Welcome to the ***Leveraged Investing Club Limited Downside Letter*** for December 7, 2014.

In spite of a couple of currently underwater energy related trades in the Zero Cost Basis Portfolio, in my opinion, the energy sector is the sector that's presently offering the most attractive opportunities.

And in this week's ***Limited Downside Letter***, we return to that space by taking a look at the new and improved **KMI** (Kinder Morgan Inc.).

KMI – Kinder Morgan Inc.

KMI is not exactly new and improved, but the company has recently abandoned the MLP model and tax structure and opted instead to consolidate its general and limited partnerships into a regularly structured C corporation.

KMI is a huge player in the midstream oil and gas pipeline business, and as such, revenues come from transportation and storage, not the price of the underlying commodity.

From the company's website:

> *Kinder Morgan is the largest energy infrastructure company in North America. We own an interest in or operate approximately 80,000 miles of pipelines and 180 terminals. Our pipelines transport natural gas, refined petroleum products, crude oil, carbon dioxide (CO2) and more. We also store or handle a variety of products and materials at our terminals such as gasoline, jet fuel, ethanol, coal, petroleum coke and steel.*

The revolutionary shale plays across the United States are creating a tremendous need for more energy infrastructure, which bodes well for us. We invest billions of dollars each year to grow the company by building new and expanding existing assets to help ensure that a variety of energy products get delivered into the marketplace. As of mid-October 2014, Kinder Morgan had $17.9 billion in expansion and joint venture investments in our backlog which have a high certainty of completion and will drive future growth at the company across all of our business segments.

In most of our businesses we operate like a giant toll road and receive a fee for our services, generally avoiding commodity price risk. For example, over 82 percent of our cash flows are fee-based and 94 percent are fee-based or hedged for 2014. Our customers include major oil companies, energy producers and shippers, local distribution companies and businesses across many industries.

Additionally, Morningstar posted this updated Investment Thesis last week:

Following the successful close of a massive consolidation transaction, which rolled up general and limited partner interests in Kinder Morgan Energy Partners, Kinder Morgan Management, and El Paso Pipeline Partners into a single entity, Kinder Morgan Inc. is now the largest midstream energy firm on the continent. Its chairman, Rich Kinder, built this pipeline juggernaut out of the unwanted "hard assets" spurned by Enron almost 20 years ago. Now Kinder Morgan spans the continent, transporting a significant fraction of the nation's crude oil, refined products, and natural gas, and is involved in virtually every link of the midstream energy value chain.

> *Kinder Morgan's size is both opportunity and challenge. Favorably, its unmatched asset footprint provides numerous opportunities for expansion, and Kinder has a seat at the table for every new project or deal that comes along and has the financial heft to execute, no matter the size of the project. However, its size can work against the company, as it needs to put $3-4 billion to work on value-enhancing projects each year to make good on its 8-10% annual dividend growth targets. We think the company can achieve this, especially given a project backlog in excess of $17 billion, but it's by no means assured that today's level of investment opportunity will persist. At some point, we believe, the great shale infrastructure boom will slow, and it will be more difficult for Kinder to maintain rapid dividend growth.*
>
> *That being said, consolidating into a single entity provides Kinder Morgan with two key advantages. First, it breaks the link to the MLP model, where quarterly distribution increases are the norm, providing eventual headroom to walk dividend growth down as the business matures and growth opportunities slow next decade. Second, it positions Kinder Morgan as a natural consolidator, and we expect that acquisitions will play a significant role in Kinder's long-term growth story.*

I really like KMI – with its vast infrastructure, strong and reliable cash flow and earnings, and overall immunity to the price of gas and oil, KMI is definitely a high quality company and is set to earn a lot of money for a very long time.

The stock closed last Friday @ $41.12/share.

2014 distributions/dividends totaled $1.76/share (giving the stock a current yield of 4.28%).

In 2015, the company is targeting $2/share in dividends. At $40/share – which is where I'm looking to write my put(s) – that's a yield of 5% even.

Previously, pre-merger, the company projected or targeted that post-merger the dividend would grow 10% a year.

There was an interesting piece last week on 24/7 Wall St that noted a change in KMI's forecast language which no longer contains that commitment to 10% dividend growth.

Of course, the company's future dividend growth will depend largely on continued acquisitions and expansion projects – prolonged lower energy prices could eventually impact that growth, although the company notes – see above – that there are $17.9 billion in back log projects that Kinder characterizes as having a "high certainty of completion" – Morningstar estimates the company needs to put $3-$4 billion per year into new projects to maintain 8-10% annual dividend growth.

These are the kind of situations I like – where the downside isn't a deterioration of the business model, or the prospects of future losses, but rather a potential slow down in growth.

I think the upcoming 2015 dividend puts a floor on this stock – again, at $40/share, the stock yields 5% based on the projected 2015 dividend schedule.

Finally, the technicals are worth noting here.

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The chart is auto-generated from the website finviz.com (and thanks to Club member Reed for putting that site on my radar).

According to Finviz, the stock may have formed a double top, a bearish technical pattern which suggests the stock could now pull back after having tried – and failed - to trade above that $42 level twice.

