

EPIC INSIGHTS

Vol. 2, No. 24

A PUBLICATION of EPIC ADVISORS, LLC

June 15, 2009

THE WEEK AHEAD

Since the credit crisis engulfed markets nearly nine months ago, investors have become accustomed to wild swings. Whether you were bullish or bearish, volatility marked all decisions as huge volumes gave rise to massive market movements. The current rally from the March lows has embodied such movements. From its low of 6,547 on March 9, the Dow Jones Industrial Average (Dow) roared to 8,574 on May 8. Although the move was sharp, the path was rocky. Of the 43 trading days between those two dates, the Dow moved 100 points in either direction 23 times (54% of the time) and it moved at least 1% on 29 of those days (67%). In the 23 trading days since, the Dow has climbed an additional 4.5% in a much more muted fashion. Only on seven days (30%) has the Dow moved more than 100 points and on only eight days (35%) has it

moved more than 1%.

Last week's movement fit this trend perfectly. In this newsletter last week I described how an absence of market specific news would force technical trends to dominate. When I made this comment I expected some wide swings. Instead we saw a continuation of dull trading patterns. For the week, the Dow moved higher 36 points with Thursday's 31-point increase representing the largest individual move. Those who had hoped for

volatility were left wanting as calm dominated.

If last week's lack of drama can be explained by a dearth of specific news items, the upcoming week of 6/15 to 6/19 (**Figure 1**) will be much different. Instead of limited data, we will need to digest many important data points. **Monday** should be the least volatile day as it features only one news event—the Empire Manufacturing report. **Tuesday** is jammed with information. It begins with earnings from Best Buy (BBY). As one of the few

Figure 1 Weekly Calendar

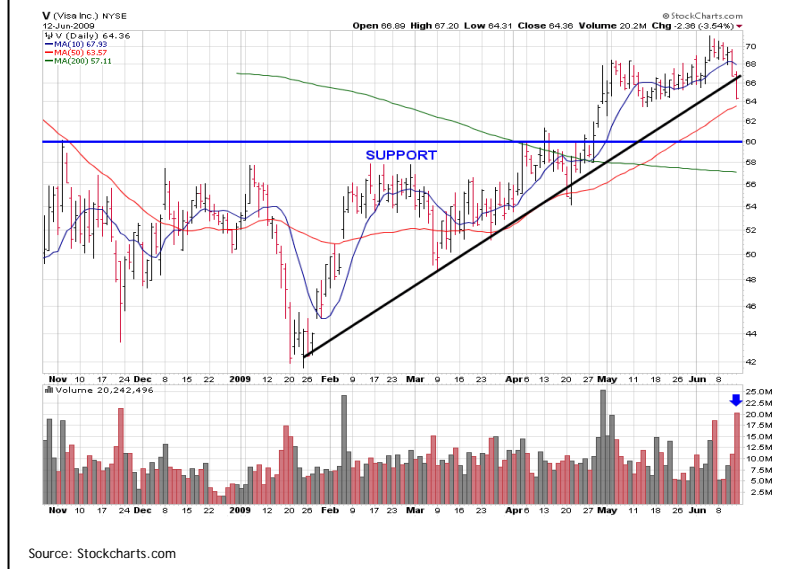
Day	Date	Announcement	Time	Estimate	Prior
Monday	6/15	Empire Manufacturing	8:30 AM	(6.0)	-4.5%
Tuesday	6/16	BBY Earnings	BMO	\$0.33	\$0.43
		Producer Price Index (MoM)	8:30 AM	0.6%	0.3%
		PPI Ex Food and Energy (MoM)	8:30 AM	0.1%	0.1%
		Housing Starts	8:30 AM	480k	458k
		Building Permits	8:30 AM	500k	494k
		Industrial Production	9:15 AM	-0.8%	-0.5%
		Capacity Utilization	9:15 AM	68.5%	69.1%
Wednesday	6/17	FDX Earnings	BMO	\$0.52	\$1.45
		Consumer Price Index (MoM)	8:30 AM	0.3%	0.0%
		CPI Ex Food and Energy (MoM)	8:30 AM	0.1%	0.3%
Thursday	6/18	Initial Jobless Claims	8:30 AM	605k	601k
		Continuing Jobless Claims	8:30 AM	6839k	6816k
		Leading Indicators	10:00 AM	0.9%	1.0%
		RIMM Earnings	AMC	\$0.94	\$0.84
Friday	6/19	June Options Expiration			

