

EPIC INSIGHTS

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THE WEEK AHEAD

The week of 11/10-11/14 (Figure 1), will offer more insight to the state of the US consumer. The first four days are light on economic reports, but heavy on earnings announcements. **Monday** morning will see AIG report earnings and they should offer some information on the current credit environment. After the close we will receive Starbucks' (SBUX) earnings report and see how discretionary spending is doing. **Tuesday** brings earnings from discounter TJX and **Wednesday** is highlighted by a report from Macys (M). **Thursday** we will see initial jobless claims in the morning and earnings reports from Wal-Mart (WMT) and Nordstrom (JWN). All these announcements should be closely watched. A deteriorating employment picture will further stress the economy and indicate the recession is worsening. However, employment is a

Figure 1 Weekly Calendar

Day	Date	Announcement	Time	Estimate	Prior
Monday	11/10	ALD Earnings	BMO	\$0.35	\$0.12
		AIG Earnings	BMO	(\$0.80)	\$1.35
		SBUX Earnings	AMC	\$0.14	\$0.21
Tuesday	11/11	TJX Earnings	BMO	\$0.56	\$0.54
		TYC Earnings	BMO	\$0.67	\$0.57
Wednesday	11/12	DSX Earnings	BMO	\$0.74	\$0.45
		M Earnings	BMO	(\$0.21)	\$0.10
		CROX Earnings	AMC	\$0.02	\$0.66
Thursday	11/13	Initial Jobless Claims	8:30 AM	480k	481k
		FIG Earnings	BMO	(\$0.10)	-0.39
		WMT Earnings	BMO	\$0.76	0.69
		JWN Earnings	AMC	\$0.32	0.58
Friday	11/14	Retail Sales	8:30 AM	-1.5%	-1.2%
		Consumer Sentiment	10:00 AM	56.5	57.6

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

lagging indicator and investors should watch for a deceleration in the rate of job loss. While initial claims will spike higher toward the end of a recession, markets will have discounted the worst and be moving higher by that point. When the actual number of unemployment claims increase, but the rate of change declines we will be closer to a bottom and can aggressively buy stocks. As for WMT and JWN, the reports will show how consumers are doing across

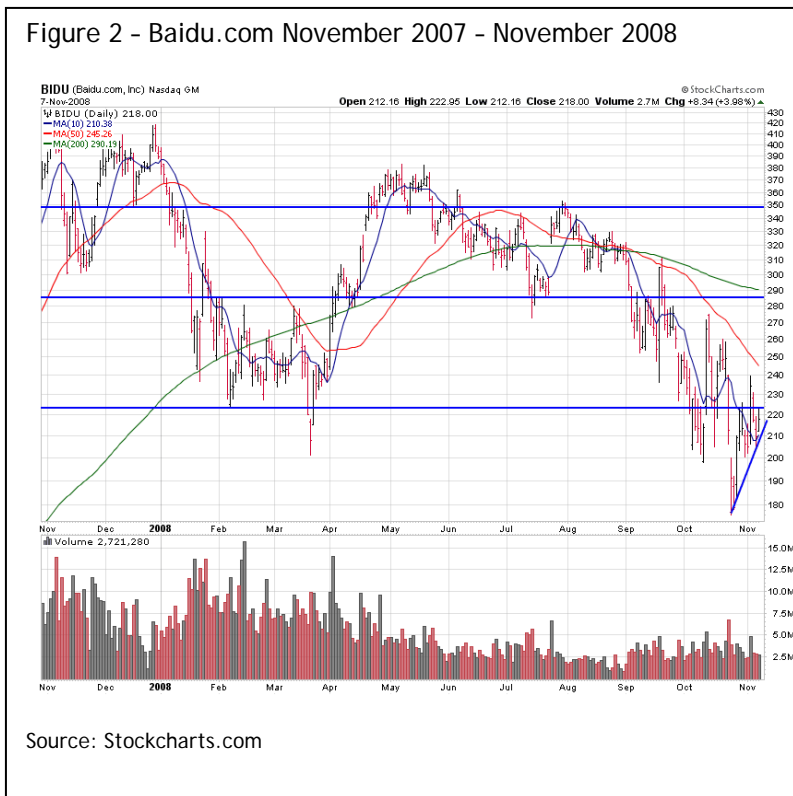
the economic spectrum (JWN at the high end and WMT at the low end). A shift of sales toward JWN would indicate the economic environment is improving. Finally, **Friday** will bring retail sales and consumer sentiments. I look for further deterioration in these reports as the economy has faltered over the last month. As always, the key is how the report relates to expectations and what message it sends about future Federal

