

# EPIC INSIGHTS

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## *THE WEEK AHEAD*

During the week of 11/3-11/9 (Figure 1), we face many important market moving announcements. **Monday** we will see insight into the economy via the ISM report and consumer spending with MasterCard's (MA) earnings announcement. **Tuesday** is the US Presidential Election where expectations are for an Obama win and a large Democratic majority in Congress. Surprise results would be a McCain win (interpreted as pro-business, a positive event for stock market) or Democrats holding 60+ seats in the Senate (interpreted as negative event for stock market). **Wednesday** is filled with additional economic announcements and corporate earnings announcement. **Thursday** we will see if the European Central Bank (ECB) continues to lower interest rates with hopes of reflating

**Figure 1 Weekly Calendar**

<u>Day</u>	<u>Date</u>	<u>Event</u>	<u>Time</u>	<u>Estimate</u>	<u>Prior</u>
Monday	11/3	ISM Manufacturing	10:00 AM	41.5	43.5
		MA Earnings	AMC	\$ 2.26	\$ 1.84
Tuesday	11/4	Factory Orders	10:00 AM	-1.0%	-4.0%
		US Elections			
Wednesday	11/5	TWX Earnings	BMO	\$ 0.27	\$ 0.27
		FWLT Earnings	BMO	\$ 0.90	\$ 0.83
		AGU Earnings	BMO	\$ 1.84	\$ 0.33
		XTO Earnings	BMO	\$ 0.99	\$ 0.84
		ADP Employment	8:15 AM	-100k	-8k
		ISM Nonmanufacturing	10:00 AM	47.2	50.2
		CSCO Earnings	AMC	\$ 0.39	\$ 0.37
Thursday	11/6	WFMJ Earnings	AMC	\$ 0.13	\$ 0.24
		ECB Interest Rate Decision	7:45 AM	3.25%	3.75%
		Initial Jobless Claims	8:30 AM	477k	479k
Friday	11/7	Nonfarm Productivity	8:30 AM	0.9%	4.3%
		October Employment Report	8:30 AM	-200k	-159k
		Unemployment Rate	8:30 AM	6.3%	6.1%
		Pending Home Sales	10:00 AM	-3.7%	7.4%
		Consumer Credit	3:00 PM	-\$ .4B	-\$7.9B

*Note: BMO = Before Market Opens, AMC = After Market Closes*  
*Note: All times are Eastern Standard Time (EST)*  
*Source: Bloomberg*

their economies. Finally, **Friday** will bring the October employment report and a reading on consumer credit. Positive information on either front will show that the Federal Reserve's (Fed) policies are working and will move the equity markets higher.

## *TECHNICAL TRADE*

Many technical traders focus upon esoteric chart patterns to determine trading targets. I prefer to focus on simple trends and moving averages. Looking at Intercontinental Exchange (ICE) chart (Figure 2), we see a stock that peaked above \$165 in early

May, violated a key support level in late May and traded as low as \$54.28 (72% below the all time peak and 67% lower since May) in late October.

Since that point, the stock has broken above the downtrend on increased volume and recently closed above both the 10 day and 50 day moving averages. I look for a 50% retracement of the recent price decline that would propel the shares toward the 200-day moving average price. **My recommendation is a 2% portfolio allocation to ICE with an upside price target between \$105-115 and a stop loss order at \$68** which would have the shares reclaiming the downtrend.

**FUNDAMENTAL  
TRADE**

With the huge drop in stock prices during October, finding an inexpensive stock for long term profit potential is relatively easy. However, in uncertain economic times we want to avoid being too early and therefore would like to look for opportunities where we can hedge our risk while benefiting from upside market movements. With this mandate, I turn to

the **banking sector**. Given the carnage that has occurred with the large money center banks; **we are provided an opportunity to buy strong companies at discounted prices**. This

Buying the shares provides a 3.7% current dividend, an earnings stream that will propel the shares toward \$55 and the security of buying shares at 1.6x

Figure 2 - Intercontinental Exchange April 2008 - November 2008



Source: Stockcharts.com

week's suggestion is **JPMorgan Chase (JPM)**. With the acquisition of Bear Stearns and Washington Mutual, JPM has evolved into a powerhouse with dominant market share in virtually all operating segments. Combined with one of the best management teams in the industry, shareholder capital is well protected.

tangible book value.