Note: BMO = Before Market Opens, AMC = After Market Closes

Note: All times are Eastern Standard Time (EST)

remaining electronic retailers, BBY is an excellent barometer of consumers' willingness to make purely discretionary purchases. From there, we see inflation via producer prices and an indication of future housing activity from housing starts and building permits. Many analysts will focus on permits and housing starts, but I am less interested. These metrics are at such depressed levels that one month's data will do little to indicate that housing has bottomed. Instead, we should focus on multiple-month trends to lend credence to the calls for a bottom. **Wednesday** will provide more indications of discretionary spending via Fed Ex's (FDX) earnings. Also, inflation data will be revealed via the consumer price index. **Thursday** brings the weekly employment report. We have seen a steady decline in initial claims and now await the final spike lower. Spikes lower in initial claims have an excellent history of predicting the end of recessions. With the rate of job loss slowing, we are all anxious for the news on this front to continue to improve. After the close, we will see earnings from Research in Motion (RIMM). RIMM

Figure 2 Visa November 2008 - June 2009



typically sees large price swings after earnings and I expect this quarter to be no different. **Friday** ends the week with the expiration of June options. This tends to be a volatile day as prices gravitate toward strike prices.

TECHNICAL TRADE

When I study charts in order to make trade recommendations, I look for a few basic ingredients. Trends must be well established so that their continuation or reversal is clear. Also, price targets must be observable. Finally, volume at key turning points helps to establish the validity of moves.

While such a recipe may seem easy to follow, I rarely find stocks that show all three key attributes.

When I do, I must take action as such opportunities often disappear quickly.

This week I have identified a stock that has the traits I seek—Visa (V).V has long been favored by the momentum crowd. Seen as a safe place to hide during the financial crisis, the stock benefited as global expansion and higher credit card acceptance provided tremendous tailwinds to its business. As V's prospects improved, the stock bottomed well before the broad market and rallied over 75% from its February low to its May high.

Now that move appears to be over as the stock has fallen from its recent high (**Figure 2**). The uptrend which had guided prices higher since February (black line) has now been broken. A general rule is the longer a trend remains in place, the more substantial it is. Therefore, when a long-lasting trend is broken, we should expect dramatic moves in the opposite direction.

Adding to the possibility of a sharp move from the trend reversal is the fact that the moves lower occurred on heavy volume (blue arrow).

Expecting lower prices, we now look for a price target. The immediate price would be the support level at \$60 (blue line). With a move off the recent high, this support level should stop any subsequent decline and offers a reasonable intermediate price target.

With a bearish technical pattern and an immediate price target calling for a 10% decline, V offers an excellent bearish trade. **I will seize this opportunity and recommend shorting V as this week's technical trade. Start with a 2% short position and look to add to**

the trade when prices begin moving in our favor.

FUNDAMENTAL TRADE

When we buy a stock we are taking an ownership position in a company. As the operating business moves up and down, we alternately prosper and suffer. Knowing that the core business will directly influence our investment performance, I gravitate toward opportunities where simple businesses with steady capital structures allow us to make decisions that are isolated from fads and trends.

This week I am focusing on a company that meets these criteria—K-Swiss (KSWS). Considering the industry in which it operates, KSWS may not at first glance appear to be a steady, predictable company. Competitors such as Nike and Adidas are constantly chasing celebrity endorsements, creating new products, and trying to capture the latest consumer fads.

KSWS take a much different approach. It focuses on one shoe, the Classic, that rarely changes designs. This tactic has enormous advantages

for an apparel company. While the company which constantly rolls out new models must concern itself with inventory and obsolescence, KSWS can focus on the long term. Product not sold this year does not face immediate liquidation, but instead is held until future periods. As long as the inventory levels remain reasonable, long trends can be used to operate the business efficiently.

