

EPIC INSIGHTS

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THE WEEK AHEAD

A common investor mistake is to associate cause with effect. Given the usefulness of such an approach in our daily lives, it is understandable that some would apply the same framework to their investments. Knowing that if we touch a hot stove we will burn our hand, investors look for similar linear relationships in the markets. However, doing so often leads to frustration and inopportune decisions. Markets are dynamic, changing beasts that do not constrain themselves to simple cause-effect rules. If I had told anyone that in a single week rumors would spread that up to 14 of the top 19 banks need additional capital, a potential flu pandemic would cause a halt in global commerce, and one of the three leading automakers would declare bankruptcy, one would expect stock prices to collapse. Instead, the Dow Jones Industrial

Figure 1 Weekly Calendar

Day	Date	Announcement	Time	Estimate	Prior
Monday	5/4	L Earnings	BMO	\$0.80	\$0.95
		Pending Home Sales	10:00 AM	0.0%	2.1%
Tuesday	5/5	ADP Earnings	BMO	\$0.80	\$0.77
		CVS Earnings	BMO	\$0.54	\$0.55
		Bernanke Testifies for Joint Econ Committee	10:00 AM		
		ISM Non-Manufacturing Composite	10:00 AM	42.0	40.8
Wednesday	5/6	PHM Earnings	AMC	(\$0.49)	(\$0.14)
		AGU Earnings	BMO	\$0.26	\$1.23
		RIG Earnings	BMO	\$3.48	\$3.80
		XTO Earnings	BMO	\$0.77	\$0.92
		ADP Employment Change	8:15 AM	-645k	-742k
		CSCO Earnings	AMC	\$0.25	\$0.33
Thursday	5/7	Nonfarm Productivity	8:30 AM	0.8%	-0.4%
		Unit Labor Costs	8:30 AM	2.8%	5.7%
		Initial Jobless Claims	8:30 AM	635k	631k
		Continuing Jobless Claims	8:30 AM	6350k	6271k
		CROX Earnings	AMC	(\$0.29)	\$0.09
		RATE Earnings	AMC	\$0.33	\$0.35
		Fed Releases Stress Test Results			
Friday	5/8	Change in Nonfarm Payrolls	8:30 AM	-606k	-663k
		Unemployment Rate	8:30 AM	8.9%	8.5%
		Wholesale Inventories	10:00 AM	-1.0%	-1.5%

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

Average (Dow) moved 1.7% higher. In the markets, we must pay equal attention to both the news flow and how markets are reacting to each piece of additional information. Relying on pure cause and effect is never enough.

Now that we have emerged from earnings season in solid condition, the upcoming week of 5/4 to 5/8 (**Figure 1**) returns our focus to the economy and

when the recession will eventually end. While each day brings multiple data points, investors should set their sights on Friday and the April employment report. Credit contraction caused the recession and market collapse. Since the ability to service our debts is dependent upon income, the unemployment rate should be watched closely. I continue to believe unemployment will reach 10% before the recession

ends. With consensus calling for an 8.9% unemployment rate in April, evidence grows that we are getting closer to this point.

For the specifics of the week, **Monday** starts with a report on pending home sales. **Tuesday** features Federal Reserve (Fed) Chairman Ben Bernanke testifying before the Joint Economic Committee and the ISM non-manufacturing report. **Wednesday** brings earnings announcements from Agrium (AGU), Transocean (RIG), and Cisco Systems (CSCO), any of which could lead to large price swings, and the ADP employment report. While the ADP report has a mixed history of forecasting the official change in nonfarm payrolls, in recent months the direction of the report has been fairly accurate. **Thursday** will be highlighted by the release of the Fed's stress test of the 19 largest banks. Data will include both aggregate results as well as company-specific numbers. Generally, we would expect these test results to lead to fireworks in the financial sector as those passing soar and those failing see share prices bludgeoned.

Figure 2 Periods of Sustained Job Loss

<u>Initial Month</u>	<u>Ending Month</u>	<u>Duration (months)</u>	<u>Total Jobs Lost</u>	<u>Estimated Population</u>	<u>Loss as % Population</u>
Oct-48	Oct-49	13	2.34	151.33	1.5%
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	Apr-09	16	5.78	305.96	1.9%

Note: Jobs lost and population numbers are in millions

However, markets have accepted each rumor well and events that should have driven prices materially lower have instead registered minimal effect. When the official report is released, I am anxious to see if this pattern continues. **Friday** ends the week with the April employment report. As I do with this report each month, comparing this recession's employment loss with that of prior recessions (**Figure 2**) provides a glimpse of the severity of our current crisis. We are now in the 16th consecutive month of job loss. This is the second longest period since 1948. Total jobs lost are now 1.9% of the population—nearly twice the typical recession. We are beyond any traditional historical comparison and now find ourselves in a gray area between prior recessions and the Great Depression.

