

EPIC INSIGHTS

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THE WEEK AHEAD

Markets can act in mysterious ways. Since reaching a panic low on March 9, the Dow Jones Industrial Average (Dow) has marched 31% higher in nine weeks. With only one down week during the stretch, the Dow has gone up despite a challenging economy and increasing uncertainty. All the recent bad news has been ignored as prices have rushed higher. After last week's 4.4% increase, we face a market that is overextended, yet shows no signs of pausing. Consider the stress test results released last week. Despite learning that Bank of America (BAC) needs an additional \$34 billion of capital, an amount that represents over 50% of its market capitalization, the shares were 69% higher on the week. In such an environment where nothing can take prices lower, investors face a conundrum. With the

Figure 1 Weekly Calendar

Day	Date	Announcement	Time	Estimate	Prior
Monday	5/11	Bernanke Speaks on Stress Tests	7:30 PM		
Tuesday	5/12	April Budget Statement	2:00 PM	-\$20B	-\$159.3B
Wednesday	5/13	Retail Sales	8:30 AM	0.0%	-1.1%
		Retail Sales less Autos	8:30 AM	0.2%	-0.9%
		Business Inventories	10:30 AM	-1.1%	-1.3%
Thursday	5/14	Producer Price Index (PPI) - YoY	8:30 AM	-3.8%	-3.5%
		PPI Ex Food & Energy - YoY	8:30 AM	3.4%	3.8%
		Initial Jobless Claims	8:30 AM	610k	601k
		Continuing Jobless Claims	8:30 AM	6400k	6351k
Friday	5/15	Consumer Price Index (CPI) - YoY	8:30 AM	-0.6%	-0.4%
		CPI Ex Food & Energy - YoY	8:30 AM	1.8%	1.8%
		Industrial Production	9:15 AM	-0.6%	-1.5%
		Capacity Utilization	9:15 AM	68.8%	69.3%

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

market looking very bullish, most are inclined to buy stocks and ride the wave higher. However, we also know that gravity always wins in the end. Prices cannot move up forever; eventually they will either drop or move sideways in order to consolidate gains, which makes chasing this rally very dangerous. Those with current positions should continue to monitor them, keeping their exit strategies in mind. Those looking to buy stocks at current levels should take the time to understand the risks they are assuming. Ultimately, this rally will end when the final investor has been lured back into the

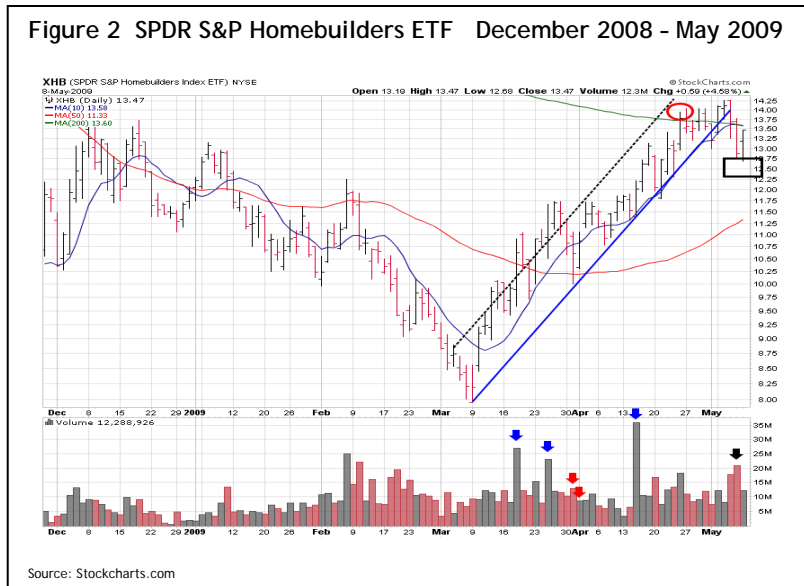
market.

