

EPIC INSIGHTS

Vol. 2, No. 20

A PUBLICATION OF EPIC ADVISORS, LLC

May 18, 2009

THE WEEK AHEAD

Finally, the rally has paused. Having suffered the first true setback since the March lows, the Dow Jones Industrial Average (Dow) declined 3.6% on the week. Now we are in a position to determine whether the 29% move from the March lows was simply a strong bear market rally or represents the beginning of a sustained move higher. The reaction over the next few weeks will help answer the question. As an overbought market consolidates, we can expect prices to gravitate toward important price levels. Over the next few weeks, the Dow retesting the 50-day moving average (currently 7,849) appears reasonable. If prices can bounce from that level it will indicate a bullish action as investors have decided to buy the dip. If not, a retest of the March low looms.

While an oversold market served as the foundation for the two-month rally, hope of economic recovery

sustained the push higher. I agree with many who believe that the economy may soon stop declining, but recovery is something different. Since Federal Reserve Chairman Bernanke mentioned “green shoots of recovery” during his *60 Minutes* interview on March 15, the phrase has been glued to investors’ tongues as a way to defend being bullish. I find this attitude premature. When an economy has suffered the damage we have over the last 18 months, bounces off depressed levels do not indicate pending recovery. Consider

one of the economic figures to be released this week—housing starts. Housing starts are bullish for the economy because builders employ workers and purchase materials with the expectation that they will profit when a house is sold. Higher starts lead to higher employment and higher economic growth. This week’s report is expected to show that housing starts increased to 520,000 from 510,000 the prior month (a 2% increase). While not a massive move, a 2% improvement in the most beleaguered asset class should be considered

Figure 1 Weekly Calendar

<u>Day</u>	<u>Date</u>	<u>Announcement</u>	<u>Time</u>	<u>Estimate</u>	<u>Prior</u>
Monday	5/18	LOW Earnings		BMO \$0.26	\$0.41
Tuesday	5/19	HD Earnings		BMO \$0.29	\$0.41
		Housing Starts	8:30 AM	520k	510k
		Building Permits	8:30 AM	530k	513k
		HPQ Earnings		AMC \$0.86	\$0.87
Wednesday	5/20	ANN Earnings		BMO (\$0.12)	\$0.47
		BJ Earnings		BMO \$0.44	\$0.29
		TGT Earnings		BMO \$0.59	\$0.74
		TOL Earnings		BMO (\$0.37)	\$0.36
		FOMC April 29 Meeting Minutes	2:00 PM		
Thursday	5/21	Initial Jobless Claims	8:30 AM	625k	637k
		Continuing Jobless Claims	8:30 AM	6610k	6560k
		DELL Earnings		AMC \$0.23	\$0.38
Friday	5/22	Bernanke Speaks at Boston College	2:00 PM		

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

progress, hence the thought of “green shoots” appearing. However, take a longer view and the picture is dismal. Since data has been collected starting in 1960, housing starts bottomed near 800,000 four times—in 1966, 1975, 1981, and 1991. Currently they are at 510,000. We would need to see a 57% improvement in the metric to reach the bottom of prior cycles. This does not indicate “green shoots,” but instead a devastated economy that is reeling to regain its footing. The recession may be nearing bottom, but true recovery remains years into the future.

The upcoming week of 5/18 to 5/22 (**Figure 1**) will keep the economy in focus as retail and housing take center stage. Given the state of the consumer and economic reports received last week, those expecting the retail sector to show continued improvement will be disappointed. **Monday** features earnings from home-improvement retailer Lowe’s (Low). **Tuesday** brings earnings from Home Depot (HD) and Hewlett-Packard (HPQ) as well as reports on housing starts and building permits.

Wednesday has Target reporting earnings and the Federal Reserve releasing the minutes from its April 29 meeting. **Thursday** offers the weekly employment report. Continuing claims are expected to increase to 6.6 million. Two months ago the tally rested at 5.4 million and I offered the prediction it would top 8 million before employment finally bottomed. As the economy refuses to rebound, that prediction becomes more likely. Considering the fiscal deficits that exist at both the federal and state levels, 8 million continuing claims would devastate budgets and push us closer to the point where the government must consider scaling back fiscal stimulus. Were that to occur, uncertainty would reign and volatility would spike higher. **Friday** ends the week with Bernanke speaking at Boston College’s Law School graduation.

TECHNICAL TRADE

When facing complex markets, we are left with two choices. The first is to embrace complexity and, through a combination of financial model and rigorous study, attempt to

comprehend what we face. The second approach is to simplify. As I explained in a recent [weekly commentary](#), markets are complex adaptive systems that do not lend themselves to financial models and complete understanding. As an example, consider all the quantitative hedge funds that imploded based on events their models said would occur once every 10,000 years.

