

# EPIC INSIGHTS

Vol. 2, No. 22

A PUBLICATION of EPIC ADVISORS, LLC

June 1, 2009

## THE WEEK AHEAD

Those expecting the markets to offer clear, decisive answers are destined for frustration. At times markets react to events in rational ways, but often they seek to frustrate us at every turn. Consider the movement of the Dow Jones Industrial Average (Dow) since January (Figure 1). Weakness early in the year led to a sharp decline (red line) as people feared the economy was descending into the abyss. Just as quickly, the market determined this view was incorrect and a sharp rally (black line) completed a classic V-shaped rebound. As this process was unfolding, economic and company-specific information dictated the ebb and flow of prices. Since the Dow topped out nearly three weeks ago at 8,575 (black arrow), less concern has been paid to news and more to the market's technical patterns. Recently, prices have



bounced in a tight trading range (black dotted lines). As I mentioned on my recent appearance on Canada's [Business News Network](#), the rising 50-day moving average (MA) and falling 200-day MA are setting up a key inflection point. Just as a coil that gets compressed for too long will eventually spring loose, we should expect stock prices to come unbound shortly. If the Dow can rally above both the recent high and the 200-day MA (8,779) we should

expect the market to eclipse 9,000 as the rally continues (black box). However, a break below the 50-day MA (8,088) would open the door to 7,400 (red box) with a likely retest of the March low (6,547). Investors will be well served to watch these price points and take action once the trend becomes clear.

Even though stock prices have moved with their own rhythm over the past few weeks, we should expect them to eventually be driven

by business and economic news. The upcoming week of 6/1 to 6/5 (**Figure 2**) will provide the catalysts to allow such a move to occur. As with the first week of every month, our attention will be glued to the employment picture. While recognizing that employment is a lagging indicator that will bottom well after the recession has already ended, we do not underestimate the effect that disappearing jobs has in a consumer-driven recession. For the specifics of the week, **Monday** brings personal income, personal spending, and construction spending. **Tuesday** features pending home sales and domestic vehicle sales. Everyone knows the horrors the auto industry has faced, yet an examination of domestic vehicle sales shows how far the industry has fallen. Since 1967, the monthly domestic sales report has averaged 11.4 million. As recently as 2004, the figure was over 14 million. This month we are set to see half that amount. Over the past 40 years, domestic sales have dropped to 7 million or below only 11 times. Unfortunately, four of those 11 events have occurred during the current year.

**Figure 2 Weekly Calendar**

Day	Date	Announcement	Time	Estimate	Prior
Monday	6/1	Personal Income	8:30 AM	-0.2%	-0.3%
		Personal Spending	8:30 AM	-0.2%	-0.2%
		ISM Manufacturing	10:00 AM	42.0	40.1
		Construction Spending (MoM)	10:00 AM	-1.8%	0.3%
Tuesday	6/2	Pending Home Sales (MoM)	10:00 AM	0.3%	3.2%
		Domestic Vehicle Sales		7.0M	7.0M
Wednesday	6/3	ADP Employment Change	8:15 AM	-530k	-491k
		ISM Non-manufacturing	10:00 AM	45.0	43.7
		Factory Orders	10:00 AM	0.5%	-0.9%
		Bernanke Before House Budget Committee	10:00 AM		
Thursday	6/4	Nonfarm Productivity (1Q Final)	8:30 AM	1.2%	0.8%
		Initial Jobless Claims	8:30 AM	620k	623k
		Continuing Jobless Claims	8:30 AM	6850k	6788k
Friday	6/5	Change in Nonfarm Payrolls	8:30 AM	-530k	-539k
		Unemployment Rate	8:30 AM	9.2%	8.9%

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

**Figure 3 Periods of Sustained Job Loss**

Initial Month	Ending Month	Duration (months)	Total Jobs Lost	Estimated Population	Loss as % Population
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	May-09	17	6.27	305.96	2.0%