The upcoming week of 5/11 to 5/15 (**Figure 1**) breaks the trend of massive amounts of information being poured onto the market. Instead, a limited amount of new information should allow us to digest what has occurred over recent weeks and plot our next move. **Monday** features a speech by Federal Reserve (Fed) Chairman Bernanke about the stress test of U.S. banks. **Tuesday** brings the April federal budget report. **Wednesday** has retail sales and business inventories. Given the consumer-led nature of this recession, sales will be

watched closely. Any lasting rebound may indicate the economy is turning higher. **Thursday** offers inflation readings via the producer price index (PPI) and the weekly employment report. After last week's 5% drop in initial claims, I will be watching for consolidation near the current number. A spike lower in weekly claims has an excellent history of predicting the end of recessions and I expect this time to be no different. **Friday** ends the week with inflation data from the consumer price index (CPI) and a reading of capacity utilization. Forecast to drop below 69%, capacity utilization is already the lowest on record. Questions remain over when it will bottom and what form a rebound will take. While things will eventually stop getting worse, that does not guarantee they will immediately look better.

TECHNICAL TRADE

Most often, technical analysis is more art than science. A group of analysts can look at the same chart and develop different views about the future path of prices. When judgment overwhelms data, it becomes easy for people to



find themselves traveling down uncharted paths.

Recognizing this risk, I prefer to use simple patterns to develop ideas. One of my favorites is the channel. A channel consists of two trendlines. The initial line can move up, down, or horizontally. After the initial trend is established, a parallel line, known as the channel line, offers guidance on how a stock should behave.

As an example, consider the SPDR S&P Homebuilders ETF (XHB). Since bottoming in March (**Figure 2**), the shares have moved higher and established a set uptrend (blue line). This data alone can be used to determine a trade, but by incorporating a channel line

(black line) we can strengthen our position.

Using a channel has two main benefits. First, a channel can help determine the staying power of a trend. When a price fails to reach the channel line, it indicates a trend is weakening and increases the likelihood of the trend failing. Two weeks ago (red circle) XHB's price failed to reach the channel line, an event which foresaw the recent break in the channel. A second key advantage of channels is they offer a measurement of expected move. When a channel is violated, the channel width serves as a guideline of expected move. XHB's channel is \$1.50 wide. When XHB fell below \$14 and violated the channel, it

established a price target of \$12.50 (black box).

When these guidelines are considered with respect to XHB's chart, the data paints an ominous picture. With an uptrend violated on increasing volume (black arrow), many of the features that took prices higher are now weakening. Bulls will cling to the belief that prices have already bounced off the downside target and are ready to move higher. This is possible, but I am more inclined to think that the declining 200-day moving average (MA) will act as resistance and the shifting volume pattern paints a bearish picture. Having bought the shares at lower levels, I see no need to remain long in such an uncertain setting. Instead, I will book profits and watch the picture unfold. Knowing we can always reenter if the technical picture improves, I **recommend selling the XHB position as this week's technical trade.**

FUNDAMENTAL TRADE

The Cub Scout motto "Be prepared" has been translated into many languages with slightly different interpretations. In

English, the motto is taken to mean that you are always in a state of readiness in mind and body to do your duty. Although my scouting days were short-lived and are now a distant memory, I follow this advice in my investing approach.

As a value investor, I believe every asset is attractive at a certain price. My job is to dig through financial statements, model risk, and determine the price at which the potential rewards outweigh the possible risks. Buying shares below that price allows me to increase the likelihood that my portfolio will increase over time.

Since markets do an excellent job of separating winning stocks from losers, my value approach eliminates most investment ideas. Of the 150 companies I actively follow, normally there are only eight to ten that I find attractive at a given time. However, markets constantly change and we must be prepared to act when they do.

For me, being prepared entails understanding what an asset is worth and what variables led to the determination of that value.

This level of preparation allows me to watch a price change and decide whether the change was driven by fundamental shifts that affect my valuation or by investor emotion. When emotions lead prices lower, buying opportunities are born.

