

EPIC INSIGHTS

Vol. 1, No.7

A PUBLICATION OF EPIC ADVISORS, LLC

DECEMBER 14, 2008

THE WEEK AHEAD

Last week was supposed to be calm, but prices swayed violently as the market processed each piece of information. For the week, the Dow Jones Industrial Average (Dow) fell 6 points. However, the average daily move was 2.1% as we flipped between gains and losses. The week was the perfect example of a rollercoaster – up and down, but finishing where it started.

If last week lacked hard data yet had violent swings, we must be prepared for the week ahead. The upcoming week of 12/15-12/19 (Figure 1) is packed with market moving news.

Monday will see the Empire Manufacturing report.

Tuesday is a massive day with earnings from Best Buy (BBY) and Goldman Sachs (GS) before the market opens and Hovnanian (HOV) after the market closes. On the economic front, we will see consumer prices (CPI), housing starts, building

Figure 1 Weekly Calendar

Day	Date	Announcement	Time	Estimate	Prior
Monday	12/15	Empire Manufacturing	8:30 AM	(27.3)	(25.4)
Tuesday	12/16	BBY Earnings	BMO	\$0.25	\$0.53
		GS Earnings	BMO	(\$3.50)	\$7.01
		Consumer Price Index (MoM)	8:30 AM	-1.3%	-1.0%
		Consumer Price Index - Core (MoM)	8:30 AM	0.1%	-0.1%
		Housing Starts	8:30 AM	735k	791k
		Building Permits	8:30 AM	700k	708k
		FOMC Rate Decision	2:15 PM	0.5%	1.0%
		ADBE Earnings	AMC	\$0.43	\$0.44
		HOV Earnings	AMC	(\$1.73)	(\$2.63)
Wednesday	12/17	GIS Earnings	BMO	\$1.23	\$1.18
		MS Earnings	BMO	(\$0.19)	(\$3.61)
		Bank of England Minutes	4:30 AM		
		MBA Mortgage Applications	7:00 AM		-7.1%
		NKE Earnings	AMC	\$0.81	\$0.71
		TTWO Earnings	AMC	(\$0.15)	(\$0.02)
Thursday	12/18	DFS Earnings	BMO	\$0.24	\$0.40
		FDX Earnings	BMO	\$1.57	\$1.26
		LEN Earnings	BMO	(\$0.76)	(\$0.42)
		Initial Jobless Claims	8:30 AM	555k	573k
		Continuing Jobless Claims	8:30 AM	4375k	4429k
		Leading Indicators	10:00 AM	-0.4%	-0.8%
		ORCL Earnings	AMC	\$0.34	\$0.29
		PALM Earnings	AMC	(\$0.46)	(\$0.02)
		RIMM Earnings	AMC	\$0.78	\$0.65
Friday	12/19	JBL Earnings	BMO	\$0.25	\$0.35
		December Options Expiration			

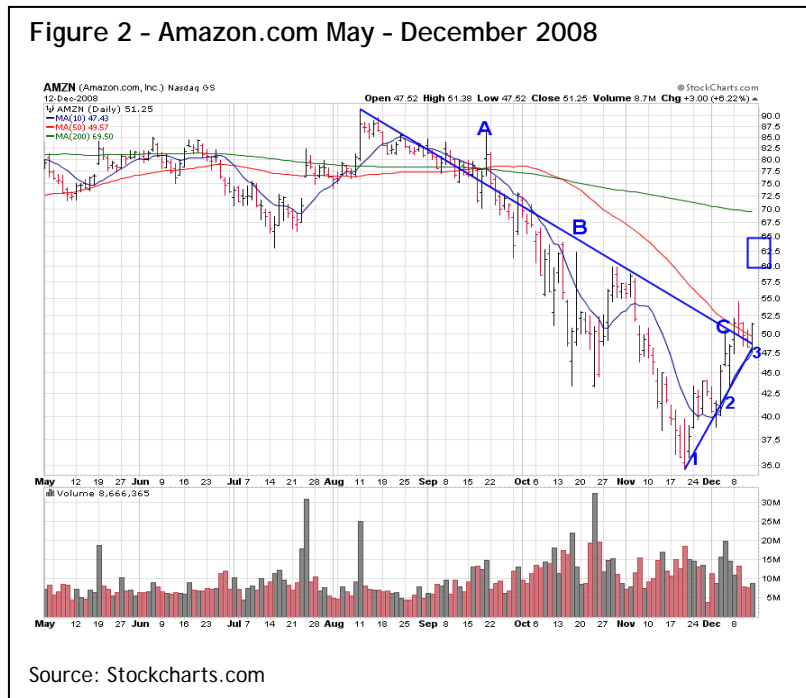
Note: BMO = Before Market Opens, AMC = After Market Closes
 Note: All times are Eastern Standard Time (EST)
 Source: Bloomberg