*Note: Jobs lost and population numbers are in millions*

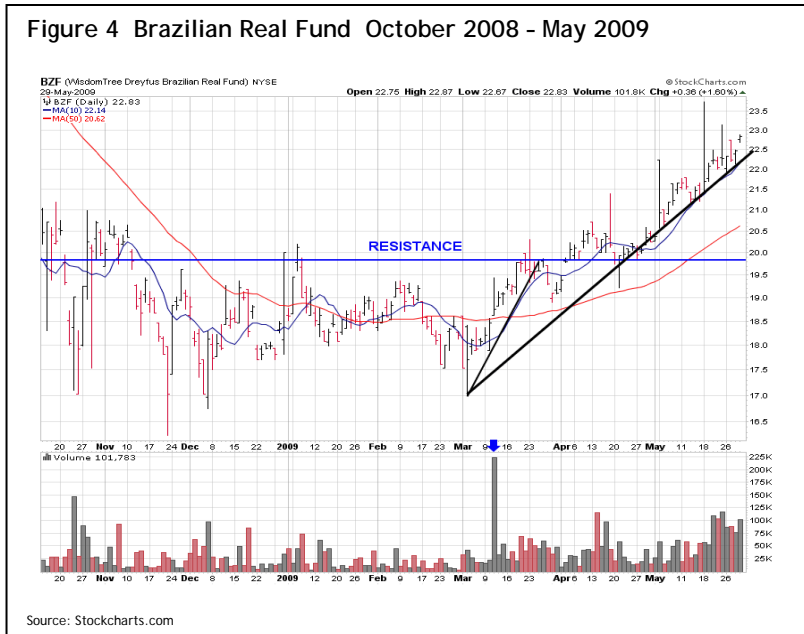
**Wednesday** gives us our first glance of the employment picture as the ADP report is forecast to show a loss of 530,000 jobs. **Thursday** offers reports on non-farm productivity and the weekly employment report. **Friday** ends the week with the report we are all anxious to see—the monthly employment data. The consensus calls for a loss of 530,000 jobs and an increase in the

unemployment rate to 9.2%. I continue to believe unemployment will peak when it exceeds 10% and the only question that remains is how long will it take for us to reach that moment. When we examine the trend and duration of the current numbers of jobs lost during the recession (**Figure 3**), we have few historical comparisons. The past 17 consecutive months of job loss is matched in duration only by the 1981-

1982 period. Total number of jobs lost and its percentage of the population exceed any post-World War II comparisons. While optimists will highlight the fact that the rate of decline is slowing, a loss of 530,000 is still a massive number. Examine the monthly data from 1960 to October 2008 and you will only find one month where jobs lost exceeded 530,000. Therefore, relying on the falling rate of decline to justify economic recovery is premature. In fact, we have now reached the point where the only historical comparison to draw is that of the Great Depression. Suffice it to say, that is not a comparison any of us long to make.

### *TECHNICAL TRADE*

Jim Cramer is among the most discussed media personalities. Some despise his antics while others enjoy his insights. While I understand the arguments on each side, I approach Cramer from a different viewpoint. Since I began writing this newsletter, my goal has always been to create at least three investment ideas each week that can be combined into a portfolio that the average



retail investor could use to take charge of their financial future while maintaining control over decisions. Based on the feedback I have received and the results the portfolio has earned, we are on our way to achieving this goal.

So how does this relate to Jim Cramer? One of the more insightful moments during the Jim Cramer/Jon Stewart debate occurred when Cramer tried explaining how his show and CNBC in general need to generate ideas to fill TV time. When Stewart quipped that Cramer should perhaps do less, those words resonated. The fact is when we search for new trades each week, we often must work with what the markets