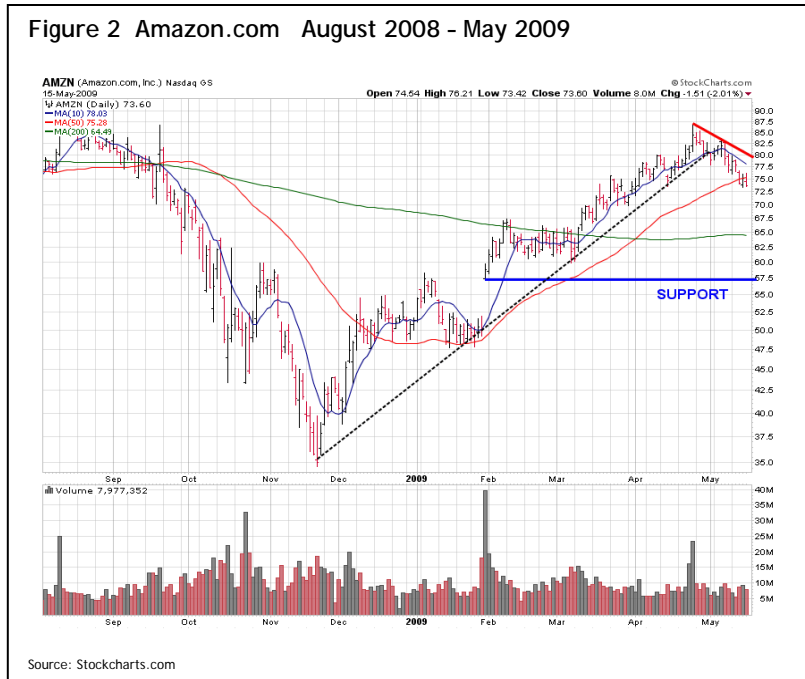
Instead, I prefer to simplify. When it comes to technical trades a simple approach is to invest with the trend. When markets were rebounding from the March lows, we were long. Now that they are reversing, we look to go short.

Considering the rally since March and subsequent pullback, we can easily find stocks that have violated uptrends and look to be breaking lower. However, in this environment that is not enough. With sharp rallies, we often face stocks that were traveling in parabolic uptrends that are well above their moving averages. When we see these stocks break lower it does us no good as the initial uptrend should not have been trusted and the distant moving averages

indicate a stock that remains overbought. Instead, we look for consistent, long-lasting uptrends that have recently broken down and moving averages that will pressure the stock lower. While such strict criteria limit our universe, they increase our odds of success.

Such a search brings us to this week's technical trade—Amazon.com (AMZN) (Figure 2). As most stocks pushed to new lows in March, AMZN defied skeptics. Despite being a retailer reliant upon discretionary spending in a deepening recession, AMZN registered its lows in November 2008 and managed to rally 149% in less than five months. During the move, a steady uptrend (black line) guided the shares higher. When AMZN reported strong earnings, a gap higher established support (blue line) that has yet to be tested. While this was occurring, both the 10-day and 50-day moving averages (MA) lent credence to the belief that a steady accumulation was underway.

Over the past three weeks the tone has changed. Since topping on April 24, a downtrend (red line) has



driven the shares lower and the stock now rests at a level below both the 10-day and 50-day MAs. Within this movement, the 10-day MA has started declining and is quickly approaching the 50-day MA. A popular trading technique known as the double-crossover involves selling shares when the shorter MA (in this case the 10-day) drops below the longer MA (the 50-day). Given the technical damage done, the crossover is quickly approaching and a powerful sell signal is days away.

With a downtrend in effect, the current price below the key MAs, and a crossover pending, AMZN presents itself as an excellent short

sale candidate. Many investors have profits on positions accumulated over the prior months and should be taking gains as the market falters. Combine these factors and we should see a rush of sale orders over the coming weeks that will drive prices lower. I will position ahead of this move to earn the profits that will follow.

With a short bias, we turn toward price targets. The first line of support for AMZN will occur at the 200-day MA (currently \$64.49). When that price falters, we should expect a test of support at \$57.50. These targets present an expected gain between 11% and 22%. With such an expected

gain, we will start small and add to the trade as proven correct. **I recommend a 2% short position in AMZN as this week's technical trade. On a close below the 200-day MA, increase the position to 5% of the portfolio.**

FUNDAMENTAL TRADE

As a value investor, I believe every asset is attractive at a certain price. Whenever markets have moved to extremes and presented the opportunity to buy shares at depressed levels, I have been a ready buyer. Since value has outperformed growth in recent years, this approach has been wise and profitable.

