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The PLYMOUTH ROCK Fund

MARKET INSIGHTS

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RISK MITIGATED DIVIDEND MAXIMIZATION

By The Plymouth Rock Fund

Q: I've worked hard to earn my money. How can I try to avoid unnecessary risks and get the maximum income from it?

A: Traditionally, from a fundamental business analysis perspective, higher yielding returns mean increased risk. Miller and Modigliani won the 1990 Nobel Prize in Finance for quantifying this relationship. However, in an investment portfolio, there are ways to mitigate risk and multiply income at the same time. This article will describe an investment strategy that can generate a 30% annual profit using a variety of prudential techniques.

This process may sound complex, but it is actually just a series of simple steps that any portfolio manager can perform when each step is addressed one at a time. Before mitigating risk, it is important to understand the nature of risk. To some portfolio managers, risk is simply viewed as idiosyncratic stock price volatility (*p*Vol) or its correlation to the market's own volatility (beta). However, this view of risk ignores inflation, and the internal threat of risk from a company that could implode. It also excludes currency risk, liquidity risk, political risk, and more. In light of lessons learned from the Roman Empire, the Weimar Republic, Yugoslavia, Argentina, Brazil, and even Britain in the "winter of discontent", it is apparent that inflation is not a "risk" so much as an expectation when government expenditures exceed certain GNP and GDP ratios. Likewise, if an investor is prepared to hold an investment for at least a few years, the *p*Vol and beta from a diversified portfolio can be mitigated to the point of near irrelevance. Thus, a prudential investor may diversify and hold a portfolio to mitigate *p*Vol and beta, and may invest for good business fundamentals and to profit from inflation for optimal risk mitigation.

Sectors that have profited from inflation, as viewed from a review of history (Rome, the Weimar Republic, Yugoslavia, et al.), include land ownership, agriculture, food production, energy & fuel production, durable goods, minerals, metals, banking, and sin stocks (such as alcohol, casinos, tobacco, *et cetera*). These sectors boom while other sectors suffer the worst (such as services provided by labor, travel, leisure, logistics, and goods purchased with expendable income). The investor should screen for stocks accordingly.

The investor should screen for stocks that have strong fundamentals. If the company can't get a loan from a bank, the prudent investor should avoid it as well. As one famous race car driver put it, "in order to finish first, one must first finish." This includes screening the stock for a good value purchase price, relative to the company's earnings.

The investor should also ensure that any stock on the buy list pays dividends. These dividends can be leveraged for increased income. Some stocks (at the time this article was written) are currently paying a 7% annual dividend yield. These dividends can be leveraged during market hours and at overnight with a margin account at a good Broker / Dealer, at a rate of 3:1. At an interest rate of 2%, this would turn a 7% yield into a 17% yield. Covered calls are considered "riskless options" due to their conservative nature, and 70% of them expire unexecuted. The portfolio manager could sell covered calls on all positions for a 1% profit, levered to increase a 17% yield to around 20%. Finally, this stock can be leased for an additional 1.9% profit, levered to increase the 20% yield now up to 23.8%. If the portfolio can achieve a 7% annual capital gain, then this 23.8% yield aggregates to a total gain of 30.8%.

In conclusion, investors can diversify to select stocks that a) are in sectors that will profit from inflation, b) have "bankable" numbers, and c) pay maximum dividends. Then these conservative stocks can be leveraged with margin for increased dividends, leased out, optioned, and ultimately sold for a capital gain as well. In total, an investor following these steps can achieve a 30% annual gain.