

# EPIC INSIGHTS

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## *THE WEEK AHEAD*

The upcoming week of 12/1-12/5 (Figure 1) is filled with various economic announcements and earnings reports. However, the key numbers to watch will be Friday morning when we receive the November employment report. The consensus calls for a loss of 323,000 jobs during November with the unemployment rate increasing to 6.8%. At first glance, these numbers appeared large so I felt compelled to look at the data series in order to determine how large they really were. To offer perspective, I reviewed data from 1960 to the present. The unemployment rate has not been at 6.8% since October 1993. A one month job loss of 323,000 would be the 10<sup>th</sup> highest on record. Given the large revisions in the data series and the poor forecasting record of most economists, if the November number comes in as a slightly worse

Figure 1 Weekly Calendar

<u>Day</u>	<u>Date</u>	<u>Announcement</u>	<u>Time</u>	<u>Estimate</u>	<u>Prior</u>
Monday	12/1	ISM Manufacturing	10:00 AM	37.0	38.9
Tuesday	12/2	BZH Earnings	BMO	(\$2.38)	\$0.02
		SHLD Earnings	BMO	(\$0.50)	(\$0.03)
		SPLS Earnings	BMO	\$0.41	\$0.42
		Domestic Vehicle Sales		7.8M	7.9M
Wednesday	12/3	ADP Employment Report	8:15 AM	-195K	
		ISM Nonmanufacturing	8:30 AM	42.0	44.4
		Beige Book	2:00 PM		
Thursday	12/4	SAFM Earnings	BMO	(\$0.58)	\$1.18
		TOL Earnings	BMO	(\$0.32)	\$0.76
		Initial Jobless Claims	8:30 AM	540k	529k
		Continuing Jobless Claims	8:30 AM	4030k	3962k
		Factory Orders	10:00 AM	-4.2%	-2.5%
		WSM Earnings	AMC	(\$0.11)	\$0.25
Friday	12/5	Nonfarm Payrolls	8:30 AM	-323K	-240K
		Unemployment Rate	8:30 AM	6.8%	6.5%

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

than forecast 360,000 loss, it would be the 5<sup>th</sup> worst on record. Simply, the job picture is bleak as more people find themselves out of work in poor economic conditions. The core of the current crisis has been over leverage as people and corporations took excessive risk and lived beyond their means. The only way to cure the excess is by having income to satisfy your current needs, debt levels and saving requirements. Large numbers of lost jobs worsen the problem.

While increased joblessness is bad for the consumer, since employment is a lagging economic indicator, should we view the spike in job losses as a potential sign the recession is nearing competition? This line of thinking would be a mistake. As opposed to focusing on one month of data, I looked at longer trends of job loss for the same data period. From 1960 to now, there have been six periods of sustained job loss.

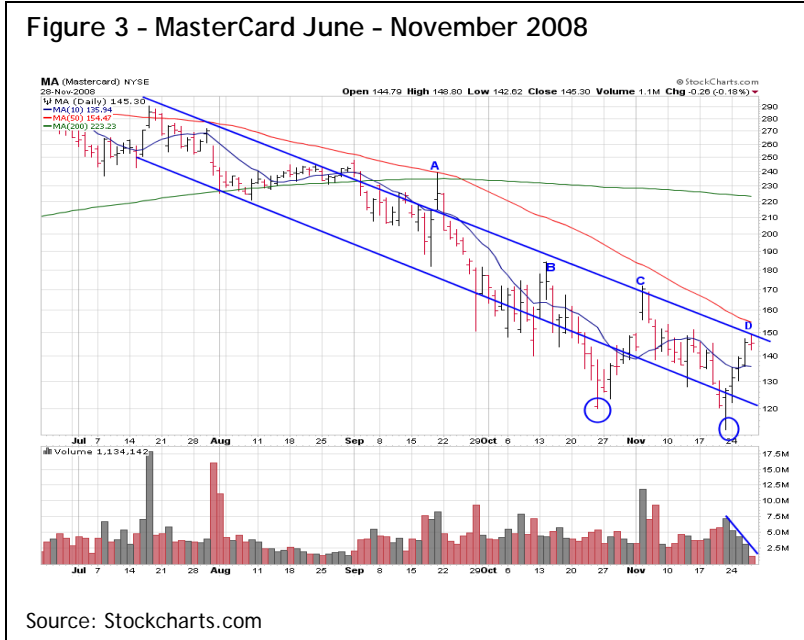
Looking at **Figure 2**, we see that past periods of job loss have surpassed what we have experienced thus far. More ominously, with our rise in population it is reasonable to see job losses higher during the current recession. In prior periods, total job loss often approaches 1% of the total population. If that pattern holds, we will experience well over 3 million jobs lost before this recession runs its course. If, as feared, this recession is worse than what was experienced in the past, the total loss number may approach 4 million with the unemployment rate nearing 10%. Simply, we are not past the midpoint of job loss and if I were to place a wager, I would bet the picture will become much darker from here. All those calling for an end to this recession based on government intervention are premature and destined to be proven wrong. As Bob Dylan told us, "It's not dark yet, but it's getting there."