permits and an interest rate decision from the Federal Reserve (Fed). All of these announcements are of extreme importance. Earnings from GS and HOV will provide insight into how the financial and housing markets are behaving. With both companies expected to report losses, the focus will

shift to each company's conference call and any guidance they provide for future quarters. BBY's call should offer the first glance at how they are doing during the holiday season. BBY has always been the best operator in their industry. With most competitors in bankruptcy, BBY should own

this segment. If they offer bleak guidance, it speaks to how poor consumer shopping has become. Housing starts and building permits are leading indicators for future home sales. If builders are not taking out new permits, housing will not rebound for months. The CPI has been relegated a lesser role as market participants will look to the Fed to reduce interest rates 50 basis points (bp). This move is largely expected and focus will turn to the Fed statement and what hints they give of future policy moves.

Wednesday is another heavy earnings day as we receive reports from General Mills (GS) and Morgan Stanley (MS) before the market opens and Nike (NKE) after the markets close. We need to watch these reports to see if they confirm what GS and BBY reported one day earlier. If MS's earnings and guidance are in-line with what GS has predicted, we can draw conclusions about the entire industry. If they differ, we must question whether we have entered a transitional period where some firms will execute well and others will not. **Thursday** we receive the weekly jobless claims and earnings from



Discover Financial (DFS), Oracle (ORCL) and Research in Motion (RIMM). DFS will offer insight to how consumers are handling their credit card balances. Given the relative strength of the NASDAQ, RIMM and ORCL will serve as key barometers to either allow the strength to continue or prompt a reversal. **Friday** is the last day to trade December options. Options expiration days tend to be volatile and I expect that pattern to continue.

TECHNICAL TRADE

As markets begin stabilizing, technical patterns develop. With the large drop in stock prices this year, many charts will show strong

downtrends. As I have discussed in the past, I am hesitant to short a stock that has pulled away from its downtrend because there is little technical support for such action. Instead, I would rather see a stock consolidate, test the trend and then determine the next move.

As stocks consolidate and move toward the existing trend line, we must consider if a trend is reversing and bullish action will follow. This leads us to our technical trade for the week – **Amazon.com (AZMZN)**.

Since August, AMZN (**Figure 2**) has been in a clear, well defined downtrend. Points A, B and C represent a

series of lower highs as each rally failed. This constitutes purely bearish activity and pointed to lower prices. As the stock swooned to a bottom in late November, the price was nearly \$20 below its trend line.

As the price has reversed, we develop a key technical pattern that points to a strong rally. The rally from the November low has created a sharp uptrend. Within that trend, we have seen a series of higher lows at points 1, 2 and 3. As lower highs are bearish, higher lows are bullish. The convergence of the uptrend and downtrend has created a symmetrical triangle. The beauty of a triangle is that it must provide a conclusive decision. Once we reach the tip, a break lower means the downtrend will resume while a break higher means the uptrend will continue. With AMZN, we see a decisive move higher at the tip of the triangle which indicates the uptrend shall continue.

Knowing we are bullish on the stock, we turn to upside price targets. Typically, a bullish move out of a symmetrical triangle should recover 50% of the prior move. The downtrend

started at \$90 and the uptrend began at \$35. 50% of the move is \$27.50 and results in an upside price target of \$62.50 (the box on the graph). A rally to this level would run into resistance dating to July and is a reasonable price target.

Given the attractive technical backdrop and large upside price potential, **I recommend a 3% long position in AMZN.**

FUNDAMENTAL TRADE

Despite the teachings of financial theory, emotions play a key role in our decision making. We often react to information in a less than optimal way and allocate capital accordingly. A perfect example can be seen in consumer product companies. New products are met with glee and the stock price jumps. Put out a poor product and the stock price crashes. In a one product company such as Crocs (CROX) this reaction may make sense. However, how should we treat an integrated company with many lines of business where one is failing? In the case of **Motorola (MOT)**, the market's verdict has been

to drive the stock to absurd valuation levels.

With MOT, we see a stock where momentum investors rushed in during 2005 as some hoped the handset business would overtake Nokia. As time passed, the stock fluctuated between \$15-20 while Carl Icahn battled the board and attempted to extract value. As shares passed from momentum traders to short-term traders looking to piggyback on Icahn, MOT has been left with a shareholder base that was more interested in short-term fluctuations than long-term value. Therefore, when the handset business began to falter, short-term investors went to the exit and the price collapsed.

