

EPIC INSIGHTS

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THE WEEK AHEAD

After six weeks of gains, the market finally paused. With the Dow Jones Industrial Average (Dow) 0.7% lower on the week, investors digested earnings reports and the state of the economy and opted to realize profits. Whether this develops into a more permanent correction or a pause before the market heads higher will be determined over the coming weeks. For now, we assess the landscape and determine how to move forward. While earnings reports have been mixed, investor reaction has not. Companies reporting solid numbers and offering constructive guidance see their share prices move higher. Also, the gains have remained after a few days, showing that investors are adjusting to company-specific news. The pattern of retaining gains on good news is how stocks should behave under normal market conditions. After

Figure 1 Weekly Calendar

Day	Date	Announcement	Time	Estimate	Prior		
Monday	4/27	GLW Earnings	BMO	\$0.05	\$0.44		
		BIDU Earnings	AMC	\$5.96	\$4.22		
Tuesday	4/28	PFE Earnings	BMO	\$0.49	\$0.61		
		Case Shiller Home Price Index	9:00 AM	-18.8%	-19.0%		
		Consumer Confidence	10:00 AM	28.8	26.0		
		JAVA Earnings	AMC	(\$0.16)	\$0.00		
		RFMD Earnings	AMC	(\$0.05)	(\$0.01)		
Wednesday	4/29	BDC Earnings	BMO	\$0.11	\$0.67		
		TWX Earnings	BMO	\$0.43	\$0.72		
		GDP - 1st Quarter	10:00 AM	-4.9%	-6.3%		
		FOMC Rate Decision	2:15 PM	0.13%	0.25%		
		CLF Earnings	AMC	(\$0.14)	\$0.16		
		ESRX Earnings	AMC	\$0.82	\$0.70		
		FSLR Earnings	AMC	\$1.54	\$0.57		
		SBUX Earnings	AMC	\$0.15	\$0.15		
		V Earnings	AMC	\$0.65	\$0.52		
		Thursday	4/30	CL Earnings	BMO	\$0.97	\$0.90
CMCSA Earnings	BMO			\$0.23	\$0.19		
EXPE Earnings	BMO			\$0.15	\$0.20		
MOT Earnings	BMO			(\$0.10)	(\$0.05)		
OMX Earnings	BMO			\$0.16	\$0.68		
PG Earnings	BMO			\$0.82	\$0.82		
Initial Jobless Claims	8:30 AM				640k		
Continuing Jobless Claims	8:30 AM				6137k		
Personal Income	10:00 AM			-0.2%	-0.2%		
Personal Spending	10:00 AM			-0.1%	0.2%		
HIG Earnings	AMC			(\$1.60)	\$2.51		
Friday	5/1			CVX Earnings	BMO	\$0.82	\$2.48
				MA Earnings	BMO	\$2.62	\$2.59
		U. of Michigan Confidence	10:00 AM	61.5	61.9		
		Factory Orders	10:00 AM	-0.7%	1.8%		
		Domestic Vehicle Sales		7.1M	7.1M		

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

living through a year where fear-driven markets led to one surprise after another, I long for an environment where normality exists and reason reigns. This week is the first hopeful sign that those days shall be here soon.

The upcoming week of 4/27 to 5/1 (**Figure 1**) continues the pattern of multiple earnings reports comingled with the occasional economic release. **Monday** starts with earnings from Corning (GLW) before the market opens and Chinese Internet firm Baidu (BIDU) after the close. GLW's

products are used in the production of consumer products so I will be interested to see if management offers any guidance on what is expected from the consumer for the remainder of the year. **Tuesday** features the Case Shiller home price index and consumer confidence. House prices are expected to decline nearly 19% and consumer confidence is forecast to increase slightly. Before we read the minor increase in confidence as an indication the economy has bottomed, we should examine the level from which the rebound has occurred. Since data was collected in 1967, consumer confidence has averaged 96 and had never dropped below 43 in any recession other than the current. Even were the measure to rebound to the expected 28.8, it would still remain 33% below the previously lowest point on record. **Wednesday** features the initial reading of first-quarter gross domestic product (GDP), an interest rate decision from the Federal Reserve (Fed), and earnings reports from First Solar (FSLR) and Visa (V). With no room to lower interest rates, markets will



focus on the Fed's future open market actions. At the last meeting, the Fed magically created \$1 trillion and embarked on a policy of quantitative easing. It will be interesting to see what it chooses for an encore. **Thursday** brings the weekly employment report, personal income, and personal spending. Last week, initial claims increased sharply to offset the prior week's spike lower. In doing so, it indicated this recession has more distance to travel before concluding. With respect to personal spending and income, I am interested to witness shifting consumer behaviors. One positive to this recession should be renewed interest in creating savings. I will watch this data for an indication that the shift has occurred. **Friday** ends the week with

earnings from MasterCard (MA) and a report on domestic vehicle sales.