Reserve (Fed) interest rate decisions. As the October employment report last week showed, terrible numbers can drive equity markets higher.

TECHNICAL TRADE

Over the years, I have found triangles to be among the most predictive chart patterns. While there are many variations, the chart of Baidu.com (BIDU) (Figure 2) shows an ascending triangle. During the market selloff in late October, BIDU closed at \$179. Since that point, the shares have rallied sharply to the current price of \$218. The result is a sharp uptrend that brings us near the next resistance level of \$225. The convergence of the uptrend and resistance create an ascending triangle.

Ascending triangles are bullish patterns. For the triangle to be formed, we need to see a close above the \$225 resistance point. From there, the upside target price would be equal to the movement from the start of the uptrend (the \$179 low) to the resistance level (\$225). Therefore, when the triangle officially forms with a close above \$225, the upside price target would be \$285.



While the triangle itself can justify action, BIDU offers other positive characteristics as well. Looking at Figure 2, we see that BIDU generally trades in wide \$60 channels. From January – April, BIDU fluctuated between \$225-285. Between April – October it traded between \$285-350. Expecting these trading channels to continue, it is reasonable to expect BIDU to remain in the \$225-285 range until early 2009.

Normally, I would wait for a close above \$225 to initiate a position. However, I like

the look of the chart and will act early. **My recommendation is a 1% portfolio allocation to BIDU. Once we close above \$225, increase the position to 3% of the portfolio. Use a close below the 10 day moving average as your stop loss (currently \$210.38).**

FUNDAMENTAL TRADE

This week's selection is Nokia (NOK). Nokia is the largest cell phone maker in the world with current market share near 38%. They also provide equipment, solutions and

services for communication networks. While other phone makers have focused upon set product niches (i.e. – Research in Motion’s focus on smart phones) or relied upon one-off products to drive growth (i.e. – Motorola hit a home run with the Razr, but has not had success since then), NOK has a diversified product base that is sold throughout the world. The end result is a steady, dominant market share with less reliance upon hot products and certain segments of the world economy to drive growth.

Over the past year, NOK’s stock has been decimated. Since peaking above \$40 in December 2007, NOK has fallen to the current price of \$15.30 (a 62% drop). Despite very high levels of return on equity and market share, NOK has lagged both its peer group (the peer group has dropped 43%) and the S&P 500 (which has dropped 38%). While the analyst community attributes the drop to shrinking margins one day and concerns over market share the next, we now find ourselves looking at a company that is cheaper than it has been in years, offers a safe, high dividend

yield and provides tremendous upside.

From a valuation perspective, NOK trades at a 7 P/E multiple (vs. a 5 year average P/E of 16.6) and pays a 4.7% dividend. Using historical measures, the shares should be trading in the upper-\$30s. Applying a conservative earnings yield methodology that assumes a 2% drop in operating margins, declining market share and a 3% terminal growth rate, I derive a fair value estimate of \$28. With the stock trading at nearly half my fair value target, we are being offered a global leader in a key industry at valuation levels that have not been witnessed in years. We also gain the benefit of a high dividend payment while waiting for the markets to recognize fair value. **I recommend a 3% long position in NOK** as this week’s fundamental trade.