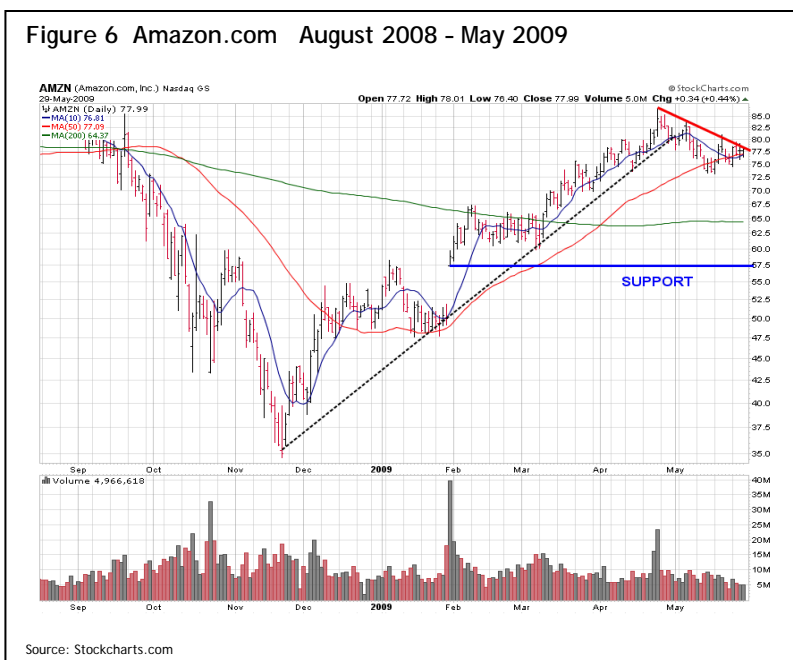
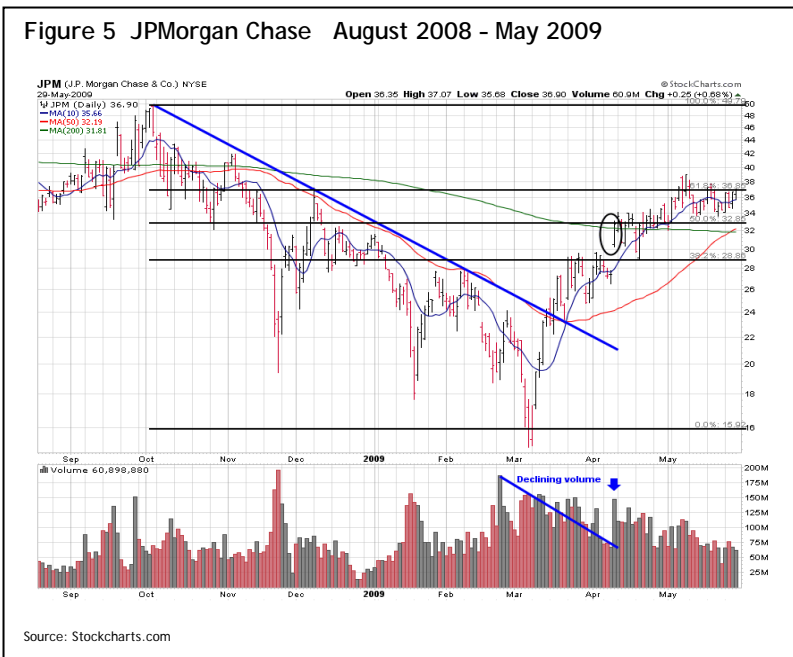
provide us. At times, the markets offer tremendous opportunities that we must seize. Other times, we serve ourselves best by doing less and waiting for an appropriate time to act.

With the broad market in a tightening trading range, initiating new technical trades is not worth the risk. Instead of recommending a new idea, I will use this section to reflect upon the technical trades we currently have and comment on what the charts are indicating.

Our current technical trades are long of the Brazilian Real Fund (BZF), long of JPMorgan (JPM), short of Amazon.com (AMZN), and short of the S&P 500 Homebuilders ETF (XHB).

With technical trades, we must monitor price movements that counter our theses. Only by keeping positions that move with the expected trend can we expect to profit.

Examining the four stocks, we see this approach in action. We purchased BZF (Figure 4) to benefit from a weakening dollar. With BZF having sliced through resistance and maintaining a powerful uptrend, we are sitting on a 16% profit as this position continues moving in our favor. JPM (Figure 5) continues to overcome Fibonacci retracement levels and appears destined to trade above \$40 in the coming weeks. We currently have a 15% profit and I expect it to grow larger. AMZN (Figure 6) remains contained by a downtrend as it flirts with its 50-day and 10-day MAs. By not bouncing decisively off its moving averages, AMZN continues to look like a stock that is destined to break violently lower after its most recent bout of consolidation. Despite being 6% underwater, I believe this position will yield large gains. Finally, XHB (Figure 7) is our most recent short position and continues to behave as expected. We are



flat on the position as the price remains contained within a downward sloping channel (green lines) and should fall below \$10 over the coming weeks.