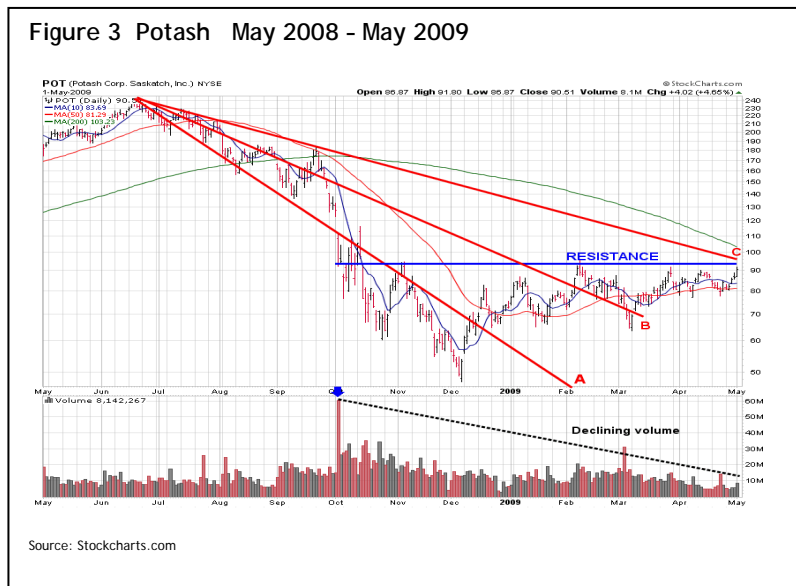
Believing that we are not entering a new Depression and that the unemployment rate will peak near 10%, the bottom in employment is quickly approaching. Employment is a lagging indicator with recessions typically ending seven to nine months before employment bottoms. Unless you believe we are entering a period where unemployment will exceed 12% in the near future, an event that would devastate our banking system and economy, we should treat each piece of incremental bad news as an indication that the end of the recession is quickly approaching. When everyone on Friday discusses the dire nature of an additional decline in payrolls of over 600,000 and the unemployment rate nearing 9%, we will be best served by recalling this fact.

TECHNICAL TRADE

As travelers on the London Underground are constantly reminded, we must always mind the gap. When a stock price gaps lower by moving sharply from the prior day's close, the gap becomes an important resistance level. Until the point when the gap is filled, rallies should stall at this level.

When commodities were reaching bubble status during 2008, investors searched for any company with an ancillary attachment to the industry. A target of this interest was fertilizer stocks. Believing that the ever-increasing price of crops would encourage farmers to plant more, Potash (POT) saw its stock price nearly triple in two years. But after reaching a peak of \$240 in June, the shares collapsed to below \$50 in six months (**Figure 3**).

The quick decline resulted in a traditional fan pattern (lines A, B, and C). With a fan, the primary trend remains in effect until all three trend lines have been broken. As a result of a rally from the recent lows, POT has moved above the two steepest trend lines and now exhibits the



characteristics of a company set to move higher and challenge the final downtrend (line C). However, a key obstacle remains; within that obstacle we develop a trading strategy.

When POT gapped lower on enormous volume on October 2 (represented by the blue arrow), that closing price (\$94) became a key resistance level. In the 145 trading days since, POT has traded above this resistance level five times (3% of the time). As POT has rallied 37% since its March low, that resistance level is 4% away.

We have been at this point before with POT and seen the stock move lower. The convergence of the final fan

line and resistance creates a tremendous hurdle.

Consider that the stock has seen consistently lower volume (black dashed line) and the quality of the move from recent lows is questionable. While the recent performance of commodities should provide a favorable backdrop for POT's business, the technical picture points to lower prices in the immediate future.

Failure to close above \$94 would make the 50-day moving average (MA) an achievable downside target (\$81) and a retest of the March low a realistic possibility (\$66).

With limited downside risk and large upside potential, I like the tradeoff. I **recommend a 3% short**

position in POT as this week's technical trade. I will give the trade a little room to work and recommend exiting the position should the shares close above \$96.

FUNDAMENTAL TRADE

Most investors rely upon Price/Earnings (PE) ratios to determine if a stock price is expensive or not. Typically, this approach works well. Academic studies have shown that stocks trading at low PEs will outperform their high-PE brethren over long periods of time. Knowing this, I often screen for low-PE stocks as a way of generating new research ideas.