For the specifics of the upcoming week, **Monday** will see the ISM report. **Tuesday** offers domestic vehicles sales. **Wednesday** offers a preview of Friday's employment numbers when we receive the ADP

**Figure 2 Periods of Sustained Job Loss**

Initial Month	Ending Month	Duration (months)	Total Jobs Lost	Estimated Population	Loss as % Population
May-60	Feb-61	10	1.44	179.32	0.8%
Aug-74	Apr-75	9	2.17	214.88	1.0%
Aug-81	Dec-82	17	2.50	226.55	1.1%
Jul-90	May-91	11	1.62	248.71	0.7%
Mar-01	May-02	15	2.20	281.42	0.8%
Jan-08	Dec-08	12	1.50	305.19	0.5%

*Note: Jobs lost and population numbers are in millions*



employment report. I would caution that the ADP report is notoriously volatile and offers little predictive value. Markets will react to the number, but I would not try to divine deep meaning from this report. **Thursday**, offers initial and continuing jobless claims. **Friday**, as discussed above, brings the November nonfarm payrolls and unemployment rate.

### *TECHNICAL TRADE*

Isaiah Berlin's essay "The Hedgehog and the Fox" divides thinkers into two categories. Hedgehogs rely on a single defining idea to influence their decision making while foxes rely on multiple experiences and cannot define their thinking into one single idea. As investors, we are confronted by many different ideas and opportunities. This leads us to often act like the fox as a

trading opportunity may be here today and then gone tomorrow. To rely on one single idea to consistently generate returns will lead to frustration. When a good trade becomes crowded, we must move on to our next idea.

At times, the market does allow us to behave like a hedgehog. When these opportunities arrive, we must take advantage. After all, I would rather trade a stock with which I am comfortable and knowledgeable than spend hours searching for the next big idea.

We now have such a trade. For the past two weeks I have used this section to discuss **MasterCard (MA)**. Let's make it three weeks in a row. **Figure 3**, shows an updated chart. Over the past week, MA has bounced off the lower end of the trading range, retested the top of the range and then pulled back. The result is a stock at the higher end of its trading range, that has set another lower high (point D) and enjoyed a 26% one week move on declining volume. Knowing that volume should follow the trend, a stock that rises on declining volume should not be trusted.

All of these factors point to a drop in MA shares that should violate the recent intraday low of \$115. **For this week's technical trade, I recommend a 5% short position in MA. I will use the 50 day moving average as the stop loss and will look to cover ½ the short position on a close below \$115.**

### ***FUNDAMENTAL TRADE***

Last week I highlighted a group of blue chip stocks that could be purchased at bargain levels. With a strong market rally, anyone buying this basket did very well. This week I am going to take a different approach and highlight a more speculative stock that is selling below book value. This week's fundamental trade is **Nautilus (NLS)**.

NLS's stock price has collapsed from over \$30 in 2005 to the current price just below \$3. What started as operational problems and low earnings quality morphed into a struggle over control of the company. As the economy has stalled, discretionary purchases have taken a backseat and NLS has seen business deteriorate further.

However, as we overcorrect opportunity exists.

