

EPIC INSIGHTS

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THE WEEK AHEAD

Last week, I warned that we were entering a period in which limited company-specific news would lend itself to volatile trading. Reviewing the past five trading days, volatility is what we saw. On the week, the Dow Jones Industrial Average (Dow) declined 5.2%. Such a massive loss is painful, but looking at only one number misrepresents the swings investors witnessed. During the week, the market experienced a sharp 382-point decline (Tuesday), a 238-point intra-day rally (Thursday), and a daily average move from high to low of 281 points (3.5%). Astute traders might love such drastic moves, but for the average investor such extreme volatility rekindles thoughts of last fall and makes effectively allocating capital more difficult. After a week where the market weakened and many indices reached 2009 lows, yet the

Figure 1 Weekly Calendar

<u>Day</u>	<u>Date</u>	<u>Announcement</u>	<u>Time</u>	<u>Estimate</u>	<u>Prior</u>
Monday	2/16	Presidents Day Holiday			Markets Closed
Tuesday	2/17	RIG Earnings	BMO	\$3.68	\$3.41
		Empire Manufacturing	8:30 AM	-23.0	-22.2
Wednesday	2/18	DE Earnings	BMO	\$0.63	\$0.83
		Housing Starts	8:30 AM	530k	550k
		Building Permits	8:30 AM	528k	549k
		Industrial Production	9:15 AM	-1.4%	-2.0%
		Capacity Utilization	9:15 AM	72.5%	73.6%
		FOMC Minutes	2:00 PM		
		BIDU Earnings	AMC	\$1.44	\$0.85
		NLS Earnings	AMC	(\$0.14)	(\$0.10)
		WFMI Earnings	AMC	\$0.18	\$0.28
Thursday	2/19	DSX Earnings	BMO	\$0.72	\$0.49
		XTO Earnings	BMO	\$0.78	\$0.95
		Producer Price Index (MoM)	8:30 AM	0.20%	-1.90%
		PPI Ex Food and Energy (MoM)	8:30 AM	0.10%	0.20%
		Initial Jobless Claims	8:30 AM	620k	623k
		Continuing Jobless Claims	8:30 AM	4818k	4810k
		Leading Indicators	10:00 AM	0.0%	0.3%
Friday	2/20	Consumer Price Index (MoM)	8:30 AM	0.3%	-0.7%
		CPI Ex Food and Energy (MoM)	8:30 AM	0.1%	0.0%

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

November market bottom held, investors continue searching for an indication of when the bear market will end and we can safely reenter.

During the upcoming week of 2/16-2/20 (**Figure 1**) expect the trend of volatile trading to continue. Because company-specific news will again be sparse and the major economic

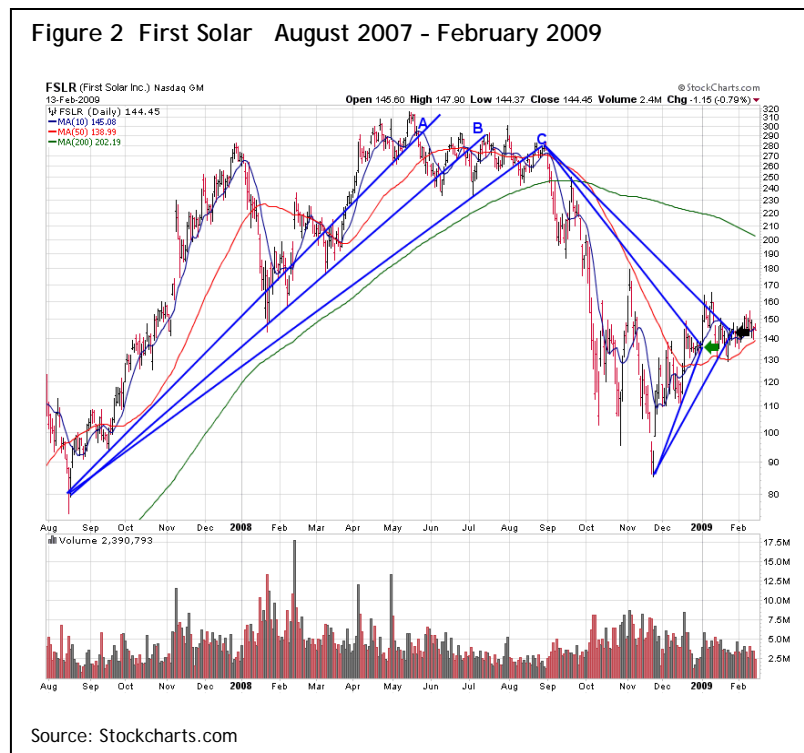
announcements will occur at the end of the week, investors will be reacting mainly to news from Washington. For now, decisions by policymakers on the economy and banking sector remain the key data points that can drive prices higher or lower.

