @ $25/share. Back then, maybe the quarterly dividend was only $0.20/quarter (which back then worked out to be the same 3.2% initial dividend yield).

Because Investor B has a much lower cost basis ($25/share vs. $50/share), Investor B's dividend yield is now 6.4% ($1.60 divided by $25) and that $5 rise in the share price (from $50 to $55) represents a 20% increase in value of the original investment, not 10%.

Again, this is key – the less you pay for your investments, the greater all your future compounded returns will be.

PROCESS VS. END RESULT

Finally, getting back to the subject of value investing processes, as I said earlier the value investing process itself is less important than the value investing result – which is owning shares of great companies with a low cost basis.

Traditionally, there have only been a couple ways to get great prices on great companies:

1. **Hope something bad happens** to either the company in question or the overall economy so that the stock you want to acquire "goes on sale."
2. **Be willing to pay a fair price** for the shares you want and just allow the underlying business to increase its value by continuing to grow its earnings over time.

But here's the cool thing - I've discovered and developed a third way: using relatively simple and low risk option trades on the side to gradually and continually lower the cost basis on my holdings – before, during, and after acquiring them.

To me, this is a much superior approach compared to the two traditional alternatives.

The big advantage is that I don't have to be patient for years waiting for a stock I want to go on sale. And I don't have to be patient at the other end either – waiting for the underlying business to grow its earnings and value over time.

The great thing about using options to manually or synthetically create my own value investing opportunities is that I can get great deals in the market at ANY time.

And the longer I do this, the more those great deals continue to get better and better - because these aren't one-time deals, but rather an ongoing and dynamic process.

VALUE INVESTING WITH OPTIONS – AKA LEVERAGED INVESTING

Incidentally, I call my approach Leveraged Investing ("Leverage" as in a lever or tool, not debt).

The point of this report isn't to go into all the nuts and bolts of the Leveraged Investing trades themselves. The objective here is to detail the specific wealth-building benefits of Leveraged Investing.

But I will take a moment or two to address the actual Leveraged Investing trades because I don't want to give the impression that these are top secret trades that I've designed in my underground laboratory.

In fact, the trades themselves are all relatively simple and straightforward – if you're concerned that option trading is too complicated or difficult to comprehend, I want to assure you that you don't need to be a super genius to be a Leveraged Investor (trust me, I'm not).

There are six separate strategies that I employ, and they're based on just three general option trading strategies – covered calls, naked or cash-secured puts, and calendar or diagonal spreads.

But the Leveraged Investing trades ARE highly customized and there are a number of critical principles I believe you really must embrace when it comes to the selection and management of your trades if you want to be successful at Leveraged Investing.

ABOUT THE 3 LIFE CHANGING BENEFITS

Finally, a quick word about the 3 life changing benefits I promised to tell you about.

The 3 benefits are to your portfolio, not to you.

Don't get me wrong – if you experience these benefits to your portfolio, it will undoubtedly change your life for the better, but how exactly those changes are implemented are up to you.

I just don't want you to think I'm promising that value investing with options will lead to three specific changes to your life – like you'll get better looking, start telling funnier jokes, or your kids will all of a sudden begin following your advice.

So having said all that, let's look at the three life changing benefits of value investing with options.

Benefit #1 – Better Returns

The first life changing benefit of value investing with options is better returns. Or as I should say – Much Better Returns.

We addressed earlier the whole rationale for value investing and how the less you pay, or the lower your cost basis, the greater your future compounded returns will be.

When we use options to perpetually lower our cost basis, we never pay full price for any investment. And it's a dynamic process, too, not just a one-time event because even after we acquire the stock, and for as long as we own it, we're looking to safely generate additional option income and further reduce the cost basis on it.

Allow me to introduce you to my favorite accounting term, Adjusted Cost Basis. I love that term. It underscores the fact that cost basis does not have to be static – that we can continue to lower it over and over and over.

Or look at it this way – if you could consistently buy $10,000 worth of stock for $9,000, and then regularly collect rebates on your investments for as long as you owned that stock (which you would then reinvest into additional shares), do you understand how much better your finances and life are going to be versus the average investor who blindly follows the self-serving advice of the managed money industry?

And once you started value investing with options and learned how to consistently achieve these kind of results, do you think you could ever invest any other way ever again?

(And based on my own personal experience, I'd say the answer is a resounding now).