I have always viewed NLS as an excellent play on the aging of America. Through multiple acquisitions, NLS controls brand names such as Schwinn, Bowflex and Stairmaster. As Americans age, they have a desire to extend and improve their quality of life. The easiest approach to achieving these goals is through a healthy lifestyle that includes routine exercise. Through various brands, NLS is positioned to serve clients that range from outdoor enthusiasts to people building home gyms to those exercising at traditional health clubs. Over the past three years, NLS has diversified their revenue stream to allow them to profit regardless of the medium used by aging Americans to increase fitness and improve their quality of life.

From a valuation perspective, the stock is cheap. Tangible book value nears \$4 per share with my adjusted book value at \$3.50. Leverage is modest and liquidity is strong. Cash conversion is improving and inventory represents 18% of total assets (down from 30% 3 years ago).

Using a variety of income based methodologies, I derive fair value that ranges from \$6-8. An example would be an earnings yield process that assumes negative growth for the next 2 years and then a slow return to profitability that never outstrips the 2004 levels. Even with a company that has no growth for a decade, we see a fair value target of \$6.

Combining all the factors, NLS represents an excellent collection of brands with improving operations that sells at a 16% discount to book value. The patient investor willing to wait for an improvement in the business cycle can easily double their money over the next few years. While the story is compelling, we must also realize the imbedded risk. For that reason I recommend keeping the position small until the market confirms we are correct. For these reasons, **I recommend starting with a 1% long position in NLS.**

### ***OPTION TRADE***

Covered calls are both simple and elegant. If you own the shares, sell calls against the position and collect the premium. It adds current income,

reduces the cost basis of your long shares and may offer the chance for upside potential. Given the simplicity, this strategy is one of the most widely used by individual investors. Unfortunately, it is often misused.

Most people I speak with use covered calls in one of two ways. The first approach is they buy a stock they think is cheap with the hopes of making a quick gain. When the stock does not move for a few days, they grow impatient, sell calls for premium and often have their shares called away. So what is wrong with this trade? To illustrate the problem, let us use an example. Imagine you do your research and believe company A is worth \$20 per share. It currently sells at \$10, so you buy it looking to double your money. A few weeks go by and the shares still trade for \$10. You grow impatient and sell a \$10 call for \$.50. A few weeks later the stock is trading near \$15 and your shares get called away. While you did make a decent return on the trade, you gave away a 50% gain to make 5%. The opportunities where you believe you have an informational edge that will

yield large gains are too few between. Never give them up for call premium.

The second way covered calls are used is as a means of betting on volatility. Many people will create a trade to capture premium without considering the underlying stock. You must remember the price may go through the strike and leave you with shares you do not want to own. An example would be company B selling for \$30 with \$30 calls selling for \$6. Some investors would see this as a chance to collect 20% premium. However, if company B sells down to \$10 you now own these shares. Unless you were willing to buy the shares for \$24 at the beginning, you gambled on volatility and lost.

So how do I look at using covered calls? In general, I like to sell calls where high volatility leads to large premiums in a stock where downside is limited and the valuation is compelling. **This leads me to Apple (AAPL) and the December 90 calls (QAA+LR).**

AAPL stock has dropped over the past year from a high of nearly \$200 to a low of \$80.49 on November

20<sup>th</sup>. With the rally last week, the shares have closed at \$92.67. If I buy the shares at this level, I could then sell QAA+LR for \$7.85. If the shares close above \$90 on December 20<sup>th</sup>, I will earn a 3 week return of 5.6%. If the shares sell down, my cost basis is \$84.82. At that level I am near both the 52 week low and a level at which I find the shares to be a compelling value. Therefore, this trade offers the opportunity to either realize a nice one month return or own shares in an excellent company near their 52 week low. I am happy with either outcome.

With this trade, portfolio weighting is key. I like to keep all positions less than 10% so given my portfolio size, I recommend buying 100 shares of AAPL and selling 1 QAA+LR against it. Adjust the trade size as needed to achieve your desired portfolio weighting.

