

EPIC INSIGHTS

Vol. 2, No. 25

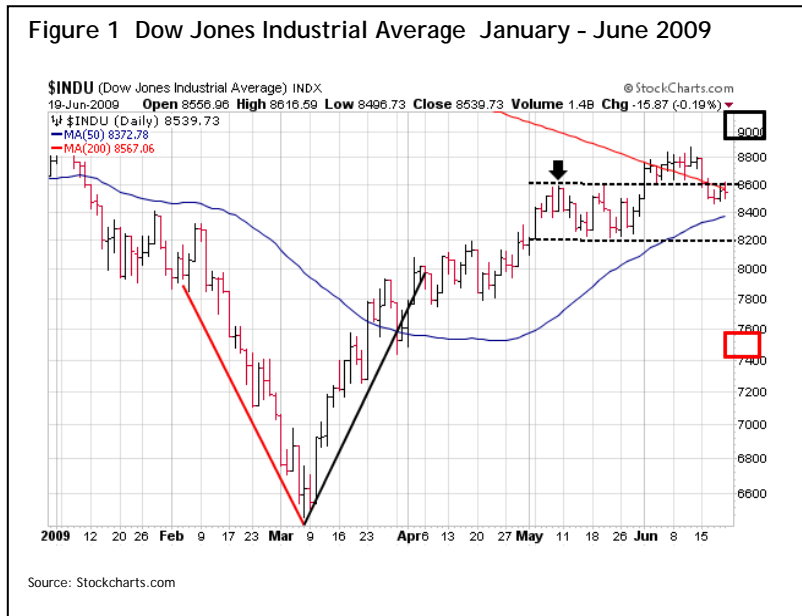
A PUBLICATION OF EPIC ADVISORS, LLC

June 22, 2009

THE WEEK AHEAD

Last week, the bulls took a beating. Having reigned supreme while the market worked 40% higher from its March low, the bulls seemed invincible. All news was construed to support stocks as the path of least resistance was higher. But over the past five trading days, that has changed. With the Dow Jones Industrial Average (Dow) falling below its 200-day moving average (MA), prices have returned to the persistent trading range which has lasted since early May (**Figure 1**). I have long felt this chart offers the key to the future. If prices can again rally above the 200-day MA, the Dow should move above 9,000 (black box). A break below the 50-day MA opens the door to 7,400 (red box). With these moving averages only 195 points apart, the inflection point is quickly approaching. Unless bargain hunters emerge that decide the Dow's weekly decline of 3%

Figure 1 Dow Jones Industrial Average January - June 2009



offers an attractive entry point, further declines lie ahead. Given the quick nature of the rally from the March lows, I fear that weakness will spur more weakness and prices will cascade lower.

At times, I am an impatient trader who anxiously awaits answers. With the market in a low-volatility trading range for nearly two months, this is one of those times. Believing we will see dramatic swings once the direction is determined, I

anxiously await the point where a new trend is established. Since news has driven this market since the March low, a data-heavy week may provide the catalyst we need. Lucky for me, the upcoming week of 6/22 to 6/26 (**Figure 2**) fits the bill.

Monday is the quietest day of the week with the only event being earnings from Walgreens (WAG). On **Tuesday** the pace with increases with reports on existing home sales and

earnings from Oracle (ORCL). As I did with housing starts last week, I advise we not become too enamored with one month's data on housing sales. Last week, housing starts, which were expected to be 485,000, actually were 532,000. Normally, topping estimates by 10% would be a time to rejoice. However, when you consider that since 1959 housing starts have averaged 1.5 million and during previous recessions have bottomed near 800,000, the actual number is very weak. Until starts climb above 800,000, we should view the data as moving from horrible to bad, not from bad to good. The same logic can be applied to existing home sales. Since collection began in 1999, existing home sales have averaged 5.8 million and have rarely been below 5 million. While a bounce to 4.8 million sales would be progress, we are still far from normality.