The current bear market, however, has altered my thinking. During this crisis, all correlations have zoomed to 1 as markets imploded worldwide, cheap stocks became cheaper, and a value bias led to losses. Knowing that the world has indefinitely changed and we can no longer invest in a vacuum, today I consider the expected trend of prices before making an investment selection. Believing that lower prices

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>
1Q 2009	30%	151.67	187.29	23%	179.00	18%
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%

lie ahead, I will be a seller rather than a buyer at this time.

Having bought shares at the market lows, we are now positioned to take profits ahead of the expected decline. Consider the purchase of Cisco Systems (CSCO). Believing fair value was \$18, we purchased CSCO on March 2 at \$14.31. Within a week the market bottomed and prices headed higher. In spite of this week's decline, we still have a 25% gain in just over two months.

With a large gain, expectations that the broad market will head lower, and a fully valued stock price, the only choice is to sell the shares. As we enter a volatile trading market, many opportunities will exist to buy stocks at bargain levels and then sell them when they reach fair value. Repeating this process will accumulate large gains and

reduce risk. Within our portfolio, this approach has allowed fundamental trades to account for 58% of the total profit. In the future we will be buyers once more. Until then, prudence reigns. **I recommend selling the CSCO position as this week's fundamental trade.**

OPTION TRADE

This marks the 29th issue of *EPIC Insights*. In the past 28 issues, I have recommended 23 different option trades. This equates to a new idea 79% of the time. That percentage is about to drop. Like the last two weeks, I will not describe a new idea here, but instead prefer to return to the trade we have been discussing for many weeks—First Solar (FSLR).

Three weeks ago, we sold a FSLR straddle expecting that any post-earnings move would reverse itself. Although a portion of the

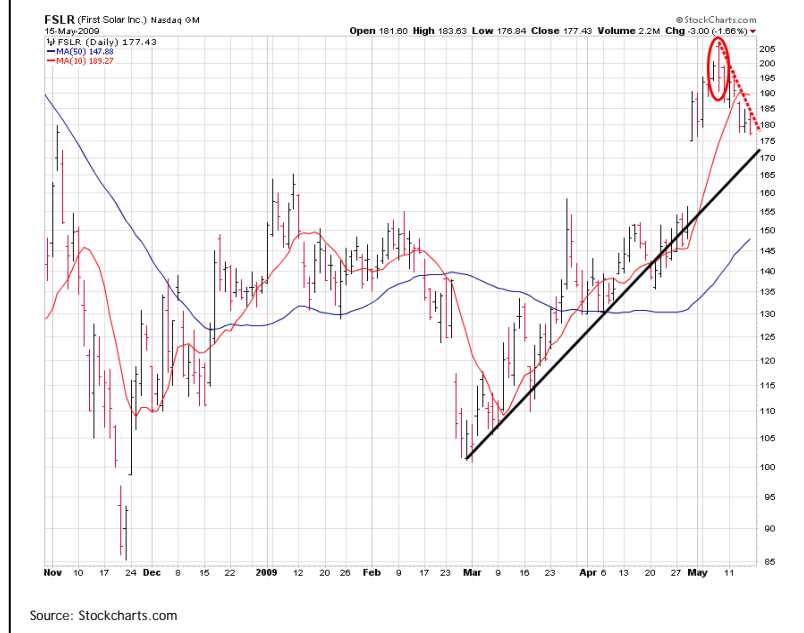
rally disappointed (**Figure 3**), the shares remain sharply higher. This left us with a small loss on the trade. With the expectation that FSLR would continue lower, we allowed the short put to expire and rolled the call to June.

We now find ourselves short the FSLR June 145 call (QHB+FI). Being short of an in-the-money call is equivalent to being short of the underlying shares. Therefore, any drop in FSLR's price will benefit our position and any increase will hurt us. With a synthetic short position, we must gauge the future path of the stock.

As the FSLR chart illustrates (**Figure 4**), the future is bleak. Six days after gapping higher, FSLR created an upside reversal as the price opened higher on the day and then closed lower (red circle). Since then the stock has formed a downtrend (red line) and is trading below the 50-day MA. Combining these factors we see a bearish picture that points to lower prices. Therefore, our short call position will profit as the shares decline.

The FSLR trade serves as a perfect example of the roller

Figure 4 First Solar November 2008 - May 2009



coaster investors face. In a matter of days, we went from a painful mistake to a likely profit. The lesson we should take is that belief in our views and discipline are paramount. Further, position sizes should remain at levels where correct decisions increase our wealth, yet flexibility remains to correct for poor trades. Had the FSLR straddle represented too great a percentage of our portfolio we would have been forced into losses. Had we reacted to temporary market setbacks we would have been forced into losses. Instead, we are left in an excellent position which will soon move in our favor. As this position

demonstrates, patience leads to profits.

CURRENT RECOMMENDATIONS

This week was an excellent example of modern portfolio theory at work. By combining option positions, stocks, and bonds we have developed a portfolio that limits risks and improves returns. As Markowitz showed, we should not concern ourselves with the riskiness of one instrument, but how the instruments perform when combined with one another.