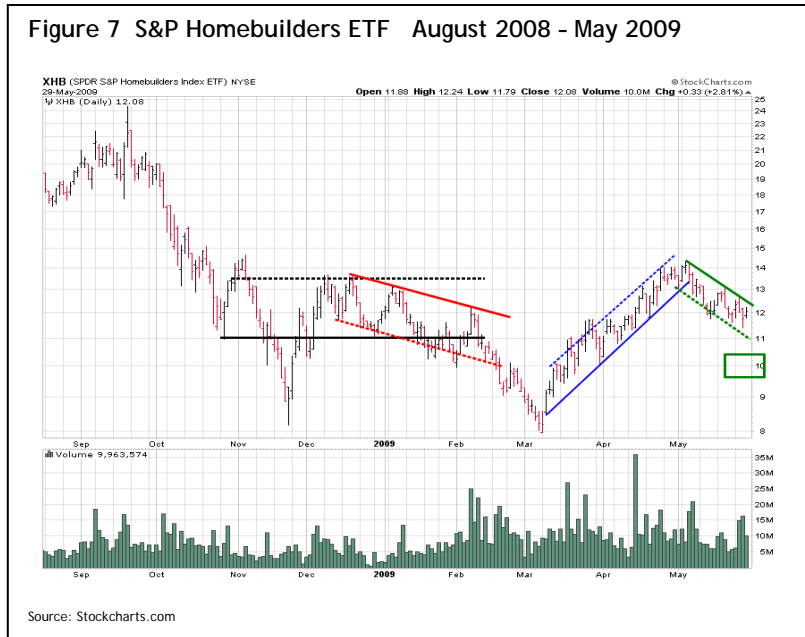
Investors believe they must constantly act in order to generate positive performance. This is often true, but sometimes taking no action is the best approach. Believing that

future weeks will provide opportunities where the rewards outweigh the risks, we will do less until the environment changes.

## *FUNDAMENTAL TRADE*

While technical trades in a tightening range-bound market make for difficulty, fundamental trades have no such issue. With fundamental trades, we are buying a piece of an operating business that will evolve over years. As investors, we perform due diligence in order to determine an estimate of fair value, wait for the market to provide us an opportunity to purchase shares at a discount to that fair value, and then act accordingly. While attention must be paid to the overall direction of the market, we are more concerned with the individual companies and the opportunities they provide.

With these directions in mind, we turn our attention to retailers. There is no dispute that the current recession has hammered retail businesses. Many once prominent chains no longer exist and others are retrenching. However, as



markets have rallied from their March lows, the broadline retailers have been on a tear. With the Dow still 3% lower on the year, broadline retailers are 42% higher. Within the group we also see large divergences with the most speculative names 50% higher while their more conservative brethren show negative year-to-date performance. Within this divergence, I see opportunities.

Of the 17 names constituting this market segment, three show negative year-to-date performance—Pricemart (PSMT), Costco (COST), and Wal-Mart (WMT). While I am unfamiliar with PSMT and find COST to be expensive,

WMT offers excellent value. Despite its size, WMT consistently finds ways to improve its core business. Its cash-conversion cycle is at its best level and has improved by 24 days since 2002. Return on equity and profit margins are ahead of those of WMT's peers and turnover ratios continue improving. In an environment where more shoppers are migrating to its segment, WMT continues to capture share and improve its business.

With such a track record, you would expect the shares to shine. Instead, WMT lags its peers. This has resulted in an attractive valuation prospect with the shares trading at a 2.2% dividend yield and a 14 P/E ratio.

I have monitored this company for years with the hopes of buying the stock at a discount to fair value. With the stock down on the year, that time has come. Using a variety of valuation models, I believe fair value is \$59. At current prices, the market provides us the opportunity to own an excellent company at a 16% discount to fair value, and I will take advantage.