Wednesday brings a lot of information. Our attention will turn to durable goods and new home sales, but our main focus will be upon the Federal Open Market Committee's (FOMC) interest rate decision. While no one expects rates to be

Figure 2 Weekly Calendar

Day	Date	Announcement	Time	Estimate	Prior
Monday	6/22	WAG Earnings	BMO	\$0.56	\$0.58
Tuesday	6/23	Existing Home Sales	10:00 AM	4.82M	4.68M
		Existing Home Sales (MoM)	10:00 AM	3.0%	2.9%
		ORCL Earnings	AMC	\$0.44	\$0.45
Wednesday	6/24	MON Earnings	BMO	\$1.19	\$1.45
		Durable Goods Orders	8:30 AM	-0.8%	1.9%
		Durables Ex Transportation	8:30 AM	-0.5%	0.8%
		New Home Sales	10:00 AM	360k	352k
		New Home Sales (MoM)	10:00 AM	2.3%	0.3%
		FOMC Rate Decision	2:15 PM	0.25%	0.25%
		NKE Earnings	AMC	\$0.96	\$0.98
Thursday	6/25	Initial Jobless Claims	8:30 AM	600k	608k
		Continuing Jobless Claims	8:30 AM	6707k	6687k
		GDP - 1st Quarter Final	8:30 AM	-5.7%	-5.7%
		Bernanke Testifies before Congress	10:00 AM		
Friday	6/26	Personal Income	8:30 AM	0.3%	0.5%
		Personal Spending	8:30 AM	0.4%	-0.1%
		U. of Michigan Confidence	10:00 AM	69.0	69.0

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

adjusted, we will be looking for any indication the FOMC gives toward future actions. With some in the market expecting the FOMC to increase interest rates later this year, we may receive a statement that clearly indicates its future plans. **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. **Friday** ends the week with reports on personal income and personal spending.

TECHNICAL TRADE

Investing is a unique activity. For someone who grew up playing sports, I understand how age works against you. When we physically slow down, activities that were routine become more difficult. With certain intellectual activities, a similar pattern holds. Perhaps reading a book takes a little longer as our eyes must work harder to capture each word. With investing, the opposite often occurs. Over the years, we gain experiences and insights that allow us to recall past events and make quicker decisions.

For this reason, I often enjoy revisiting past ideas to determine whether the market has provided us a new opportunity. Knowing I possess a working knowledge of the stock, analysis becomes easier and insights more powerful. For this week's technical trade I return to an old favorite—Potash (POT).

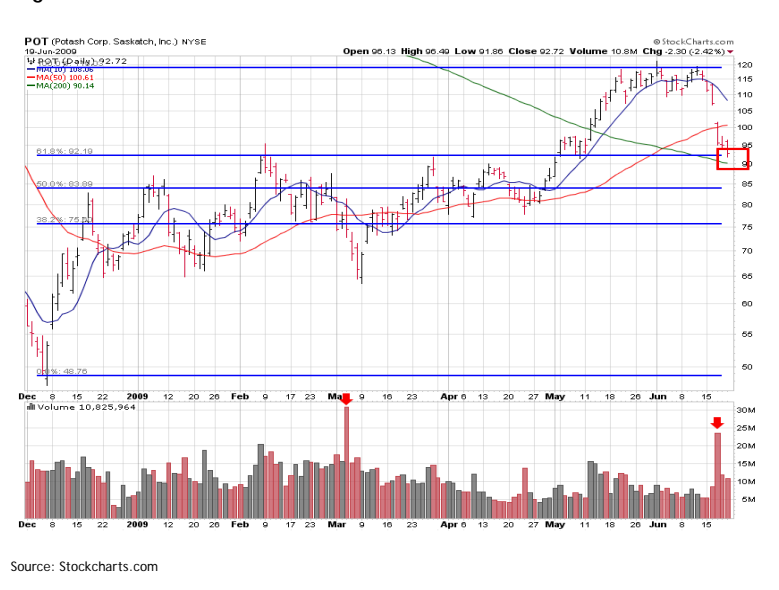
POT is a fertilizer company that is correlated to grain prices. When grain prices increase, farmers look to increase planting and buy more fertilizer. When prices drop, the opposite occurs. Knowing this correlation, it is easy to see why POT has rallied sharply over the last few months. As the business environment improved, so did its stock price.