Within the price collapse is where I find opportunity. I agree with all who bemoan the problems of the handset business. For years, MOT has not been able to create a follow-up to the Razr. This has caused MOT to morph from must-have phones into another commodity phone producer. With this transition, margins and sales drop. When you have a large internal infrastructure that cannot be redeployed quickly, this margin drop creates the

losses we continue witnessing.

While I agree with the markets pessimism over the handset business, Mr. Market has ignored that MOT's other businesses are profitable, growing and have strong economic moats. The Home and Networks Mobility and Enterprise Mobility businesses deliver over 50% of MOT's sales and remain profitable. Despite this, investor focuses remains glued to the handset business.

Assuming the handset business remains troubled for the next 2 years and then resumes growth, the total operating business is worth \$6. Further, MOT has a liquid book value of \$2.50 and net cash of \$1.50. I will use the net cash and operating valuation to derive a fair value target of \$7.50. As always, buy at a discount to fair value in order to provide a margin of safety. In this case, I will use a 30% discount and would initiate a position at any price below \$5.25.

With the shares trading nearly 20% below my conservative entry point, MOT offers tremendous value. We are paid a dividend yield of 4.6% while

awaiting the market to recognize fair value. By focusing upon a company's true wealth instead of letting consumer trends dictate our investments, MOT offers a way for patient investors to realize large gains in the years to come. **I recommend a 2% long position in MOT as this week's fundamental trade.**

OPTION TRADE

With earnings season quickly approaching, we should see many opportunities to apply option trades. Earnings announcements are the ultimate catalyst for shares to move sharply in either direction. Within these moves opportunistic traders can realize swift gains.

As detailed earlier in the letter, many important companies report earnings over the coming week. When deciding on a trade, we must make an assessment of where the market is headed, see where option markets disagree with that view and position accordingly.

On rare occasions the option markets provides the ability to own a stock for less than the market price of that stock. This week we

have that opportunity. Research in Motion (RIMM) closed Friday at \$38.82, but a bull spread will allow you to own the shares for \$37.85. **Obviously this sets up a nice arbitrage opportunity that presents itself as this week's option trade.**

Over the years, one of my most successful earnings driven option trade has been a bull spread coupled with a short position in the stock. Looking at the December options for RIMM, we can buy the 35 call (RUP+LG) and sell the 40 call (RUP+LH) for a net cost of \$2.85. With this trade, we will make money on the 35 call when the stock trades above \$35 and will lose money on the short call when the stock is above \$40. By using options, I have effectively purchased the shares for \$37.85 (\$35 strike plus the \$2.85 cost of the spread) versus the current market price of \$38.82 with a maximum gain achieved once the shares reach \$40. If you are bullish on RIMM and think next week's earnings report will be received well, stop there. I do not believe the shares will respond well next week and am looking

for some optionality to the short side of the market.

This is where the short sale overlay comes into play. By shorting the stock, I profit from both a decline in the shares as well as a modest rise. The beauty of this trade is that large implied volatility in the out of the money \$40 call allows me to construct a profitability curve where a 5-7% move in either direction results in a small profit while a large decline delivers tremendous gains (Figure 3).

The risk to this trade is that a large spike in the shares will accrue swift losses to the short position once the market price moves above \$42. Therefore, we need to watch market reaction and be prepared to cover the short position if it appears that \$42 will be given and the shares are set to run.

Combining the likelihood of modest gains with strong optionality to the downside, I recommend 400 shares short of RIMM with a 400 share 30/45 bull spread.

CURRENT RECOMMENDATIONS

Our portfolio continues to perform very well. Last week our portfolio was

Figure 3 Research in Motion Option Trade

Position	Type	Qty	Price	Gain/Loss at a Range of Stock Prices				
				\$25	\$30	\$35	\$40	\$42
35 Calls	Long	400	\$4.50	(\$1,800)	(\$1,800)	(\$1,800)	\$200	\$1,000
40 Calls	Short	(400)	\$1.65	\$660	\$660	\$660	\$660	(\$140)
Shares	Short	(400)	\$38.82	\$5,528	\$3,528	\$1,528	(\$472)	(\$1,272)
Total Trade Gain/(Loss)				\$4,388	\$2,388	\$388	\$388	(\$412)