TECHNICAL TRADE

Since reaching a panic low of 676 on March 9, the S&P 500 (**Figure 2**) closed higher six consecutive weeks before finally pausing. Over that period, the index rose 29% in a methodical manner. Although those rallies are great to catch, they become difficult to trade. Nearly 80% of the rally occurred over the first three weeks and resulted in a trendline (green line) which was so steep that chasing the rally was extremely dangerous. Also, with the S&P having bounced from an extremely oversold condition, it became difficult to determine proper support levels and price targets. The S&P's behavior over the last

three weeks eliminates the conundrum.

Looking at the index since May 2008, a clear fan pattern (lines A, B, and C) has guided shares lower. A fan is a technical pattern where three trendlines of differing slope exist on the same graph. For prices to break the primary trend, all three lines must be broken. Until then, we should view countermoves as corrections within a long-lasting pattern.

With the S&P, most of the post-September meltdown has occurred beneath line A. On a few occasions, prices moved above the trend then quickly pushed lower. None of these rallies offered significant movement, indicating the potential of a reversal. The recent rally is the first where line B has been challenged and alters the picture.

On the first few attempts to violate line B, the existing trend pushed prices lower. Now we ask if that shall continue. Looking at the chart, we see the framework for a decisive challenge over the weeks ahead that would have significant ramifications. Were the S&P to move through this trendline and better its

recent peak of 869, it would validate the current rally and indicate that market lows have been seen. Such a powerful move would target the 200-day moving average (MA) as the next price target before beginning a final assault of the primary trend. However, were the opposite to occur, it raises the possibility that the low of 676 will be retested and indicates that this bear market is not nearing completion.

Examining the current price of the S&P versus each target, we have the makings of a beautiful short trade. Were the market to go higher and better the recent peak, someone short would suffer a 0.3% loss. However, if the trendline does offer stiff resistance and the March lows are revisited, they would see a gain of 22%. Anytime I can risk 0.3% to make 22%, it is a trade worth doing.

We will be using the SPDR Trust (SPY) as a proxy for the S&P 500. Currently, the portfolio has a 2% short position in this security. Considering the attractive risk versus reward tradeoff, **I recommend an additional 3% short position in SPY as this week's technical trade.** Use a close above 869 as a

stop loss to exit the entire short position.

FUNDAMENTAL TRADE

The credit crisis-induced recession has battered stock markets and altered long-held beliefs. Companies that felt they could always finance themselves in the commercial paper market disappeared. Those that believed a low stock price would encourage corporate buyers to acquire them now stare at single-digit prices. As the rules have been rewritten, entire industries have disappeared. No example is as obvious as the heart of Wall Street—the independent investment bank.

One year ago, markets were recovering from Bear Stearns' forced sale to JPMorgan. Despite this shock, four independent firms remained—Merrill Lynch, Lehman Brothers, Goldman Sachs (GS), and Morgan Stanley (MS). Within a few days in mid-September, Lehman was bankrupt, Merrill was sold to Bank of America, and Morgan and Goldman had converted to commercial

banks. Wall Street as we knew it was over.

While GS and MS changed their corporate structures and regulators, many things remained the same. Their cultures were intact and their lines of business were as well. In general, each firm receives revenue from trading, asset management, and advisory services. During boom times, the asset-management business grows, traders earn large gains by bringing product to market, and the advisory business thrives as companies seek merger advice and look to take themselves public. But these are not boom times.

Having recently read both GS's and MS's annual reports, I am left with more questions than answers. Over the last three years, GS enjoyed operating margins of 60% versus 20% between 2003 and 2005. Which is more indicative of what they will earn in the future? MS has \$86 billion of Level 3 assets on its balance sheet (27% of total assets). Are these marked correctly or is danger lurking? Conventional metrics says MS trades for 50% of book and 6.5 times 2010 earnings. Similarly, GS trades for book value

and 10 times 2010 earnings. Looking at these metrics, the shares appear to be compelling. However, I am uncertain.

Turning to their businesses, both companies saw their investment-management businesses shrink with the market. The advisory arm is nonexistent at the moment. Neither has shown the will or intent to grow a traditional lending business that would allow for consistent interest income. That leaves them with trading and indicates where our opportunity exists.