For the week we saw a 0.1% increase while the S&P 500 declined 5.0%. **Since inception we show a gain of**

18.7% versus a decline of 8.9% for the S&P 500 (Figure 5). When you consider that we have never been more than 50% invested at any time and that our current portfolio is only 17% invested in the equity markets, both the absolute and relative returns are very impressive.

With our risk-averse stance, we should do well over the coming week. I believe equity markets are heading lower and the Dow will test its 50-day MA. Content with the stocks we own and seeing no need to gallop into a coming freight train, we will maintain our positions over the coming week. Other than the trades outlined in this newsletter, no other action is recommended at this time.

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>
ABFS	98	\$23.74	\$24.40	\$2,327	\$2,391	2%
BZF	163	\$19.62	\$21.31	\$3,198	\$3,474	3%
CSCO	136	\$14.31	\$17.94	\$1,946	\$2,440	2%
EFA	(67)	\$31.60	\$43.75	(\$2,117)	(\$2,931)	-2%
EVF	1,236	\$3.32	\$4.29	\$4,104	\$5,302	4%
EWA	264	\$11.41	\$14.99	\$3,012	\$3,957	3%
EWC	184	\$16.34	\$20.01	\$3,007	\$3,682	3%
EWZ	88	\$34.17	\$47.81	\$3,007	\$4,207	4%
GE	135	\$14.68	\$12.84	\$1,982	\$1,733	1%
GIS	37	\$58.05	\$52.61	\$2,148	\$1,947	2%
GLD	(55)	\$86.03	\$91.52	(\$4,732)	(\$5,034)	-4%
GS	30	\$119.34	\$134.51	\$3,580	\$4,035	3%
HYG	41	\$75.25	\$73.80	\$3,085	\$3,026	3%
JPM	110	\$31.86	\$35.00	\$3,505	\$3,850	3%
KO	72	\$42.20	\$44.96	\$3,038	\$3,237	3%
LOD	31	\$100.19	\$97.20	\$3,106	\$3,013	3%
MOT	490	\$4.19	\$5.91	\$2,053	\$2,896	2%
MS	(165)	\$21.60	\$26.05	(\$3,564)	(\$4,298)	-4%
MSFT	100	\$19.90	\$20.20	\$1,990	\$2,020	2%
NLS	363	\$2.83	\$1.02	\$1,027	\$370	0%
NOK	189	\$15.90	\$14.09	\$3,005	\$2,663	2%
PFE	126	\$15.76	\$15.01	\$1,986	\$1,891	2%
QQQQ	(36)	\$26.09	\$33.31	(\$939)	(\$1,199)	-1%
TBT	90	\$40.19	\$49.13	\$3,617	\$4,422	4%
USO	170	\$27.72	\$31.30	\$4,712	\$5,321	4%
FSLR June 145 Call	(300)	\$36.00	\$35.00	(\$10,800)	(\$10,500)	-9%
MA Jan 90 Put	100	\$7.00	\$3.60	\$700	\$360	0%
SPY Sep 77 Call	(300)	\$3.50	\$13.20	(\$1,050)	(\$3,960)	-3%
SPY Sep 77 Put	300	\$13.60	\$4.00	\$4,080	\$1,200	1%
Cash Position					\$79,170	67%
Portfolio Total					\$118,686	
<i>Portfolio Metrics:</i>						
<i>Portfolio Return</i>			18.7%			
<i>S&P 500 Return</i>			-8.9%			
<i>Portfolio Beta</i>			0.3			
<i>Portfolio Yield</i>			1.9%			
<i>Equity Exposure</i>			17%			
<i>Net Exposure</i>			33%			
<i>Total Exposure</i>			62%			

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.

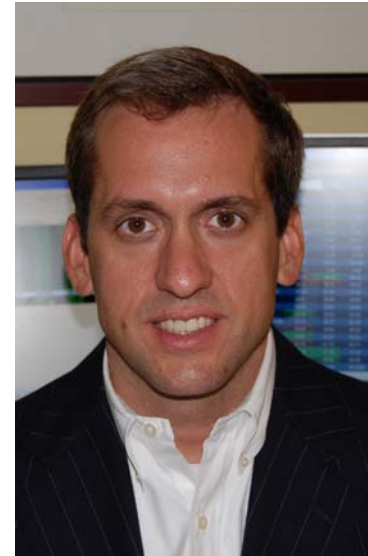
Option Trade – Based on the market environment, I will recommend option trades. In general, I prefer to write, rather than buy, options and will always look for opportunities to receive premium while hedging my risk.

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.



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, or 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
www.epicadvisorsllc.com

Circulation
BLAIN REINKENSMAYER

Design & Layout
CSP RESEARCH