Finally, on another side note, if you think those “big institutions” with all their technological resources, industry contacts, and full time support staff have an unfair advantage over the individual self-directed investor – Think Again!

Benefit #2 – High Yield Income

There are basically two ways that value investing with options can lead to high yield income.

But before I go over those, I want to take a couple of minutes and address the concept of dividend growth investing . . .

DIVIDEND GROWTH INVESTING

If you’re already familiar with dividend growth investing, you know what a powerful, time-tested, and proven long term investing model it is.

High quality dividend paying companies who consistently increase their earnings year over year also tend to increase their dividend payout each year. In fact, there are some companies that have increased their dividends every year for more than 50 years.

To illustrate the profound long term possibilities of investing in these type of companies, allow me to share the following example:

INVESTING FOR MEGA DIVIDENDS

If you had bought shares of Johnson & Johnson (JNJ), Coca-Cola (KO), McDonald's (MCD), Procter & Gamble (PG), and Walmart (WMT) back on the final trading day of 1990 and then simply held those shares for two decades (no new investments, no reinvesting your dividends), check out what your results circa 2010 would be:

Company	Effective Yield / Yield on Cost
JNJ	36.18%
KO	23.62%
MCD	33.52%
PG	29.87%
WMT	23.55%

If you've never heard of effective yield or yield on cost, don't worry. It's simply a way of calculating your dividend yield in terms of your original investment.

Screeeeeeeech!!!! Say What?

That's right. If you'd simply held the above stocks for those two decades, spent all the dividends you received, and did absolutely nothing else other than wait, your dividend income twenty years later would represent annual payouts of approximately 25%-35% of your original investment.

If you'd invested $100,000 in JNJ at the end of 1990, by the time 2010 rolled around you'd be receiving more than $36,000 in dividends - every year!

And those dividends would only continue to GROW over time.

That's the power of dividend growth and the magic of compounding.

OPTIONS-ENHANCED DIVIDEND GROWTH INVESTING

So you probably already see where I'm going with this. When you use options to lower your cost basis and then reinvest the proceeds of that cost basis reduction, you take the dividend growth model and put it in overdrive.

In fact, there's a pretty cool metric that I like to use to track my own dividend-based investments.

We've been taught to focus on the overall value or net worth of our investments. We track our performance based on how much the value of our investments increase or decrease in any given year.

But you know what? Net worth is just another word for liquidation value – what you could conceivably raise in total dollars (or the denomination of your choice) if you simply cashed out all of your investments.

But how realistic is that?

As I enjoy pointing out, it's not net worth or the value of your investments that pays the bills – it's the income and cash flow those investments generate.

So when I track my own investment returns, what I prefer to track on a year over year basis is the percentage by which my income increases.

Ultimately, the market sets the liquidation value of your investments – but if your income is growing by 15%, 20%, 25% a year or more, who really cares what Mr. Market thinks your investments are worth?

The only thing that matters is that your income and standard of living are improving every year.

To illustrate this point, I want to give you a very basic but powerful example of what's possible even when we assume some very conservative numbers.

Here's a table that shows what happens when you invest in a stock that pays an initial 3% dividend yield, increases that dividend by 10% annually, and assuming that you're able to lower your cost basis on your investment by a mere 5% a year (which you then reinvest in new shares presumably paying a 3% initial yield).

$10K Invested; 3% Initial Yield, 10% Growth Rate; 5% Premium income; Dividends and Premium reinvested						
End of Year	Existing Dividends	Previous Year's Reinvested Dividends	Previous Year's Premium Income	Previous Year's Reinvested Premium	Total Dividends	Annual Income Growth
1	$300.00	n/a	n/a		$300.00	n/a
2	$330.00	$9.00	$500.00	$15.00	$354.00	18.00%
3	$389.40	$10.62	$500.00	$17.70	$417.72	18.00%
4	$459.49	$12.53	$500.00	$20.89	$492.91	18.00%
5	$542.20	$14.79	$500.00	$24.65	$581.63	18.00%
6	$639.80	$17.45	$500.00	$29.08	$686.33	18.00%
7	$754.96	$20.59	$500.00	$34.32	$809.87	18.00%
8	$890.85	$24.30	$500.00	$40.49	$955.64	18.00%
9	$1,051.21	$28.67	$500.00	$47.78	$1,127.66	18.00%
10	$1,240.42	$33.83	$500.00	$56.38	$1,330.64	18.00%
11	$1,463.70	$39.92	$500.00	$66.53	$1,570.15	18.00%
12	$1,727.17	$47.10	$500.00	$78.51	$1,852.78	18.00%
13	$2,038.06	$55.58	$500.00	$92.64	$2,186.28	18.00%
14	$2,404.91	$65.59	$500.00	$109.31	$2,579.81	18.00%
15	$2,837.79	$77.39	$500.00	$128.99	$3,044.17	18.00%
16	$3,348.59	$91.33	$500.00	$152.21	$3,592.12	18.00%
17	$3,951.34	$107.76	$500.00	$179.61	$4,238.71	18.00%
18	$4,662.58	$127.16	$500.00	$211.94	$5,001.67	18.00%
19	$5,501.84	$150.05	$500.00	$250.08	$5,901.98	18.00%
20	$6,492.17	$177.06	$500.00	$295.10	$6,964.33	18.00%