OPTION TRADE

Most investors have heard the statistic that 80-90% of all options expire worthless. While hard data to substantiate this claim is not easily found, I will assume the 90% rule is correct. Based on that number, wouldn’t buying

options be a bad decision since you only stand a 1 in 10 chance of realizing gains? Personally, I understand this thought process and often prefer to write options than buy them. However, a key error with this line of thinking is that a high success rate can be overwhelmed by 1 or 2 large losses. For example, if I sell 10 options for \$1 each and see 9 of the options expire worthless, I have made \$9 (90% of the initial position). However, if the one contract that does not expire worthless moves against me and results in a loss of \$10, I will lose 10% on the entire pool of options despite being right 90% of time time. With option trades, the potential for large gains on a few contracts can offset frequent, small losses.

Hunting for large gains in the option markets leads us to this week’s trade. Starbuck’s (SBUX) stock price has been in decline for over two years as the former highflier has sunk nearly 75%. A combination of over expansion, branching into unrelated businesses, corporate restructuring and concern over the economic environment have all pushed the price lower.

Leading into Monday's earnings announcement, the stock fell 24% the previous week and has discounted poor earnings. I view the market stance as so pessimistic, that even weak news can be construed as positive and stands an excellent chance of creating a large one day move on Tuesday morning. As Leapfrog (LF) and Whole Foods (WFMI) showed last week, well received news can lead to 25-40% one day moves in battered shares. While the gain may not last, astute investors can position for these one day events and book large, quick gains.

Looking at Starbucks, the November 12 calls (SQX+KN) offer such an opportunity. They are currently offered at \$0.25 per contract and I recommend buying them at that level. If Starbucks delivers any news that the market interprets bullishly, the shares could trade into the \$13.25 - 14.50 range. Considering the stock was at this level a week ago, the price gain seems reasonable. Having bought the calls for \$0.25, investors will see substantial gains in a very short time frame. **My**

recommendation is to allocate 0.50% of the portfolio to SQX+KN at a limit price of \$0.25. I will look to take advantage of any rally and will enter a limit order to sell ½ the position at a price of \$1.40.

CURRENT RECOMMENDATIONS

Our first week encountered success. In a week where the S&P 500 declined 3.9%, we had a return on the entire portfolio of 0.2% and a return on invested capital of 2% (Figure 3). Our decision to buy ICE and JPM resulted in losses while the short position of WFC resulted in substantial gains and the option trade has worked as well.

Knowing that the total change in value is more important than the individual components, we are pleased with both the positive results and the relative performance vs. the S&P 500.

For this week, we will not be changing any of the current trades and will be adding the long positions in BIDU, NOK and SBUX calls mentioned throughout the letter. As always, trades will be done at the market Monday morning for BIDU and NOK and at the limit price for the SBUX calls. Maintain a stop loss order on ICE at \$68 and once you have bought the SBUX calls immediately enter an order to sell ½ the position at \$1.40.

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>% Total</u>
ICE	24	\$ 84.56	\$ 80.00	\$ 2,029	\$ 1,920	2%
JPM	98	\$ 41.00	\$ 37.88	\$ 4,018	\$ 3,712	4%
WFC	(119)	\$ 33.73	\$ 28.72	\$ (4,014)	\$ (3,418)	-3%
MA Bull Spread	100	\$ 3.50	\$ 3.80	\$ 350	\$ 380	0%
Cash Position					\$ 97,616	97%
Portfolio Total					\$ 100,211	
<i>Portfolio Metrics:</i>						
<i>Portfolio Return</i>			0.2%			
<i>Return on Invested Capital</i>			2.0%			
<i>S&P 500 Return</i>			-3.9%			
<i>Portfolio Beta</i>			0.03			
<i>Portfolio Yield</i>			0.6%			
<i>Net Exposure</i>			3%			
<i>Total Exposure</i>			9%			

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 – I will be indentifying economic reports, earnings' releases and other events that could lead to swings in stock prices. Note that I will only list the items I 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 – I 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 me, ending price is the only one that matters and will be used to judge trends, stop loss price and other pieces of information.

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

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

premium while hedging my risk.

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

Current Recommendations
This section will be used to track my 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 basis points and no transaction fees will be charged.

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