During this bear market, we have seen many emotion-driven plunges erased by wild optimism. While I believe the economy is nearing a bottom, I do not believe a sharp V-shaped rebound is in the future. Instead, I foresee years of subpar growth while we adapt to slower overall growth and a declining quality of life. In this environment, emotion-driven plunges offer buying opportunities while strong rallies lead to sales. Fundamental trades—buying what is cheap and selling at full value—have accounted for 65% of our portfolio's profits.

Following this pattern, one of my first fundamental trades was Walt Disney (DIS). I believe that fair value for DIS is \$25, and the market allowed me to purchase the shares at a discount. With the current rally, that discount is now gone. At the moment, I find

the shares fully valued and will take advantage of the opportunity to exit.

By clearly modeling risk and reward, we prepare ourselves for whatever the market delivers. When investing, we must remember that a sale approach is equally as important as a buy approach. Markets will provide us multiple chances to buy stocks at a discount. By realizing profits when stocks hit our target, we prepare for new opportunities. Therefore, I **recommend selling the DIS position as this week's fundamental trade.**

OPTION TRADE

Options offer excellent returns and carry large risks. By utilizing risk-management tools that allow for the customization of strategies, we can structure portfolios that allow us to maintain certain risk profiles while profiting from expected price movements.

Over the last few months, the *EPIC Insights* model portfolio has displayed this approach. By owning attractive stocks and using a combination of put and call options, we have seen

increased performance with very low volatility. Clearly, the benefits of options have proved true for us.

However, there is also a downside to this approach. When an option position moves against you, losses can pile up very quickly.

As an example, consider our short straddle on First Solar (FSLR). By being short both a call and a put, we were positioned for static prices. As FSLR has raced higher, the put is now worthless and we are left with a short call. A short call is equivalent to being short the stock so any increase in price leads to losses.

With the options set to expire Friday, we face a decision. The risk-averse may wish to close the trade at a loss and move ahead to the next idea. After all, not every trade will be a winner and despite the loss on this position, our portfolio continues to perform well on both a relative and absolute basis.

I understand the logic of avoiding risk, but prefer to head in a different direction. A key to option trading is to keep positions small enough so they are inherently flexible. With a

short call we can employ a strategy known as rolling for credits. When we short a call, we receive cash if the shares trade below the strike price. If the shares are above the strike at expiration, we can close the short call at a loss and then sell another call in the future. Since prices will eventually correct (nothing goes higher forever) we will earn our initial profit target when the share price drops below the strike price.

Following this strategy has the benefit of allowing a long time horizon for our thesis to work. However, it also carries risks. By rolling losing trades, we must watch the portfolio position to ensure that one trade does not overwhelm our risk management. After all, if you continue to roll and the trade moves against you, the risk increases that the one large loss will eliminate your capital.

Knowing both the potential of this strategy as well as the risks, I always keep option positions small. Doing so allows great flexibility to react to an adverse move and position for the future.

Following this approach, I **will be rolling the short 145**

call from May to June as this week's option trade. To execute this trade, buy to close QHB+EI and sell to open QHB+FI. Unlike most trades, do not enter this at the open Monday. Instead enter it as a market order for Friday's close. This will allow you to benefit from any market move occurring during the week.

CURRENT

RECOMMENDATIONS

After one week of losses, our portfolio has returned to its winning ways. For the week we saw a 2% increase while the S&P 500 increased 5.9%. **Since inception we show a gain of 18.6% versus a decline of 4.1% for the S&P 500 (Figure 3).**

Given our current positioning, we should expect our portfolio to lag strong rallies yet outperform in declining and static markets. At the moment, beta is .3 with a 22% equity exposure. Most of our risk has been hedged via options and short positions. Since I expect markets to remain highly volatile, such an approach is wise. We have worked methodically to amass excellent performance in a limited