Figure 4 Portfolio Composition and Performance

Position	Quantity	Purchase Price	Current Price	Total Cost	Current Value	% Total
AAPL	100	\$ 91.33	\$ 98.27	\$ 9,133	\$ 9,827	10%
AAPL 90 Call	(100)	\$ 7.25	\$ 8.27	\$ (725)	\$ (827)	-1%
DIS	93	\$ 21.29	\$ 22.61	\$ 1,980	\$ 2,103	2%
GE	135	\$ 14.68	\$ 17.11	\$ 1,982	\$ 2,310	2%
JNS	248	\$ 8.27	\$ 7.47	\$ 2,051	\$ 1,853	2%
JPM	98	\$ 41.00	\$ 30.94	\$ 4,018	\$ 3,032	3%
MA	(36)	\$ 139.48	\$ 138.81	\$ (5,021)	\$ (4,997)	-5%
MSFT	100	\$ 19.90	\$ 19.36	\$ 1,990	\$ 1,936	2%
NLS	363	\$ 2.83	\$ 2.14	\$ 1,027	\$ 777	1%
NOK	189	\$ 15.90	\$ 15.37	\$ 3,005	\$ 2,905	3%
PFE	126	\$ 15.76	\$ 16.92	\$ 1,986	\$ 2,132	2%
TBT	47	\$ 43.81	\$ 42.58	\$ 2,059	\$ 2,001	2%
TGT	70	\$ 28.28	\$ 35.85	\$ 1,980	\$ 2,510	2%
UYG	225	\$ 4.40	\$ 5.55	\$ 990	\$ 1,249	1%
DIA 82 Put	(200)	\$ 9.30	\$ 6.50	\$ (1,860)	\$ (1,300)	-1%
DIA 86 Call	200	\$ 7.70	\$ 8.70	\$ 1,540	\$ 1,740	2%
VIX 50 Put	600	\$ 3.60	\$ 3.30	\$ 2,160	\$ 1,980	2%
Cash Position					\$ 73,435	72%
Portfolio Total					\$ 102,665	
<i>Portfolio Metrics:</i>						
Portfolio Return					2.7%	
Return on Invested Capital					4.2%	
S&P 500 Return					-9.2%	
Portfolio Beta					0.3	
Portfolio Yield					1.2%	
Net Exposure					29%	
Total Exposure					42%	

unchanged as was the market. **Since inception, we show a portfolio return of 2.7% and a return on invested capital of 4.2%. This compares very well to a decline of 9.2% for the S&P 500 during the same period (Figure 4).**

At the moment, our largest position is a short of Mastercard (MA). We must

maintain our stop loss on this position and will exit if we see a close above the 10 day moving average (currently \$138). Other than initiating new positions detailed in this letter, no other stop loss orders or actions are recommended over the coming week.

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 identifying 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.

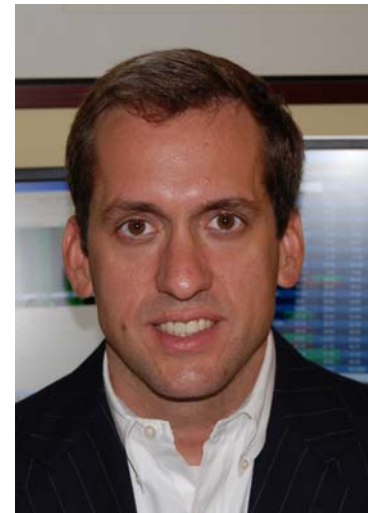
General Comments – Here I will share any relevant thoughts I may have. Topics may range from the capital markets to the economy to politics.

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.

Author Profile

Sean Hannon, CFA, CFP, is the President of [EPIC Advisors LLC](http://www.epicadvisorsllc.com). EPIC is a Registered Investment Advisor who offers separately managed accounts to clients ranging from high net worth individuals to young families who are just starting to invest in the market. Sean has over 10 years of financial services experience having worked for both Goldman Sachs and JP Morgan Chase prior to starting EPIC. Through solid research and disciplined risk management, EPIC portfolios have been able to outperform during various market cycles.



DISCLAIMER – The information provided is for informational purposes only and is not intended to be used as a solicitation to buy or sell securities, investment products or other financial instruments. This report is prepared for general circulation and does not have regard to the specific investment objectives, financial situation and the particular needs of any specific person who receives this report. You should independently evaluate particular investments and consult an independent financial advisor before making any investments or entering into any transaction in relation to any securities mentioned in this report, doing so at your own risk. Principals of EPIC may or may not hold similar positions and reserve the right to trade with or against any of the recommendations made.

Author & Publisher
SEAN HANNON CFA, CFP

For subscriptions email: blain@stocktradingtogo.com

Research Assistant
RICH WINTER

For trade ideas and inquiries contact:

EPIC ADVISORS LLC
735 Fairacres Avenue
Westfield NJ 07090
908-928-0211

sean.hannon@epicadvisorsllc.com

Circulation
BLAIN REINKENSMEYER

www.epicadvisorsllc.com

Design & Layout
CSP RESEARCH