For the specifics of the week, on **Monday** markets are closed in observance of

the Presidents' Day holiday. **Tuesday** sees earnings from Transocean (RIG) that should indicate whether the large drop in oil prices has begun affecting exploration budgets. **Wednesday** brings earnings from Deere (DE), reports on housing starts and building permits, and the minutes from the FOMC's January meeting. Building permits and housing starts are key leading indicators for home prices. Until builders believe home prices have bottomed, permits will remain depressed. We must watch for an indication that the trend is changing as it will be among the first signs that housing is healing and the banks' problems are ending. **Thursday** features inflation and the weekly employment information. Employment is the key factor for the economy. Until job losses begin slowing, consumers will remain defensive and economic growth will cease. **Friday** sees the week end with the consumer price index reading of inflation.

TECHNICAL TRADE

Four weeks ago, I highlighted First Solar (FSLR) as an ideal stock to buy. I felt the markets were



preparing to move higher and that solar companies would be beneficiaries of the Obama administration's efforts to foster an alternative energy industry. Also, most importantly, a review of FSLR's chart showed clear technical patterns that pointed to a move higher (**Figure 2**).

Reviewing the prior 18 months, FSLR moved higher in a fan pattern (A, B, and C), cascaded to a low that surrendered the entire bull market gain, and then rebounded. In moving higher from a classic triangle pattern (green arrow), FSLR showed signs of approaching the 200-day

moving average (MA).

A month later we show a small profit on our position. Although I always enjoy profits, I am becoming concerned with this position. Over the past month, uneven movement in the stock has resulted in another triangle pattern forming. This time, instead of a decisive move from the tip of the triangle (black arrow), we see sideways action. I am impressed that the shares have consistently found support at the 50-day MA, but I question whether that support can last. In a bear market, once resistance is broken, prices plummet.

With FSLR, each time we see the share price drop toward the 50-day MA, we wonder whether this is the time the level will fail to hold and prices will break materially lower. I am convinced that time will come and have no desire to stay in the shares to watch it happen. We always want all of our trades to show large profits, but in the markets, walking away when uncomfortable is often the best decision. For that reason, **I recommend closing our long position in FSLR as this week's technical trade.**

FUNDAMENTAL TRADE

A core belief behind value investing is that every asset is attractive at a certain price. In an environment where stocks continually push lower and the Dow is 45% below its all-time high, one would consider this a value investor's dream. In theory I agree.

I have a research universe of nearly 200 stocks that I have followed for many years. In a normal environment, I find eight to ten stocks that I believe are cheap and offer positive risk/return characteristics.

Currently, 67 stocks pass my filter as being cheap. With such a large universe to choose from, you would expect this section of the newsletter to write itself. Instead, I often find myself agonizing over which stock to recommend each week.

It is important to remember that I am both recommending stocks and building a portfolio. While individual stock selection is important, modern portfolio theory teaches us that how the stocks interact with one another is equally important. We must focus on stock selection, but also total portfolio risk and an equity exposure we find reasonable for the current market environment.

Over the past six months, I have often seen stocks I thought were at lifetime buy levels continue to drop in price. The lesson I learned is that we need not buy stocks just because they are cheap. Tomorrow they may be even cheaper. Instead, I assess the landscape, determine what I believe is a prudent posture, and begin building a portfolio accordingly.

I am nervous about the possibility of stock prices breaking violently lower. Our

current portfolio holdings are solid companies at cheap levels. Therefore, I will not select certain names to sell as a method of reducing our risk profile. Instead, I will use ETFs to create short positions that will profit from broad market declines.

There are many ways to create a short ETF profile, but I will go with a simple approach. The problems facing worldwide economies and markets are severe. Generally, I believe the United States has done a better job addressing our problems than the rest of the developed world. For this reason I expect international stock markets to suffer more from a sharp drop in prices. However, most of our equity exposure is in U.S.-based companies and we must use these indices to hedge. By selecting ETFs from the U.S. and other industrialized countries, we can hedge the downside risk without altering our current portfolio holdings.