Having established KSWS's steady, predictable business model we turn to the company's financial position and relative valuation. As the consumer-led recession took grip, KSWS saw its stock price fall over 50% as net income fell from \$76 million in 2006 to \$21 million in 2008. Despite the decline, the balance sheet has remained strong with nearly \$8 per share in cash and excellent liquidity. Assuming net income continues to deteriorate and does not better the recent \$21 million until 2012, I find the operating business to be worth \$6 per share. If you take an excessively conservative approach and assume my number is off by 50%, the shares still look

cheap. With cash of \$8 and an operating business conservatively worth \$3, I determine a fair-value target of \$11. With the shares now trading below \$9, we can buy an interest in the company at 20% below fair value. Consider the conservative approach taken to derive that price and KSWs offers the rare combination of large upside potential with limited downside risk. Looking to capitalize on this, I **recommend a 1% position in KSWs as this week's fundamental trade.**

OPTION TRADE

This week the calendar presents us a rare opportunity. Unfortunately it is one we will not be taking advantage of in this newsletter. As I mentioned in The Week Ahead, on Thursday Research in Motion (RIMM), an extremely volatile stock, will report earnings the day before options expire. For traders this represents a nirvana that calls for action.

As I have mentioned in many previous newsletters, earnings announcements offer the ultimate catalysts. When pricing an option two key components are the amount of time until

expiration as well as the volatility of prices between today and expiration. When a company has a catalyst with only one day remaining until expiration, the time factor disappears and we focus solely on volatility. This is where the nirvana exists as it allows us to ignore time value and speculate on a directional move.

I have earned some of my largest gains by taking out-of-the-money positions ahead of such triggers. In these cases, the options are typically cheap as a small move would cause the options to expire. When price changes are dramatic, the gains are large.

Unfortunately, such an event does not work well with the confines of this newsletter. I have no ability to predict where RIMM will trade in four days and which options will be out-of-the-money. Further, if we stick with traditional approaches, a purchase of options Monday will require us to spend large amounts of time value, thus defeating the purpose of the trade.

Considering these factors, I do not have a new option trade recommendation. Instead, I will alert investors

to the possibility of large moves. Those looking to do a trade should assess where RIMM is trading Thursday afternoon and determine which direction they expect prices to move. From there, look for an option position that will cost minimal amounts of capital, but also provide large gains were things to move in your favor.

CURRENT RECOMMENDATIONS

Last week featured minimal moves in the market. Our portfolio acted in a similar fashion. In such an environment, we expect stock picking to shine, and looking at our portfolio, that is what occurred.

For the week the S&P 500 increased 0.6% and our portfolio increased 1.1%. With our new positions moving in our favor, we were able to post solid results despite having only 19% of our portfolio invested in equities. As we have seen our portfolio grow while taking minimal market risk, we remain well positioned to react to future market moves.

Since inception we show a gain of 22% versus a decline of 2.3% for the S&P

500 (Figure 3). With such large relative and absolute performance, I remain focused on the future and where prices are headed. Recent trades have focused on the short side of the market and our portfolio continues to become more conservative over time. While I remain optimistic about the future, I am concerned by the inability of certain indices to better their recent peaks. Because these pockets of weakness may foretell lower prices, I am closely watching these prices.

The only trade we must address next week is the short FSLR 145 calls that will expire at the end of the week. I remain bearish on FSLR and continue to believe this trade will yield excellent results. Therefore, wait until Friday and then roll this position to future months. In order to do so, buy to cover the June calls and then short sell the same amount in the July contract. As always, this approach is different than our typical approach so if you would like clarification on how to manage this trade, please contact me via e-mail.