Although this approach is intuitive, things are not always what they seem. At times, low-PE stocks trade at such levels for a reason. As an example, consider economically sensitive stocks. When the economy is strong, these companies make large profits. However, the stock market is more concerned with the future than how business is today. Knowing the business cycle will peak and then decline, share prices remain static or decline even though current profits

are soaring. Low PEs become even lower as stock prices shrink while profits race higher.

As an example, consider Arkansas Best (ABFS), a trucking company. When consumers are spending and its business is strong, ABFS's earnings move higher. During the recent cycle, earnings peaked at \$4.06 per share in 2005 and are forecast to fall to \$0.24 in the current year. Those who bought the shares at a 9 PE in 2005 show 35% losses while those scared by the current 97 PE are missing an opportunity.

Throughout business cycles, ABFS management has remained focused and disciplined. Debt remains low, turnover ratios are impressive, and capital is well allocated. Currently the shares trade at a discount to book value and offer a 2.6% dividend yield. Assuming the company never betters its 2005 earnings per share of \$4.06 and cannot top the 2007 level of \$2.26 until 2012, the shares are worth \$34 on an earnings yield basis.

Knowing that PEs for cyclical companies are counterintuitive, I rely upon

book value and earnings yield as a better proxy of value. On both accords, ABFS passes my valuation criteria. I believe this recession will end in the near future and ABFS should be a major beneficiary. Unless you are convinced the economy is simply resting before heading lower, purchasing shares at the current price makes a great trade. **I recommend a 2% long position in ABFS as this week's fundamental trade.**

OPTION TRADE

Markets will often try our patience. I spend a great amount of time researching ideas, looking for market inefficiencies, and designing trades. When I discover an opportunity, I put on my position knowing that I must wait for the market to see the wisdom of my approach. As the waiting period is unknown, I always want it to shorten. Having established my position, I expect markets to immediately conform to my view. Unfortunately, immediate recognition rarely occurs.

Last week, I highlighted the performance of First Solar (FSLR) near earnings announcements (**Figure 4**). As expected, FSLR beat its

numbers and saw a large price swing. However, the shares have since retreated from the initial rally and appear poised to continue the pattern of reversing the initial move.

To trade this volatility, we executed a short straddle that would remain profitable if FSLR's stock price remained between \$121 and \$169. With the price currently near \$180, we are sitting on losses. While I would have preferred the shares had not moved and allowed us to exit the trade quickly, we must remember that we initiated the position with a possible three-week holding period. Last quarter we executed the same trade, initially started at losses, and ultimately closed the trade with a 78% profit. I see no reason to expect a different outcome.

Given the nature of the trade and the contracts used, the short straddle has the same effect of being short of the stock. If you are concerned with FSLR moving higher, take your losses and move forward. I believe the shares will retreat over coming weeks and will take no action at this time.

Figure 4 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>
1Q 2009	30%	151.67	187.29	23%	?	?
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%

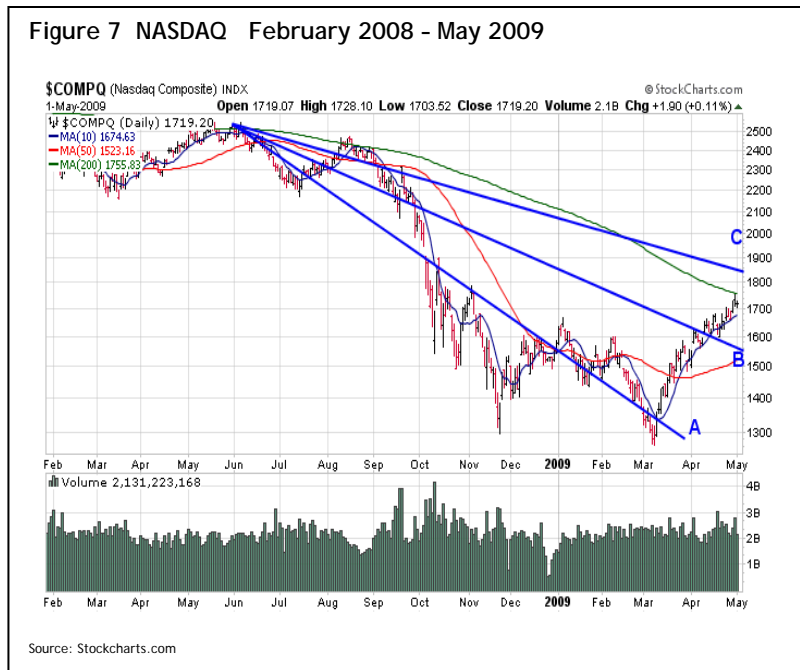
Figure 5 Portfolio Composition and Performance