To execute the transaction, I will be using the **iShares MSCI EAFE Index Fund (EFA) and the SPDR Trust (SPY)**. To balance total portfolio risk and reduce our net exposure to a more

reasonable level, I will assume a 10% combined short position. For this reason, I recommend a 5% short position in EFA and a 5% short position in SPY as this week's fundamental trade.

OPTION TRADE

When trading options, I have two simple rules. The first is I would rather be receiving proceeds than paying premium. The second is to constantly monitor and manage risk as markets change. Looking to profit from the general trend of the market while avoiding paying option premium, I often gravitate to trades where I am long one contract and short a different contract. In prior newsletters, we have effectively used this strategy to pair trade, construct bullish trades, and profit from bearish price action. At the moment, an example of such a trade is our no cost bullish position constructed by shorting the QQQQ March 29 put (QAB+OC) and using the proceeds to buy the QQQQ March 29 call (QAV+CC).

When I initiated this position, the main catalyst was the expectation of an end to the bear market. My

Figure 3 Index Lows

Index	Prior Low	Date of Low	Recent Low	Date of Low	New Low?
Dow Jones Industrial	7,552	11/20/2008	7,880	2/13/2009	No
Dow Jones Transport	2,989	11/20/2008	2,909	2/2/2009	Yes
NASDAQ	1,316	11/20/2008	1,440	1/20/2009	No
S&P500	752	11/20/2008	805	1/20/2009	No
Wilshire 5000	7,451	11/20/2008	8,100	1/20/2009	No
FTSE 100	3,781	11/21/2008	4,052	1/22/2009	No
DAX Index	4,127	11/21/2008	4,179	1/23/2009	No
CAC 40	2,881	11/21/2008	2,849	1/23/2009	Yes

thesis was based on the fact that when markets hit their lows in November 2008, the breakdown was synchronized across the globe (Figure 3). While markets had been weak to start 2009, they did not show the synchronization that marks major bottoms. For me, this indicated that we were more likely building a long-term base and that the prior lows should hold. This past week has altered my view.

During a week when the Dow plunged and then staged a strong counter-rally yet still declined 5.2%, we now see markets becoming more closely aligned. As the Dow rests at a 2009 low, investors now question if a retest of the November lows lies ahead. With the exception of the NASDAQ, U.S. markets are only 1 to 3% above their 2009 lows. One bad day and we could

see a synchronized breakdown to a new annual low. Although most markets would remain above where they traded in November, the likelihood increases that those lows will be tested and violated. Such an event would be devastating. If the November lows are violated, the Dow could easily trade to 6,000 and most likely would not bottom until it approaches 5,000.

Having taken a bullish position that still shows a profit, **we are better served to close our current positions in QAV+CC and QAB+OC.** Eventually this bear market will end and investors who properly pick the turning point will prosper. However, as we spiral lower the risk increases that such an ending point is far into the future. We are better served by remaining solvent, realizing gains, and

conserving capital until the bottom has been reached. I recommend selling QAV+CC and covering QAB+OC as this week's option trade.

CURRENT

RECOMMENDATIONS

Despite a dreadful week in the market, our portfolio performed well. We closed our Apple (AAPL) covered call and Google (GOOG), Visa (V), and MasterCard (MA) option trades Monday morning. Wednesday saw Research in Motion (RIMM) decline sharply in price as earnings were forecast to reach the lower end of the expected range. This price decline led us to sell our shares. As for the new positions, Potash (POT) moved 7% in our favor and the JPMorgan (JPM)/Goldman Sachs (GS) pair trade shows a small loss. By continually adapting to a changing environment, we saw our portfolio decline 3% during a brutal week when the S&P 500 declined 4.8%.

Overall, our portfolio continues performing well on both a relative and absolute basis. Since inception, we show a portfolio loss of 0.2% versus