GS has long been known as the best trading firm. In the first quarter, GS earned \$6.6 billion from fixed income trading while MS earned \$1.3 billion. In an environment where spreads are wide and competition low, MS has decided to curtail risk. By doing so, it begs the question where does it expect to generate income in the future. I have similar concerns when looking at each firm's balance sheet. As mentioned, 27% of MS's fair value assets are Level 3. By comparison, only 11% of GS's assets are marked this way. Level 3 valuation is used when market inputs are not observable. This

increases the possibility that the assets are mismarked. With such a high percentage of Level 3 assets, any mistake would cause great damage to MS's equity position.

All of these facts clearly point in GS's favor. While its premium valuation versus MS addresses some of these issues, I believe there is more difference to come. Over the last six months, the shares of MS and GS have moved in line. When markets realize GS has a better financial position and stronger earnings power, this link will sever.

The best way to position for this difference is from a pair trade. By being long of GS and short an equal amount of MS, you eliminate the broad market and focus on the difference between the firms. Following this strategy, **I recommend a 3% long position in GS and a 3% short position in MS as this week's fundamental trade.**

OPTION TRADE

For those of us looking to profit from the markets, it is a brutal trip. Against millions of profit-seeking investors, we must search for original ideas that

provide us with a competitive edge. Given the speed with which information flows, this is not easy. For that reason, when we find a profitable idea we are best served to return to it many times. Until it ceases to work in our favor, a tested, proven idea is extremely valuable.

Two months ago in this newsletter (Volume 2, Number 8), I highlighted the performance of First Solar (FSLR) around earnings announcements (**Figure 3**). FSLR showed impressive patterns. Over the last seven quarters, the company beat estimates and usually saw its share price move sharply. During this time period, the shares typically moved 18% the day after earnings were released. If you exclude the two smallest moves, the average change is 24%. While such data could be the basis of a trade, I find the two small moves disheartening. Position for a large move, receive one of the smaller ones, and quick losses arrive. Instead, I focus upon where the shares are one to two weeks later. On that basis, the shares moved an average of 6% in either direction. Such muted

Figure 3 FSLR After Earnings Reports

<u>Period</u>	<u>EPS % Surprise</u>	<u>Stock Price Pre-Earnings</u>	<u>Stock Price 1 Day Later</u>	<u>% Move</u>	<u>Px in 7-10 days</u>	<u>% Move</u>
4Q 2008	23%	137.68	107.65	-22%	126.50	-8%
3Q 2008	16%	115.75	144.07	24%	110.06	-5%
2Q 2008	46%	277.57	285.00	3%	280.74	1%
1Q 2008	15%	291.99	263.35	-10%	284.50	-3%
4Q 2007	41%	175.56	228.46	30%	205.26	17%
3Q 2007	146%	167.12	224.43	34%	185.39	11%
2Q 2007	204%	112.57	107.50	-5%	109.90	-2%

reaction leads me to our next trade—a short straddle.

A straddle is an option strategy with a put and call at the same strike price. If you buy a straddle, you believe the price of the stock will move sharply in either direction. At this point, the gain from one contract offsets the loss from the other and allows you to profit. If you feel the price will remain within the range, you would sell the straddle with the intent of watching volatility decline and prices fall.

Looking at FSLR, the shares currently trade for \$147.46. The May \$145 calls (QHB+EI) trade for \$12 and the May \$145 puts (QHB+QI) for \$10. With a total cost of \$22, the 145 straddle is pricing in an expected move of 15%.

Given FSLR's historical pattern, I recommend a short straddle on FSLR as this week's option trade. With at-the-money options

pricing a 15% post-earnings move, odds favor us closing this position quickly. However, even if FSLR moves greater than 15% we should see the movement quickly fade with the one-week price change being much lower.

For the specifics of the trade, short the May 145 call (QHB+EI) and the May 145 put (QHB+QI). I will be selling three of each contract. Adjust the trade size to conform to your portfolio.

CURRENT RECOMMENDATIONS

Even though the market decided to pause and consolidate its gains, our portfolio did not. Despite a week where the S&P 500 declined 0.4%, we saw our portfolio increase 0.7%. This marks the ninth consecutive week we have seen positive performance and gives weight to the belief than an actively managed portfolio that carefully examines risk

and seeks opportunities can outperform a static buy-and-hold approach. For months I have declared that buy-and-hold is dead. I hope that the portfolio performance convinces you of that as well.

Since inception we show a gain of 18.7% versus a decline of 10.6% for the S&P 500 (Figure 4). Most hedge funds would kill for the fees that such outperformance would generate. I hope my investors have enjoyed it without the fees or the hassle. Throughout this time period, we have remained well hedged with short positions and put options to temper any decline. While the relentless rally from the March lows made this process appear foolish, this week shows the wisdom of that approach. No matter your skill, you can never be on the right side of every market. Instead, make your best assessment, position for the expected move, but prepare yourself for the unexpected. Doing so allows you to profit in good markets and bad.

