

Compound Stock Earnings Programs - Caveat Investor

The caller seemed surprised that I had never heard about Compound Stock Earnings Programs, or CSEs. "People are earning three to six percent per month with little or no risk", she continued, "I'm thinking of attending a seminar". A wise man once said: "If it sounds too good to be true, it probably is", but this sure is a creative euphemism for what has to be a rather complicated options strategy.

The buyer of a "call" option obtains the right to purchase a specified quantity of a security from the seller of the option, at a stated "strike price", and at any time on or before the contract expiration date. When the option seller owns the security, it is called a "covered" call. The CSE hucksters don't deny that their magic cash flow system is based on selling "covered" call options, but the "come on" includes a laundry list of misinformation, partial truths, and inaccuracies about the stock market and investing.

Covered calls have been around forever, but this is the first time I've seen them touted as safe investment vehicles. They are certainly the safest of a complex array of option strategies, but very few registered, certified, or well known and experienced investment gurus would ever use the word safe when discussing options--- or recommend them. All options are speculations, no matter how well sugar coated and no matter how fail-safe the trading system appears. The risk is in there.

Options are bets about the future price movement of exchange-traded securities--- it's just that simple. The prospect of unusually high returns always signals unusually high risk. Caveat emptor, in spades. Here are some things to consider before you think about attending that free seminar--- not to mention the basic reality that equities are not at all the proper investment vehicle for an income-generating portfolio. That's what income securities are all about.

The pitch begins with the accurate statement that most investment portfolios are chock full of equity mutual funds, and that such funds rarely produce enough income to pay the bills. Consequently, principal drainage occurs when mutual fund shares have to be sold during market downturns. But no mention is made of the fact that really low-risk, monthly-income, and easily traded alternatives (currently ranging upward from above 5% tax free and above 7.5% taxable) are readily available.

The second CSE selling point laments the declining dividend yield on NYSE traded securities. Again, equities have never willingly accepted a job description that includes "provide monthly spending money to shareholders". The purpose of stock ownership is growth in the form of capital gains. When income becomes the purpose of the investment program, proper advice would be to sell the stocks and to buy monthly income producing securities.

Actually, there has never been a time when common stock dividend yields were as high as some of the CSEs report in their propaganda, and historical growth rates of the Dow and S & P have always been calculated ex-dividend. Similarly, the glossies talk about the low yield on individual bonds and treasury securities as though these were the only alternatives an investor has, which they obviously are not. Based on website review alone, it's doubtful that the CSE marketing companies are registered with the Securities and Exchange Commission (SEC).

Even if we pretend that an equity portfolio's growth rate can be enhanced with a covered call strategy, let's look at the things the investor has to think about after he puts the option premium into his pocket. What if someone drops the ball (or if something really good happens over night) and the stock is actually called away? Think of the tax consequences of a gain on low cost-basis holdings, or the actual capital loss if you are writing the calls on stocks that have fallen in price, as you will certainly be doing during corrections.

Additional drawbacks of the covered call program are: (a) limiting the amount of profit on a rising stock; (b) reducing portfolio liquidity and flexibility because the underlying securities cannot be sold unless the option has been bought back; (c) there can be up to four separate commissions paid in one completed transaction; (d) higher premiums are generally associated with higher price volatility and higher risk levels--- which is as it should be. Another possibility is that the call buyer might exercise his option early in order to capture the underlying stock's dividend, or because of take-over rumors.

So as safe as the CSE promoters want you to believe the process is, there is a significant potential for both loss and inconvenience--- enough so that managed municipal, corporate, and government CEFs, REITs, preferred stocks, etc. look better and better and better for investors who need safe (actually safe) income.

While you are thinking about Compound Stock Earnings Programs, consider this. Why aren't our dear friends on Wall Street pushing these programs or mass advertising this revelation? Why are option specialists the pariahs of most brokerage firm offices? Why are special risk acceptance forms required by brokerage firms to separately authorize the use of options? Why are options, commodities, futures, margin programs, and short selling

way up there on most qualified investment adviser listings of inherently speculative financial products?

Certainly, the CSE promoters have provided adequate documentation, instructional material, testimonials, and software to describe the workings of their covered call option programs. But in addition to the in-your-face hype, greed food, and numerous pages of disclaimers, can they show you the customer's yachts?

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