Figure 4 Portfolio Composition and Performance

Position	Quantity	Purchase Price	Current Price	Total Cost	Current Value	% Total
DIS	93	\$21.29	\$18.52	\$1,980	\$1,722	2%
EVF	1,236	\$3.32	\$3.98	\$4,104	\$4,919	5%
EWA	264	\$11.41	\$12.25	\$3,012	\$3,234	3%
EWC	184	\$16.34	\$16.58	\$3,007	\$3,051	3%
EWZ	88	\$34.17	\$38.99	\$3,007	\$3,431	3%
FSLR	14	\$145.50	\$144.45	\$2,037	\$2,022	2%
GE	135	\$14.68	\$11.44	\$1,982	\$1,544	2%
GIS	37	\$58.05	\$56.84	\$2,148	\$2,103	2%
GS	(32)	\$97.44	\$96.45	(\$3,118)	(\$3,086)	-3%
HYG	41	\$75.25	\$73.80	\$3,085	\$3,026	3%
JNS	248	\$8.27	\$5.71	\$2,051	\$1,416	1%
JPM	116	\$26.62	\$24.69	\$3,088	\$2,864	3%
KO	72	\$42.20	\$43.85	\$3,038	\$3,157	3%
LQD	31	\$100.19	\$98.60	\$3,106	\$3,057	3%
MOT	490	\$4.19	\$3.87	\$2,053	\$1,896	2%
MSFT	100	\$19.90	\$19.09	\$1,990	\$1,909	2%
NLS	363	\$2.83	\$0.91	\$1,027	\$330	0%
NOK	189	\$15.90	\$12.06	\$3,005	\$2,279	2%
PFE	126	\$15.76	\$14.58	\$1,986	\$1,837	2%
POT	(45)	\$92.19	\$86.06	(\$4,149)	(\$3,873)	-4%
RIG	42	\$52.39	\$60.15	\$2,200	\$2,526	3%
TBT	90	\$40.19	\$47.71	\$3,617	\$4,294	4%
TGT	70	\$28.28	\$30.08	\$1,980	\$2,106	2%
UYG	225	\$3.24	\$2.98	\$729	\$671	1%
QQQQ 29 Call - Mar	300	\$1.87	\$2.70	\$561	\$810	1%
QQQQ 29 Put - Mar	(300)	\$1.94	\$0.70	(\$582)	(\$210)	0%
Cash Position					\$52,783	53%
Portfolio Total					\$99,820	
<i>Portfolio Metrics:</i>						
Portfolio Return						-0.2%
Return on Invested Capital						-0.7%
S&P 500 Return						-14.6%
Portfolio Beta						0.5
Portfolio Yield						2.5%
Net Exposure						47%
Total Exposure						67%

a decline of 14.6% for the S&P 500 (Figure 4).

Over the past two weeks, we have taken many actions to limit the portfolio exposure and protect ourselves from a declining market. Currently, we have a net equity position of 32% and a beta of .46. Based on the actions recommended in this newsletter, we will start the week with a net equity position of 20% and a beta of .33. Such a stance will allow us to profit from a recovery in stock prices, but

also offers enough safety should prices spiral lower.

For the coming week, I recommend leaving the portfolio intact and will not be taking any actions other than those mentioned throughout the newsletter. We should expect another bumpy ride, but with a portfolio that has low beta and high yield, we should perform well.

USERS' GUIDE

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

The Week Ahead – Here I identify economic reports, earnings releases, and other events that could lead to swings in stock prices. Note that I only list items I find relevant and ignore 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 Trade – I prefer to use simple trends and moving averages to identify trading opportunities.

This section either provides a new trade idea or revisits a prior trade. All new trades are 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 Trade – As a long-term value investor, I use 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.

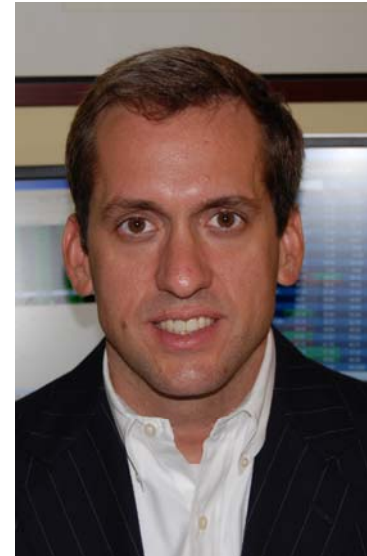
Option Trade – Based on the market environment, I will recommend option trades. In general, I prefer to write, rather than buy, options and will always look for opportunities to receive premium while hedging my risk.

General Comments – Here I share any relevant thoughts I may have on topics ranging from the capital markets to the economy to politics.

Current Recommendations – This section is where I track my investment recommendations and performance. All trades are 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 newsletter. 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 newsletter. Cash balances will earn LIBOR -100 basis points with no transaction fees charged.

Author Profile

Sean Hannon, CFA, CFP, is the President of [EPIC Advisors LLC](#). EPIC is a Registered Investment Advisor offering 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.



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