Bottom Fishing For High Dividend Stocks - Part 2 – June 1, 2009

In part 1 of this series, we used the following 6 screens to identify an undervalued, high dividend stock, Cal-Maine Foods, (CALM), with a strong balance sheet:

1. High Dividend Yield - Above 5 % (The S&P 500 average dividend yield is approximately 3.42%).

2. Moderate Dividend Payout Ratio - Below 50 % (The S&P's payout ratio is approximately 59%).

3. Less Than 40 % Above 52-Week Low

4. Options Available

5. Current Ratio: Over 1.5

6. Long Term Debt to Equity: Under .5

We then used the conservative bullish approach of selling covered calls to increase Cal-Maine's already high dividend even further.

But, what approach can you take if you're not so bullish on the market, which has gained over 35% since March 9, 2009, or, if you want to accumulate CALM at a lower entry price?

Instead of buying CALM at $24.93, (its June 1, 2009 opening price), a more conservative approach would be to sell covered puts on it, at a lower price. Selling a put on a stock means that you are selling someone the option to sell, or "put" the stock to you by a future date. Each put contract corresponds to 100 shares of the underlying stock.

Normally, most options aren't exercised until near or on the expiration date, so the timing of possibly having the stock sold to you will depend upon what expiration month you choose. Due to the time value of money, if 2 options are at the same strike price, the one that's further out in time usually commands a higher price. However, you should compare them on an annualized basis, in order to get a clear comparison of their returns.

How would this work? First, you'd want to get an idea of this stock's 52-week price range, which is $17.01-$48.80.
Due to the market's decline before the current rally, and higher volatility, it has been possible in the last 8 months to profit by selling puts at or near a stock's 52-week low. This is a rather conservative approach, which allows investors to "nibble around the edges", instead of jumping in at a current higher price.

Looking at the option chain for CALM, and using the strategy of trying to sell a put as close to the $17.01, 52-week low as possible, we see that the August $20 put, (QKMTD), is currently priced at a $.75 bid, which equals 16.7% on an annualized basis.

There are 2 possible outcomes to this trade:

1. The stock declines to or past your $19.25 breakeven point, ($20 strike price less $.75 put premium). You would then be sold 100 shares for every put contract you sold. The sale price would be $20.00, but your true net cost would be $19.25, (the $20 strike price less the $.75 put premium).

Owning CALM at $19.25 would place you just 13.2% above the 52-week low for this stock.

In addition, your $19.25 cost is 22.8% lower than the current price of $24.93.

ALSO, the $1.73/share dividend would equal an 8.98% dividend yield at this level, as opposed to the current 6.9% dividend yield level.

2. The stock doesn't decline to or past your breakeven point. In this case, you'd simply walk away with your $.75/contract, 16.7% annualized profit.

Cash Reserve requirements: Brokers will vary on how much cash reserve they make you put up for selling puts. Currently, Schwab mandates a cash reserve equal to 100% of the value of the strike price times the shares you'd end up having put to you. In our example, if you sold one $20 contract, which corresponds to 100 shares, you'd have to put up $2000.00 cash reserve.

Other brokerages, such as Options Xpress, require less cash reserve, which would increase your leverage and your margins. However, if the stock does start to decline closer to your strike price, the broker may ask you to put up additional cash in reserve.

So, if you like a stock, but you think the market's gotten ahead of itself, selling puts is another way to profit.

Disclosure: Author is long CALM.

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