However, over the past week, things have changed. For the week, the Powershares DB Agriculture fund (DBA), a grain proxy, fell 4.8%. During the same time frame, POT dropped 20%. Given the large divergence between these drops, we must determine whether this was a simple disconnect, or something more troubling is on the horizon. To answer this question, we turn to technical analysis.

Figure 3 Potash May 2008 - June 2009



Figure 4 Potash December 2008 - June 2009



To get the full picture, I studied the stock during two different time periods. The first covers price action since May 2008 and captures the journey from a high of \$240 to a low below \$50 (Figure 3). Of all the information on this graph,

the most important is the resistance/support level (blue line) at \$94. When prices were falling, this resistance level spurned each rally. Once it was topped, it became support. As the pressure on the stock has brought this

support back into play, we must see how prices react to this price level. As support failed Friday afternoon, we should expect the stock to drop much further.

Turning to a shorter time frame, I studied the rally from the December low to the recent high (**Figure 4**). Using Fibonacci retracements, we see that the recent sell-off has surrendered nearly one-third of the rally. The question is whether this represents all of the damage, or will prices drop further.

This chart has shown two distinct spikes in volume (red arrows). Both occurred with the stock dropping. Also, after the first occasion, prices continued to move lower. Were this pattern to repeat, we would see POT fall through both the one-third retracement and longstanding support. Given the downward momentum in this stock, I believe that such an event is occurring.

With POT down so much on the week and support having been violated, how should we trade this position? The simple answer is to become short. Convinced that much lower

prices will occur in the near future while being mindful of the large weekly drop, I will take a small short position and look to add as the market confirms my view. With that strategy, I **recommend a 2% short position in POT as this week's technical trade.**

FUNDAMENTAL TRADE

When everyone rushes toward the same idea, prices race higher. As a value investor, I gravitate toward what is out of favor. Therefore, sustained rallies neutralize my investment discipline and prevent me from buying solid companies at a discount to fair value. However, when everyone rushes away from an idea, I can apply my analysis to acquire shares of outstanding businesses at low levels.

When following such an approach, we need to understand whether stocks are cheap because of problems in the operating business or because investors have focused elsewhere.

The rally from the March lows has presented some interesting opportunities. Like most bear market

rallies, the weakest, most speculative companies have increased the most. In the current market, so many professional investors have trailed their respective indices that momentum chasing has become more pronounced. The outcome is that as speculative niche producers increase, diversified strong businesses lag.

Such events have presented excellent long-term investment options. When I first built my investment universe, I examined large companies with dominant brands such as Microsoft (MSFT), Coca Cola (KO), and others. Over the years I watched these companies receive premium valuations as investors paid for brand names and predictability. Over the past three months, though the market has favored beta over stability and I have been able to add some of these names to our portfolio as their prices dropped. This week, I will add another.

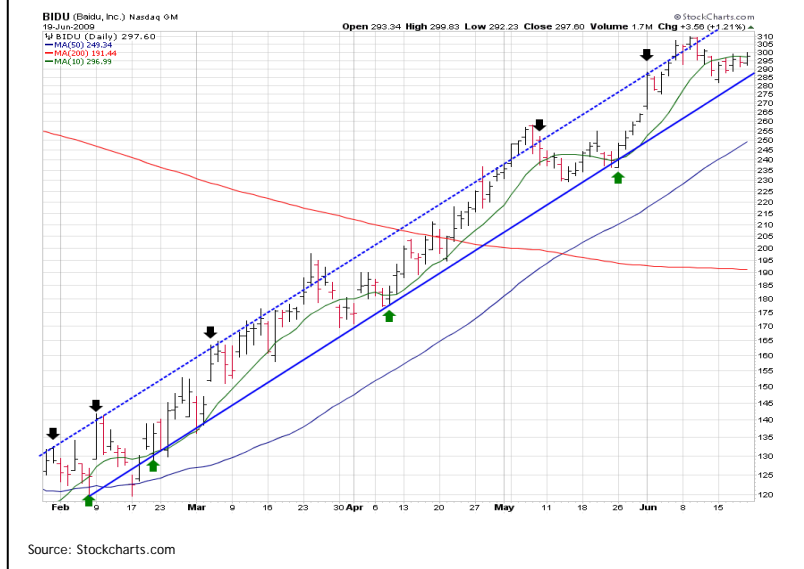
Procter and Gamble (PG) is among the dominant consumer franchises. With 20 different brands that each generates over \$1 billion in annual sales, PG is a cash-generating machine. Examining its financial

statements, profit margins are wide and stable, liquidity is strong, and operating ratios continue to improve. With a global presence and dominant brands, PG consistently innovates and grows its business.