Next week, we continue to focus our eyes on the exits. Fearing this rally may soon end, I recommend selling **Cliff Natural Resources**

Figure 4 Portfolio Composition and Performance

Position	Quantity	Purchase Price	Current Price	Total Cost	Current Value	% Total
BZF	163	\$19.62	\$20.15	\$3,198	\$3,284	3%
CLF	159	\$12.61	\$21.86	\$2,005	\$3,476	3%
CSCO	136	\$14.31	\$18.45	\$1,946	\$2,509	2%
DIS	93	\$21.29	\$20.26	\$1,980	\$1,884	2%
EFA	(67)	\$31.60	\$41.53	(\$2,117)	(\$2,783)	-2%
EVF	1,236	\$3.32	\$4.03	\$4,104	\$4,981	4%
EWA	264	\$11.41	\$14.59	\$3,012	\$3,852	3%
EWC	184	\$16.34	\$18.93	\$3,007	\$3,483	3%
EWZ	88	\$34.17	\$44.47	\$3,007	\$3,913	3%
GE	135	\$14.68	\$12.13	\$1,982	\$1,638	1%
GIS	37	\$58.05	\$48.85	\$2,148	\$1,807	2%
GLD	(55)	\$86.03	\$89.65	(\$4,732)	(\$4,931)	-4%
HYG	41	\$75.25	\$74.73	\$3,085	\$3,064	3%
JNS	248	\$8.27	\$9.58	\$2,051	\$2,376	2%
JPM	110	\$31.86	\$33.63	\$3,505	\$3,699	3%
KO	72	\$42.20	\$42.79	\$3,038	\$3,081	3%
LOD	31	\$100.19	\$96.23	\$3,106	\$2,983	3%
MOT	490	\$4.19	\$5.81	\$2,053	\$2,847	2%
MSFT	100	\$19.90	\$20.87	\$1,990	\$2,087	2%
NLS	363	\$2.83	\$0.97	\$1,027	\$352	0%
NOK	189	\$15.90	\$14.05	\$3,005	\$2,655	2%
PFE	126	\$15.76	\$13.19	\$1,986	\$1,662	1%
QQQQ	(36)	\$26.09	\$33.80	(\$939)	(\$1,217)	-1%
SPY	(31)	\$67.97	\$86.99	(\$2,107)	(\$2,697)	-2%
TBT	90	\$40.19	\$47.45	\$3,617	\$4,271	4%
USO	170	\$27.72	\$28.90	\$4,712	\$4,913	4%
XHB	283	\$12.33	\$13.90	\$3,489	\$3,934	3%
AAPL Bull Spread	300	\$3.20	\$3.00	\$960	\$900	1%
AMZN Bull Spread	500	\$2.00	\$3.15	\$1,000	\$1,575	1%
MA Jan 90 Put	100	\$7.00	\$3.60	\$700	\$360	0%
SPY Sep 77 Call	(300)	\$3.50	\$13.60	(\$1,050)	(\$4,080)	-3%
SPY Sep 77 Put	300	\$13.60	\$4.10	\$4,080	\$1,230	1%
Cash Position					\$61,616	52%
Portfolio Total					\$118,726	
<i>Portfolio Metrics:</i>						
Portfolio Return						18.7%
S&P 500 Return						-10.6%
Portfolio Beta						0.5
Portfolio Yield						1.9%
Equity Exposure						32%
Net Exposure						48%
Total Exposure						62%

(CLF) at \$23. Janus (JNS) at \$10, and Motorola (MOT) at \$7. With Amazon.com (AMZN) and Apple (AAPL) having experienced their earnings-induced rally, I see no reason to keep exposure to these stocks. Therefore, **sell the AMZN and AAPL bull spreads at the market Monday morning.**

Other than the trades outlined in this newsletter, no other trades are recommended at this time.

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.

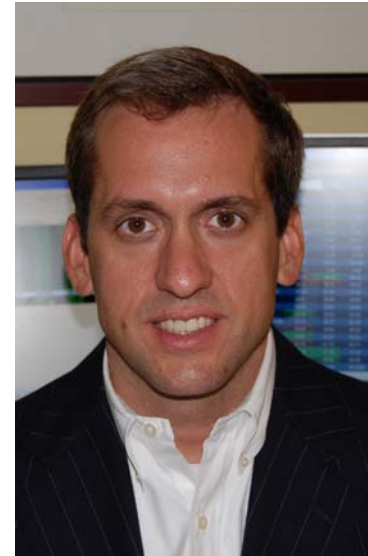
Option Trade – Based on the market environment, I will recommend option trades. In general, I prefer to write, rather than buy, options and will always look for opportunities to receive premium while hedging my risk.

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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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
www.epicadvisorsllc.com

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