Figure 3 Portfolio Composition and Performance

<u>update</u> <u>Position</u>	<u>Quantity</u>	<u>Purchase</u> <u>Price</u>	<u>Current</u> <u>Price</u>	<u>Total</u> <u>Cost</u>	<u>Current</u> <u>Value</u>	<u>% Total</u>
ABFS	98	\$23.74	\$28.51	\$2,327	\$2,794	2%
AMZN	(32)	\$73.96	\$84.08	(\$2,367)	(\$2,691)	-2%
BZF	163	\$19.62	\$23.42	\$3,198	\$3,817	3%
COP	(54)	\$44.76	\$44.37	(\$2,417)	(\$2,396)	-2%
DBC	164	\$21.77	\$23.85	\$3,570	\$3,911	3%
EFA	(67)	\$31.60	\$48.43	(\$2,117)	(\$3,245)	-3%
EVF	1,236	\$3.32	\$4.83	\$4,104	\$5,970	5%
EWA	264	\$11.41	\$17.65	\$3,012	\$4,660	4%
EWC	184	\$16.34	\$23.03	\$3,007	\$4,238	3%
EWZ	88	\$34.17	\$56.88	\$3,007	\$5,005	4%
GE	135	\$14.68	\$13.51	\$1,982	\$1,824	1%
GIS	37	\$58.05	\$54.92	\$2,148	\$2,032	2%
GS	30	\$119.34	\$145.64	\$3,580	\$4,369	4%
HYG	41	\$75.25	\$79.74	\$3,085	\$3,269	3%
JPM	110	\$31.86	\$35.13	\$3,505	\$3,864	3%
KO	72	\$42.20	\$46.89	\$3,038	\$3,376	3%
LQD	31	\$100.19	\$99.02	\$3,106	\$3,070	3%
MOT	490	\$4.19	\$6.73	\$2,053	\$3,298	3%
MS	(165)	\$21.60	\$29.64	(\$3,564)	(\$4,891)	-4%
MSFT	100	\$19.90	\$23.33	\$1,990	\$2,333	2%
NLS	363	\$2.83	\$1.33	\$1,027	\$483	0%
NOK	189	\$15.90	\$15.68	\$3,005	\$2,964	2%
PFE	126	\$15.76	\$14.76	\$1,986	\$1,860	2%
QQQQ	(36)	\$26.09	\$36.65	(\$939)	(\$1,319)	-1%
TBT	90	\$40.19	\$56.59	\$3,617	\$5,093	4%
WMT	72	\$50.18	\$49.84	\$3,613	\$3,588	3%
XHB	(197)	\$12.12	\$12.14	(\$2,387.64)	(\$2,392)	-2%
DIA July 83/86 Strangle	500	\$6.85	\$7.85	\$3,425	\$3,925	3%
FSLR June 145 Call	(300)	\$36.00	\$35.00	(\$10,800)	(\$10,500)	-9%
MA Jan 90 Put	100	\$7.00	\$1.00	\$700	\$100	0%
SPY Sep 77 Call	(300)	\$3.50	\$18.00	(\$1,050)	(\$5,400)	-4%
SPY Sep 77 Put	300	\$13.60	\$1.15	\$4,080	\$345	0%
VIX July 32.50 Call	500	\$4.40	\$2.55	\$2,200	\$1,275	1%
Cash Position					\$77,349	63%
Portfolio Total					\$121,979	
<i>Portfolio Metrics:</i>						
Portfolio Return			22.0%			
S&P 500 Return			-2.3%			
Portfolio Beta			0.2			
Portfolio Yield			1.9%			
Equity Exposure			19%			
Net Exposure			37%			
Total Exposure			88%			

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.

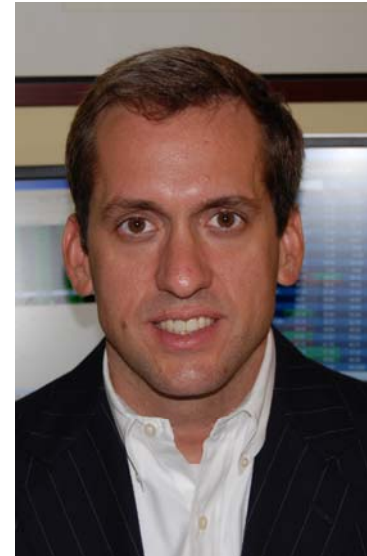
Option Trade – Based on the market environment, I will recommend option trades. In general, I prefer to write, rather than buy, options and will always look for opportunities to receive premium while hedging my risk.

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