### ***CURRENT RECOMMENDATIONS***

Last week was very successful. Monday morning we closed the airline pair trade, MA short and WFC short while going long a handful of names. As

Figure 4 Portfolio Composition and Performance

Position	Quantity	Purchase Price	Current Price	Total Cost	Current Value	% Total
DIS	93	\$ 21.29	\$ 22.52	\$ 1,980	\$ 2,094	2%
GE	135	\$ 14.68	\$ 17.17	\$ 1,982	\$ 2,318	2%
JPM	98	\$ 41.00	\$ 31.66	\$ 4,018	\$ 3,103	3%
MSFT	100	\$ 19.90	\$ 20.22	\$ 1,990	\$ 2,022	2%
NOK	189	\$ 15.90	\$ 14.17	\$ 3,005	\$ 2,678	3%
PFE	126	\$ 15.76	\$ 16.43	\$ 1,986	\$ 2,070	2%
TGT	70	\$ 28.28	\$ 33.76	\$ 1,980	\$ 2,363	2%
UYG	225	\$ 4.40	\$ 6.29	\$ 990	\$ 1,415	1%
DIA 82 Put	(200)	\$ 9.30	\$ 6.50	\$ (1,860)	\$ (1,300)	-1%
DIA 86 Call	200	\$ 7.70	\$ 9.80	\$ 1,540	\$ 1,960	2%
Cash Position					\$ 84,078	82%
Portfolio Total					\$ 102,802	
<i>Portfolio Metrics:</i>						
<i>Portfolio Return</i>			2.8%			
<i>Return on Invested Capital</i>			6.8%			
<i>S&amp;P 500 Return</i>			-7.5%			
<i>Portfolio Beta</i>			0.16			
<i>Portfolio Yield</i>			1.1%			
<i>Net Exposure</i>			15%			
<i>Total Exposure</i>			19%			

the market rallied, we profited. **In one week our long positions in UYG, TGT and GE returned 43%, 19% and 17% respectively. After one month, we have created a portfolio that has returned 2.8% versus a loss of -7.5% for the S&P 500 (Figure 4).** Further, we have returned 6.8% on invested capital.

Next week I will be adding the short position in MA and the long positions in NLS and the AAPL covered call discussed in the letter. No actions are recommended on the existing portfolio.

### ***GENERAL COMMENTS***

Last week's 12% rally in the S&P 500 was welcomed by

most investors. The move represents the largest one week move since 1974 when the S&P 500 was coming off the bottom of the brutal 1973-1974 bear market. I have talked in the past about the 1973 bear market and believe it holds parallels to what we are facing today. The 1973 bear market was global in nature with long lasting economic effects. It also created damage to investors' portfolios that took decades to repair. It was 10 years after the end of the 1973 bear market before the Dow Jones Industrial Average (Dow) closed above the preceding peak in nominal terms. In

real terms, it took nearly 20 years to reclaim the peak.

I have often stated that I felt Dow 7,800 would represent a bottom in this bear market. However, we must always remember that a bounce off the bottom does not mean an immediate resumption of a bull market. Instead, bounces represent an increase in prices that allow for quick profits and rebalancing. Further, large sharp rallies are often indicative of bear market rallies. As an example, look at the rally we saw from mid-October until Election Day (**Figure 5**). In a few weeks, the Dow bounced off a panic low, rallied 18% and then stalled. From there we violated the panic low and sold down to a new bear market low. Having moved nearly 18% on declining volume from the intraday lows achieved only a week ago, are we in for a repeat?

I fear we are. While the move this week was fun, a retest of the recent bottom will likely occur over the next 3 months. Personally, I look for the market to continue higher for a few more weeks, but fear the retest of Dow 7,500 will occur sometime after the New Year. Further, a

Figure 5 - Dow Jones Industrial Average September 2007 - November 2008



resumption of a massive bull market could be years away.

Given the damage to portfolios, massive amounts of stock remain for sale and the risk averse will sell into most rallies. Also, as the economy continues to deteriorate, job loss rises, and spending drops the markets will remain under pressure. It took nearly 10 years for the Dow to rise above the level where it traded before the 1973 bear market began. We could see a similar pattern with this bear market. Assuming we are near 2020

before the Dow trades above 14,000, an entire generation will have gone without decent returns or increased wealth. The societal impacts of this fact are enormous.

When you consider that more money is lost on people chasing bear market rallies than on the initial drop in stock values, patience is warranted. Those who chase every rally will occasionally catch a bottom and sell a peak. However, if you play that game too many times you are destined to lose.

## ***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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