While I am bullish on JPM, we must also hedge our risk. The purest approach would be to use the option market. However, JPM options are priced with very high volatility levels making hedging uneconomic. Instead, I will turn to a pair trade. **Wells Fargo (WFC)** currently trades at 3.1x

tangible book value. This represents a huge premium to both JPM and Bank America (BAC). Further, with JPM's decision to modify delinquent loans, WFC will be forced to follow. WFC has a large home equity portfolio and is inheriting a toxic mortgage portfolio from Wachovia. Therefore, I expect the damage inflicted on WFC from a loan modification program to be material. This will limit WFC's ability to compete for new business and will put them behind JPM and BAC. With a premium valuation, WFC's stock price should decline even if the economic picture improves. **I recommend a 4% long position in JPM with a 4% short position in WFC as a hedge.**

### ***OPTION TRADE***

I often use the option market as a means to speculate on earnings reports. An ideal trade is one where stocks have moved sharply in anticipation of market moving news. Believing that emotions take prices too far, I look for a mean reversion to drive profit potential. Monday's earnings announcement from **MasterCard (MA)**

provides an opportunity. MA shares have fallen over 50% from the high achieved in May. During the same time period, MA has underperformed Visa (V) by nearly 20%. Last week, V's earnings were well received and the stock moved 17% off its low. I look for MA to behave in a similar fashion with the shares moving toward \$160 over the next three weeks. To profit from this move, **I recommend a November 150/160 bull spread.** By buying the November 150 Call (MAL+KJ) and selling the November 160 Call (MAL+KL), you will receive \$10 if MA's stock closed above \$160 on November 22<sup>nd</sup>. Look to pay a total cost of \$3.50 on this trade and your upside is 185% in a few weeks time. **I recommend allocating %0.50 of your portfolio to this trade.**

### ***CURRENT RECOMMENDATIONS***

I will be using this section to track current recommendations and the returns they derive (Figure 3). All position sizes are based on a \$100,000 portfolio and the percentages dictated above. All trades are to be done at the opening price. The table below will measure our current recommendations and how they have performed.



*“There is one side to the stock market; and it is not the bull side or bear side, but the right side.”*

*Jessie Livermore*

Figure 3 Portfolio Composition and Performance

<u>Position</u>	<u>Quantity</u>	<u>Purchase Price</u>	<u>Current Price</u>	<u>Total Cost</u>	<u>Current Value</u>	<u>Return</u>
ICE	24	\$ 84.56	\$ 84.14	\$ 2,029	\$ 2,019	-0.5%
JPM	98	\$ 41.00	\$ 40.84	\$ 4,018	\$ 4,002	-0.4%
WFC	(119)	\$ 33.73	\$ 33.80	\$ (4,014)	\$ (4,022)	-0.2%
MA Bull Spread	100	\$ 3.50	\$ 8.00	\$ 350	\$ 800	128.6%
Cash Position					\$ 97,616	
Portfolio Total					\$ 100,416	0.4%

## ***USERS GUIDE***

This guide is intended to identify how to use the data provided in the newsletter by section. The key to each section is as follows:

**The Week Ahead** – We will be indentifying economic reports, earnings' releases and other events that could lead to swings in stock prices. Note that we will only list the items we find relevant and will be ignoring many pieces of data that other investors may find notable. This is not meant to be a complete list of upcoming events for the next week.

**Technical Trades** – We prefer to use simple trends and moving averages to identify trading opportunities.

This section will provide either a new trade idea or revisit a prior trade. All new

trades will be accompanied by prices at which the trade should be closed. For us, ending price is the only one that matters and will be used to judge trends, closing price and other pieces of information.

**Fundamental Trades** – We are long term value investors and plan on using this section to highlight our research. We never use stops on fundamental positions, but revisit the investment rationale when a stock moves 20% against us. Upon review, we must either increase or close out the position – maintaining the status quo is never an option.

**Option Trades** – Based on market environment, we will recommend option trades. In general, we prefer to write, rather than buy, options and will always look for opportunities to receive

premium while hedging our risk.

**General Comments** – Here we will share any general thoughts we have. Topics may range from the capital markets to the economy to politics.

**Current Recommendations**  
This section will be used to track our investment recommendations and performance. All trades will be based on a portfolio size of \$100,000 as of 11/1/08 and will be scaled to represent the portfolio weightings mentioned throughout the letter. All new positions will be initiated at the opening market price each Monday morning and closing trades will be based upon closing prices mentioned in the letter. Cash balances will earn LIBOR -100 and no transaction fees will be charged.

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