<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>
BZF	163	\$19.62	\$20.37	\$3,198	\$3,320	3%
CSCO	136	\$14.31	\$19.58	\$1,946	\$2,663	2%
DIS	93	\$21.29	\$21.94	\$1,980	\$2,040	2%
EFA	(67)	\$31.60	\$42.41	(\$2,117)	(\$2,841)	-2%
EVF	1,236	\$3.32	\$4.26	\$4,104	\$5,265	5%
EWA	264	\$11.41	\$14.81	\$3,012	\$3,910	3%
EWC	184	\$16.34	\$19.35	\$3,007	\$3,560	3%
EWZ	88	\$34.17	\$46.78	\$3,007	\$4,117	4%
GE	135	\$14.68	\$12.69	\$1,982	\$1,713	1%
GIS	37	\$58.05	\$50.48	\$2,148	\$1,868	2%
GLD	(55)	\$86.03	\$86.95	(\$4,732)	(\$4,782)	-4%
GS	30	\$119.34	\$127.08	\$3,580	\$3,812	3%
HYG	41	\$75.25	\$75.56	\$3,085	\$3,098	3%
JPM	110	\$31.86	\$32.49	\$3,505	\$3,574	3%
KO	72	\$42.20	\$42.47	\$3,038	\$3,058	3%
LOD	31	\$100.19	\$95.97	\$3,106	\$2,975	3%
MOT	490	\$4.19	\$5.54	\$2,053	\$2,715	2%
MS	(165)	\$21.60	\$25.82	(\$3,564)	(\$4,260)	-4%
MSFT	100	\$19.90	\$20.24	\$1,990	\$2,024	2%
NLS	363	\$2.83	\$0.95	\$1,027	\$345	0%
NOK	189	\$15.90	\$14.30	\$3,005	\$2,703	2%
PFE	126	\$15.76	\$13.58	\$1,986	\$1,711	1%
QQQQ	(36)	\$26.09	\$34.37	(\$939)	(\$1,237)	-1%
TBT	90	\$40.19	\$50.20	\$3,617	\$4,518	4%
USO	170	\$27.72	\$29.62	\$4,712	\$5,035	4%
XHB	283	\$12.33	\$13.20	\$3,489	\$3,736	3%
FSLR Straddle	(300)	\$24.00	\$35.00	(\$7,200)	(\$10,500)	-9%
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)	-4%
SPY Sep 77 Put	300	\$13.60	\$4.10	\$4,080	\$1,230	1%
Cash Position					\$74,535	64%
Portfolio Total					\$116,184	
<i>Portfolio Metrics:</i>						
Portfolio Return					16.2%	
S&P 500 Return					-9.4%	
Portfolio Beta					0.5	
Portfolio Yield					1.9%	
Equity Exposure					19%	
Net Exposure					36%	
Total Exposure					62%	

**CURRENT
RECOMMENDATIONS**

We knew our portfolio could not increase forever, so after nine consecutive weeks of gains, we finally saw some losses. During the week, we closed our positions in Cliff Natural Resources (CLF) and Janus (JNS) at gains of 82% and 21%, respectively, while being stopped out on our short position of the SPDR Trust (SPY) for an 11% loss. For the week we saw our portfolio decrease 2.2% while the S&P 500 increased 1.3%. Despite the poor relative performance, **since inception we show a gain of 16.2% versus a decline of 9.4% for the S&P 500 (Figure 5).**

With the S&P 500 (Figure 6) and NASDAQ (Figure 7) both bettering their recent highs and looking to extend above recent downtrends, the markets' technical picture is improving. In turn, I am becoming cautiously optimistic and believe that the March lows will represent the bottom of this bear market. While price action over the next few months will remain erratic, the general direction is higher.



At the moment, our portfolio is only 19% invested in equities. Over the coming weeks I will work to unearth trades that will allow that

percentage to grow. Until then, we will remain disciplined, search for opportunities, and look for the next great idea that will drive our portfolio higher.

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.

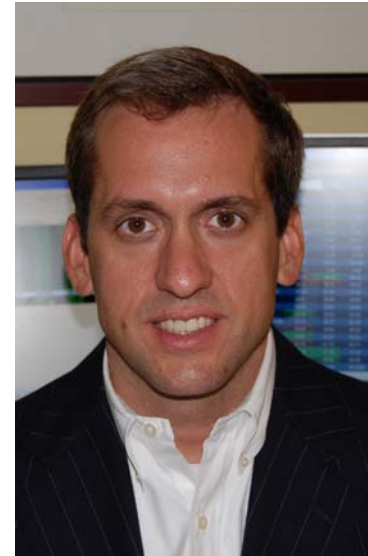
Option Trade – Based on the market environment, I will recommend option trades. In general, I prefer to write, rather than buy, options and will always look for opportunities to receive premium while hedging my risk.

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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