I view purchasing shares in WMT similarly to the decision I made months ago to buy Coca-Cola (KO). Seeing an opportunity to own an excellent franchise at a discount to fair value, we purchased KO and now have a 16% profit. WMT holds a similar promise. By waiting for the market to provide us with opportunities, we can build a portfolio of excellent companies at reasonable valuations that will perform for years into the future. Stocks are ownership interest in operating businesses, and strong businesses will ultimately prevail. **I recommend a 3% position in WMT as this week's fundamental trade.**

### *OPTION TRADE*

One of the excellent features of options markets

is that they allow us to create positions that cannot be achieved with stocks alone. As an example, consider the state of the Dow. As shown in Figure 1 on the front page of this newsletter, prices are in a tight trading range that will eventually be broken. If the range breaks higher, the Dow will travel above 9,000. A break lower takes the Dow toward 7,400. Knowing a price move is coming, but not knowing the direction of the move, makes using stocks to profit difficult. While plenty of instruments profit from a move in either direction, few will profit regardless of direction. However, if we examine option prices we find that a trade is possible.

To trade an expected large price move, two strategies can be deployed. The first is a trade we have done many times—a straddle. A long straddle involves owning a put and call with the exact same strike. It represents a prediction that prices will move sharply. If prices move higher, the call increases while the put loses value. Were prices to fall, the opposite occurs. If we receive a large enough move in either direction, the gain from one option

overwhelms the loss from the other and results in a profitable trade.

Using the DIAMONDS Trust (DIA) as a proxy for the Dow, July option prices are expecting a dramatic price move. To buy the at-the-money straddle, we would expend \$6.20. In order to break even on this trade, we would need to see the Dow trade to either above 9,160 or below 7,920. This range coincides with my upside price target and allows for some profit to the downside. However, given the wide range (15%) and large cash outlay, I find the straddle to be uneconomical.

This leads me to the next way to profit from a large price move—a strangle. Similar in nature to a straddle, a long strangle involves an in-the-money call combined with an in-the-money put. By using in-the-money options, my outlay is capped at the amount of time value spent while maintaining the same profit range.

As an example, consider the DIA August 83 calls (DAV+GE) and the DIA August 86 puts (DAV+SH). At current prices, we can purchase the calls for \$4.40. That option gives us

the right to buy DIA for \$83 when the current price of DIA is \$85.40. Therefore, \$2.40 of the purchase price represents the difference in prices and the remaining \$2 is time value. Similarly, the puts will cost \$3.20 with \$0.60 representing the difference in price and the remaining \$2.60 representing time value. With this trade, the cost of time value is what we have at risk. If the DIA did not change price between now and July 18, time value would disappear and the difference in price would be returned to us.

With \$4.60 of time value at risk, this represents the price movement needed to turn a profit. Applying this amount to each option price, we will earn a profit if the Dow trades above 9,060 or below 7,840. Interestingly, this range is 20 points tighter than that needed for the straddle to become profitable and offers similar maximum and minimum prices. Also, since the maximum potential loss is nearly 25% lower, the strangle offers clear benefits over the straddle.

Believing that prices are preparing for a large move and having analyzed two different ways of benefiting,

**I recommend a 2% position in a long strangle as this week's option trade.** This equates to five contracts for my portfolio. Adjust the quantity to conform to your portfolio. **To execute this trade, buy five DAV+GE and buy five DAV+SH.**

### *CURRENT RECOMMENDATIONS*

As always we mark our portfolio to the closing prices each Friday evening. Such a habit has me monitoring the screen every Friday afternoon as I compile ideas for the newsletter and consider our portfolio versus the broad market. Typically, little occurs during the final 60 minutes as traders are already contemplating the weekend. This week was not typical. What had been a strong week for the market turned even stronger as the S&P 500 increased over 1.3% during the last 30 minutes of trading. While such a sharp move occurring at a month-end is often window dressing that should be reversed the following day, we will await Monday's open to determine whether the price move will sustain itself.

Combining the late sprint forward with positively received economic news, the market performed well last week. For the week we saw a 0.8% increase in our portfolio while the S&P 500 increased 3.6%. Given all the actions taken over the last few weeks, we have a portfolio that is 15% invested in stocks and has a beta of 0.1. With such a low beta, we should expect our portfolio to move 10% of the S&P 500, or 0.36%. With a gain of over twice that amount, we are pleased with the ability to continually add value for our subscribers.

**Since inception we show a gain of 20.1% versus a decline of 5.1% for the S&P 500 (Figure 8).** Believing the current trading range will resolve itself over the coming weeks, we will remain disciplined and wait for market confirmation before taking action. With a large cash position and market-neutral stance, we can react to the market's movements. Great results do not come from predicting the direction in which a trading range is resolved, but by acting decisively when the trends become clear.