Now, we're only talking about a one-time investment of $10,000, so the total dividends here aren't anything you're going to be able to retire on.

But here's the point – thanks to the reinvested option income, your total dividend income increases by 18% a year. And after 20 years, you're looking at a 69.64% effective yield or yield on cost (current year's dividend income divided by the value of the original investment).

Realistically, a 5% annual cost basis is, in my opinion and experience, an extremely conservative assumption.

OPTION INCOME

Secondly, and real briefly, the other high yield income opportunity afforded by this value investing with options approach is what I call the **Retained Option Income Method**, not because I want it to sound all official and intimidating, but because I haven't been able to come up with a better name for it.

In truth, it's a very simple premise. Because the goal of Leveraged Investing, or value investing with options, is to safely generate option income from and related to a long term high quality investment portfolio, you tend to end up with a steady stream of cash, a steady stream of the high yield variety.

The standard strategy – which I recommend – is to build long term wealth (and long term high yield DIVIDEND income) by reinvesting the OPTION income into new shares of high quality companies.

But there's no law that says you have to use the option income as an additional funding source for more shares. By eliminating that final step, you can simply keep the option income and treat it (or spend it) as the high yield income it is in and of itself.

Benefit #3 – Reduced Risk

For the uninitiated, option trading sometimes has a terrible reputation as a high risk endeavor, comparable perhaps to lion taming or cliff diving.

Actually, options are risk management tools. They help manage risk.

So, yes, they can be used to take on a lot of risk. You'll get no argument from me – they absolutely can be used indiscriminately and as lottery tickets.

But here's the key point - they don't have to be. Options also work the other way - they can be used to actually ***reduce*** risk.

And everything in between.

In fact, the analogy I like to use which I believe gives the most accurate portrayal of options is that they are effectively a "risk dial."

Options are not a risk switch, they are a risk dial.

It's up to the individual to choose where he or she sets that dial - and it's a dynamic process as well.

That dial can be adjusted as desired. It can be adjusted, it can be fine-tuned, it can be customized - all according to your own individual preferences, needs, and strategies.

In my own life, once I got past the "options are too risky" surface mindset, I discovered a deeper underlying reality, a key concept that dramatically changed my perspective and long term results.

The key concept I'm talking about is that when you combine certain strategic option strategies with long term investments in individual, high quality companies, it's simply not necessary, in my experience, to assume a lot of options-oriented risk in order to significantly boost your entire, overall returns.

MORE THOUGHTS ON RISK

Here's another way of looking at risk that I think can be pretty helpful.

Instead of thinking stressing over the theoretical short term risk of an individual trade, look at the bigger picture and the longer term results in terms of your entire portfolio.

Who has more risk? The investor who eschews option trading and pays full price for his or her investments, or the savvy investor who methodically lowers the cost basis on his or her holdings so that he or she ends up never paying more than half price for his or her investments?

Or said another way – in a previous example, Investor A originally paid $50/share for a (now) $55 stock while Investor B originally paid $25/share (many years earlier).

Now imagine (Leveraged) Investor C who uses options to replicate Investor B's cost basis (and in a fraction of the time).

The less you pay for your investments, the greater your margin of error and buffer.

And when you can achieve the same results as a successful investor in a fraction of the time, in effect accelerating the process, you've reduced your risk in another, less obvious way – the risk of time.

Time is one of three critical components of compounding wealth (the other two being the amount you're compounding and the rate at which you're compounding).

Value investing with options, it seems to me, assists the savvy investor with all three aspects of the formula.

And if that doesn't reduce your long term risk, I don't know what does.