What I find noteworthy about the chart is that while KMI sold off with the rest of the energy market back in mid October, the stock really didn't participate in the second sell off at the end of November/beginning of December.

OTHER FACTORS

#1. Regarding KMI's calendar of events, I don't have any hard dates in front of me, **but the next earnings release** will probably be around January 15th (meaning it would be included in

the regular monthly January option cycle that ends on January 17th).

#2. But the company's **next ex-dividend date** will likely be at the end of January, meaning that at this point, February will be the first monthly expiry that includes both the earnings release and the ex-dividend date, although currently those aren't available (see #5 below).

#3. The stock trades monthly options delineated in $2.50 strike price increments and weeklies in $0.50 increments (which means that the monthlies will at some point convert to weeklies and add a lot more strike prices).

#4. An FYI - depending on your broker, you may see numerous "non-standard" duplicate strike prices (which you should ignore) included in your option chains – I assume those are the result of previous/existing option contracts that were converted when Kinder consolidated multiple stocks and structures into a single entity.

#5. There are currently only "non-standard" strikes available in the regular February monthly cycle – so no real way to trade this monthly until, presumably, the December 20th (monthly) options expire.

The Scenarios

OK – so having laid all that out, I see different combinations worth considering – one at the $40 strike and one at the $37.50 strike and also at different expirations.

Additionally, I'm personally looking at monthly expirations only rather than weeklies – there's nothing necessarily wrong with the weeklies, but they have considerably less volume and are therefore likely to have larger bid-ask spreads to have to navigate.

I'm also looking at different ways to incorporate the earnings calendar and dividend cycle.

So let's look at the choices – I've detailed 3 potential approaches to consider:

#1 – The first choice would be to simply wait and see if the alleged double top pullback materializes before writing a put, ideally somewhere around the $37.50 strike where an at or near the money short put would be extremely attractive both on a premium income basis and a valuation/dividend basis.

This could also be a good choice if, at this moment, you don't have a lot of free capital to deploy. If that's the case, this would be a great situation to monitor to see if it becomes even more attractive over the next week or two.

#2 – In spite of the potential double top in the chart, I'm personally looking at the $40 strike. It's a little out of the money as of last Friday, but it's still near enough the money, and with enough time value priced into it, that it still packs a pretty decent punch in terms of returns.

As of last Friday, excluding commissions, **the KMI January 17 2015 $40 put was offering an annualized rate of around 19% over 43 days.** As a reminder, that expiration would include the company's quarterly earnings release (but not the ex-dividend date).

This could be a strategically attractive choice in that you could lock in some pretty great returns over nearly a month and a half, lower your potential cost basis on the stock to the low $39s (and subsequently lock in a 5%+ 2015 yield on a very stable source of income), and still have some wiggle room to further improve/repair the trade if necessary.

By choosing an expiration date on this side of the end of January ex-dividend date, you would make it easier to roll or adjust a

position for a net credit since those expiration dates on the other side would have the dividends priced into them

(For newer Club members, please see the Dividend Absorption special strategy report in The Dividend Accelerator course to see how the dividend cycle positively impacts the pricing of put options and how we can use that to our advantage for repairs and extra returns).

Currently, as mentioned earlier, the regular February puts aren't available (those "non-standard" options, all priced at much higher strikes, are undoubtedly something leftover and converted from the recently consolidated limited partnerships).

Bottom line – writing a February monthly put at the $40 strike as a way to incorporate both the earnings report and the dividend isn't currently available.

But that does naturally beg the question – when is the first monthly expiry that includes both earnings and the ex-dividend date?

#3 – The KMI March 2015 $40 put looks very interesting as it's currently the first monthly expiration that includes both earnings and the dividend (which positively impacts the price of the put), even though it won't expire for more than 3 months (which negatively impacts the annualized ROI of the trade).

Still, it has its merits – because of the impact of earnings and dividends, based on Friday's closing numbers, it looks like it might be possible to lock in 14%+ annualized returns for a period of more than 100 days.

I find that both impressive and intriguing.

If you've followed these trades for very long, then you know that I'm often willing to sacrifice annualized returns in exchange for locking in still very solid rates for longer periods of time.

Another advantage of going out that far is that, while the annualized rate is lower, more overall premium is collected upfront.

And the more overall premium collected upfront, the lower the initial breakeven (or "worst case scenario cost basis") established upfront. In this case, you'd likely be looking at something in the $38.50 range factoring in commissions, or a 5.19% dividend yield assuming the projected $2/share 2015 dividend payout.

And, by the time of expiration on the March cycle, the next quarterly earnings would be just one month ahead at that point in April.

That means that even if the stock was trading below $40 and you wanted to adjust or improve it, the April and later cycles would have an earnings-related bump in their premium levels to help you out on any subsequent rolls and net credits.

Reminder - I'm not a licensed financial advisor and I'm not officially advising or recommending any specific trade - I'm simply sharing with you with as much transparency, honesty, and detail as I can what goes into my own trade selection and thought process. Only you can decide whether any specific trade I discuss is right for you.