**Figure 8 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	\$28.40	\$2,327	\$2,783	2%
AMZN	(32)	\$73.96	\$78.10	(\$2,367)	(\$2,499)	-2%
BZF	163	\$19.62	\$22.83	\$3,198	\$3,721	3%
DBC	164	\$21.77	\$23.20	\$3,570	\$3,805	3%
EFA	(67)	\$31.60	\$47.45	(\$2,117)	(\$3,179)	-3%
EVF	1,236	\$3.32	\$4.73	\$4,104	\$5,846	5%
EWA	264	\$11.41	\$16.52	\$3,012	\$4,361	4%
EWC	184	\$16.34	\$22.96	\$3,007	\$4,225	4%
EWZ	88	\$34.17	\$55.71	\$3,007	\$4,902	4%
GE	135	\$14.68	\$13.50	\$1,982	\$1,823	2%
GIS	37	\$58.05	\$51.18	\$2,148	\$1,894	2%
GLD	(55)	\$86.03	\$96.17	(\$4,732)	(\$5,289)	-4%
GS	30	\$119.34	\$144.61	\$3,580	\$4,338	4%
HYG	41	\$75.25	\$77.84	\$3,085	\$3,191	3%
JPM	110	\$31.86	\$36.74	\$3,505	\$4,041	3%
KO	72	\$42.20	\$49.10	\$3,038	\$3,535	3%
LQD	31	\$100.19	\$98.00	\$3,106	\$3,038	3%
MOT	490	\$4.19	\$6.10	\$2,053	\$2,989	2%
MS	(165)	\$21.60	\$30.27	(\$3,564)	(\$4,995)	-4%
MSFT	100	\$19.90	\$20.86	\$1,990	\$2,086	2%
NLS	363	\$2.83	\$1.40	\$1,027	\$508	0%
NOK	189	\$15.90	\$15.21	\$3,005	\$2,875	2%
PFE	126	\$15.76	\$15.17	\$1,986	\$1,911	2%
QQQQ	(36)	\$26.09	\$35.38	(\$939)	(\$1,274)	-1%
TBT	90	\$40.19	\$52.76	\$3,617	\$4,748	4%
USO	170	\$27.72	\$36.37	\$4,712	\$6,183	5%
XHB	(197)	\$12.12	\$12.08	(\$2,387.64)	(\$2,380)	-2%
FSLR June 145 Call	(300)	\$36.00	\$43.00	(\$10,800)	(\$12,900)	-11%
MA Jan 90 Put	100	\$7.00	\$3.00	\$700	\$300	0%
SPY Sep 77 Call	(300)	\$3.50	\$13.60	(\$1,050)	(\$4,080)	-3%
SPY Sep 77 Put	300	\$13.60	\$3.00	\$4,080	\$900	1%
VIX July 32.50 Call	500	\$4.40	\$3.90	\$2,200	\$1,950	2%
Cash Position					\$80,744	67%
Portfolio Total					\$120,104	

*Portfolio Metrics:*

<i>Portfolio Return</i>	20.1%
<i>S&amp;P 500 Return</i>	-5.1%
<i>Portfolio Beta</i>	0.1
<i>Portfolio Yield</i>	1.9%
<i>Equity Exposure</i>	15%
<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.

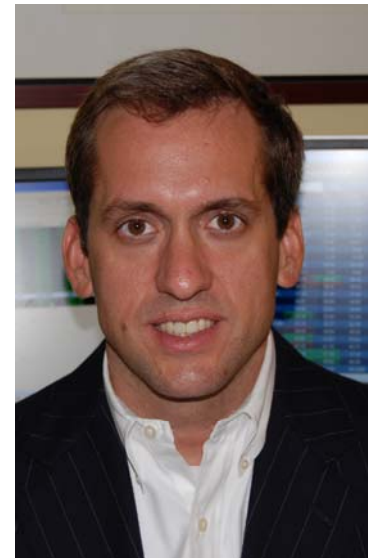
**Option Trade** – Based on the market environment, I will recommend option trades. In general, I prefer to write, rather than buy, options and will always look for opportunities to receive premium while hedging my risk.

**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.



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Circulation  
BLAIN REINKENSMAYER

Design & Layout  
CSP RESEARCH