The Hazards of Choosing Stocks (February 24, 2019)

In my previous post on February 16th, I discussed the various trades I have made over the years, the money I have lost and the occasional victory I've enjoyed, which included my timing with Intel. I bought the stock, as I reported a week ago, around $22 a share in 2011, and it's currently trading at a little over $50. Last week, I decided to sell the call option that I described to my readers. But instead of going all the way out to January 2021, I was persuaded by my broker in St. Louis to come in a bit closer, to January 2020. My broker reminded me of what most people know who trade options, namely, there is more "swing" in a nearby option. This means that the price of the call will fluctuate more readily in response to daily news. An option listed for nearly two years out has considerable "time value" built into its price and responds more sluggishly to daily price movement and the news. The price of the more distant call is higher because the buyer has an extra year to consider whether to exercise the option and buy the stock from the seller. But this means that day-to-day events that affect the market and individual stock prices are unlikely to influence the price of the call, at least not until you get much closer to expiration time—which, in the option I chose, would be January 2020.

My friend Sam recommended that I choose the option with a strike price of $52.50. When we discussed the trade in the middle of February, the strike he suggested was two dollars over the price of Intel stock. That gave me very little protection in case the stock moved higher, and in the end, I accepted his advice. The result? I received from an unknown buyer $4.45 for five options contracts, which represent 500 shares of the stock. For this transaction I received $2,225, less a modest commission.

I was pleased with the trade. I think my broker was right in encouraging me to come in by twelve months on the expiration date. Sam was right in pushing me to a slightly higher strike price. I earned less money by going up to $52.50, but I was left with some wiggle room in case the price improves. As matters happened, Intel flipped about in small 20-cent increments in the days following the trade. But on Feb. 22, Intel had a big upward move of over a buck. It closed almost exactly at my strike price.

I began regretting the trade, at least a bit. But not because the stock appreciated almost immediately after the trade and made it plausible for the other trader to claim the securities. I had begun checking stock reports on other companies. I do this whenever I sell a call, because of course I could lose Intel—could be forced to sell it at $52.50—at any moment between now and January 2020. I'm prepared to do that, of course, but I don't want to get caught with uninvested funds. If the buyer exercises the option and claims the stock at $52.50, I'll reinvest the sum--$26,250—as quickly as possible. I don't like to have money lying around unused in a brokerage account, especially when interest rates are so low.

But what happened next illustrates another point I made in my last post. I wrote that markets and individual stocks are too unpredictable to forecast with any reliability. That's why I suggested buying companies that appear to have a safe revenue stream and a reliable dividend. Going through *Value Line* reports, which I have been reading for twenty years, I came across a promising article on Kraft Heinz Co., the food processing giant, that seemed to meet exactly this description. At the time the report was written, KHC had a reasonable price-earnings ratio of

12.6 and a dividend yield of 5.5 percent. The author of the report, Justin Hellman, was bullish on the stock. He gave it an A+ rating for financial strength and a number 2 ranking for price stability. The piece is dated January 18, 2019.

The one-page study notes that KHC has eight $1 billion-plus brands, including Jell-O, Kool-Aid, and Maxwell, among others. “We expect 2019 to be a decent year for the packaged-food company,” Mr. Hellman wrote. He predicted improved sales growth as “the company gives more of its mainstay products a healthy makeover.” He added: “The current entry point [$45.37] appears attractive for conservative buy-and-hold investors.” Well, that’s exactly how I would describe myself. I’m a conservative investor. I’ve learned the danger of reaching for a fat yield. And some of the companies I own have been in my account for twenty years or more.

But everyone who reads the financial press knows what happened to Kraft-Heinz, and how suddenly it all happened. In a quarterly report released on Feb. 21, the company indicated that demand for its processed foods was unexpectedly weak, and that the cost-cutting measures imposed by management have not been effective. The public’s taste, reasonably enough, has been shifting to fresher and more healthful products. The company reported a $15 billion write-down on the value of its best-know brands, including Kraft cheeses and Oscar Mayer cold cuts. More alarming still, the company also reported that the Securities and Exchange Commission is investigating its accounting practices, a serious blow to any company. The immediate losses attributable to the write-down are measurable, but the effects of an SEC investigation are an unknown that can linger over a company for weeks and months. How bad is the accounting scandal going to prove to be? What fines might be levied, and what other losses will have to be reported? Kraft Heinz cut its dividend by 36 percent, and the share price dropped by 27 percent the next day.

So I feel like I dodged a bullet. I still own Intel, even if the stock is trading at the strike price. But if my shares are claimed by some other trader, I won’t be buying Kraft. And it shows that even very competent analysts can make serious mistakes.

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