Figure 3 Portfolio Composition and Performance

Position	Quantity	Purchase Price	Current Price	Total Cost	Current Value	% Total
ABFS	98	\$23.74	\$25.77	\$2,327	\$2,525	2%
BZF	163	\$19.62	\$21.66	\$3,198	\$3,531	3%
CSCO	136	\$14.31	\$18.73	\$1,946	\$2,547	2%
DIS	93	\$21.29	\$25.46	\$1,980	\$2,368	2%
EFA	(67)	\$31.60	\$45.95	(\$2,117)	(\$3,079)	-3%
EVF	1,236	\$3.32	\$4.34	\$4,104	\$5,364	5%
EWA	264	\$11.41	\$16.34	\$3,012	\$4,313	4%
EWC	184	\$16.34	\$21.35	\$3,007	\$3,928	3%
EWZ	88	\$34.17	\$51.10	\$3,007	\$4,497	4%
GE	135	\$14.68	\$14.53	\$1,982	\$1,962	2%
GIS	37	\$58.05	\$53.40	\$2,148	\$1,976	2%
GLD	(55)	\$86.03	\$89.98	(\$4,732)	(\$4,949)	-4%
GS	30	\$119.34	\$139.59	\$3,580	\$4,188	4%
HYG	41	\$75.25	\$76.75	\$3,085	\$3,147	3%
JPM	110	\$31.86	\$38.94	\$3,505	\$4,283	4%
KO	72	\$42.20	\$42.92	\$3,038	\$3,090	3%
LOD	31	\$100.19	\$96.62	\$3,106	\$2,995	3%
MOT	490	\$4.19	\$6.50	\$2,053	\$3,185	3%
MS	(165)	\$21.60	\$28.20	(\$3,564)	(\$4,653)	-4%
MSFT	100	\$19.90	\$19.42	\$1,990	\$1,942	2%
NLS	363	\$2.83	\$1.09	\$1,027	\$396	0%
NOK	189	\$15.90	\$14.75	\$3,005	\$2,788	2%
PFE	126	\$15.76	\$14.40	\$1,986	\$1,814	2%
QQQQ	(36)	\$26.09	\$34.23	(\$939)	(\$1,232)	-1%
TBT	90	\$40.19	\$52.24	\$3,617	\$4,702	4%
USO	170	\$27.72	\$32.49	\$4,712	\$5,523	5%
XHB	283	\$12.33	\$13.47	\$3,489	\$3,812	3%
FSLR Straddle	(300)	\$24.00	\$40.00	(\$7,200)	(\$12,000)	-10%
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					\$72,080	61%
Portfolio Total					\$118,554	
<i>Portfolio Metrics:</i>						
Portfolio Return						18.6%
S&P 500 Return						-4.1%
Portfolio Beta						0.3
Portfolio Yield						1.9%
Equity Exposure						22%
Net Exposure						39%
Total Exposure						62%

time period and I see no need to rush after every incremental gain. Instead, I am comfortable remaining cautious and compounding gains at a steady rate.

Although I remain bullish, I am also concerned. This rally has become overextended and must

eventually pause. Knowing that financials have led the move higher, I will be watching for a retreat in share prices as an indication that a correction is coming. If the banks begin to weaken, the rest of the market will quickly follow.

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.

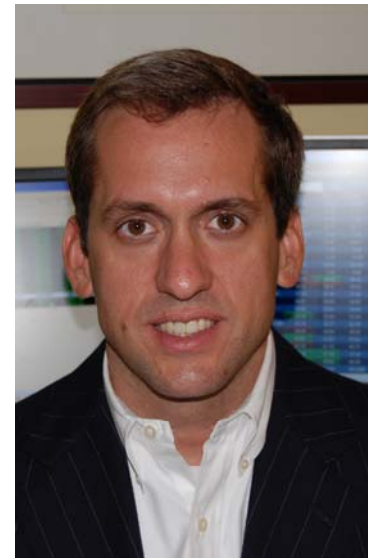
Option Trade – Based on the market environment, I will recommend option trades. In general, I prefer to write, rather than buy, options and will always look for opportunities to receive premium while hedging my risk.

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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