For such stability, the market has yawned. PG trails its peer group over the one-month, three-month, and year-to-date periods. Further, the shares are off 11% this year while the S&P 500 is 2% higher.

With such uninspired performance, the shares have become attractively valued. Using a conservative earnings yield approach, I find the shares to be worth \$65. Apply a Price/Earnings (PE) or Price/Sales (PS) model and the fair value increases to \$70. Using the lower number, the shares are more than 20% undervalued. Combine this with PG's 3.44% dividend and the stock becomes an ideal investment. A dominant franchise selling at a large discount to fair value while also paying a high dividend gives us exposure to an improving economy while receiving income as we await the recovery. **I recommend a 2%**

Figure 5 Baidu February - June 2009



position in PG as this week's fundamental trade.

OPTION TRADE

When managing money, security selection is extremely important. However, it is only one part of the process. Equally important is position size.

As evidenced by last week's decision to short Visa (V), we will occasionally find a trade that works in our favor from day one. When you stumble upon those trades, nothing else matters. Having been profitable since the second it was initiated, the position could have been multiples of our portfolio and never caused us concern.

Unfortunately, V is the exception, not the rule. The more typical experience is that we continually wrestle with our decisions as prices fluctuate. With the market attempting to force us into emotional decisions, large position sizes are our enemy. Our portfolio position in Microsoft has a 21% gain. However, there were many weeks where this investment was underwater. Had it been too large of a concentration we may have closed the trade prematurely. Only by maintaining flexibility were we able to accumulate this gain.

In order to achieve such flexibility, we must consider both the idea and its size. An attractive trade I have

been watching is a long position in Baidu (BIDU). Since bottoming in December, BIDU's stock has moved 186% higher. With such sharp rallies, we often expect to see spikes higher. Instead, BIDU has followed a predictable channel (Figure 5). The longer a channel has existed and the more points of contact, the greater the likelihood that the channel will hold. With BIDU, the long trend and multiple contact points (black arrows indicate when it bounced lower from the channel line; green arrows indicate when it bounced higher from the trendline) both increase the odds that the shares will move higher within this pattern.

Having identified an excellent stock to own, we turn to position size. Here, our problems mount. At nearly \$300, a 2% position in BIDU would consist of only eight shares. Were we to correctly see a 10% move higher, the results would be too small to impact our portfolio. To combat this problem, we can follow one of two approaches. The first would be to take a larger stake in BIDU. I find this plan overly risky and quickly dismiss it. The other choice is to turn to the option

markets to structure a trade with reasonable upside and controlled downside risk.

An excellent way to speculate on rising share prices is via a bull spread. A bull spread involves buying one call and then selling short a call at a higher strike price. Our maximum loss is the net cash spent and our maximum gain becomes the difference in strike prices.

Believing BIDU will travel to \$310 over the coming weeks, I will buy the July 290 calls (BDU+GY) and simultaneously sell short the July 310 calls (BDU+GA). This trade should cost \$9 while providing a maximum gain of \$20 (122%). By using the option market, we will see material gains while keeping the position size reasonable. Further, we have a clear indication of expected gain and potential maximum losses. With such a goal, **I recommend a 1.50% position in the BIDU 290/310 bull spread as this week's option trade.** That is two contracts for my portfolio size. Adjust your position size as needed.

CURRENT RECOMMENDATIONS

Last week may have been difficult for the broad market, but it was excellent for our portfolio. Having waited what seemed like an eternity for First Solar (FSLR) to confirm our bearish views, the stock finally broke lower and our portfolio benefited. During a week when the S&P 500 declined 2.6% we saw our portfolio increase 0.6%. Adding these results to prior gains, **since inception we show a gain of 22.7% versus a decline of 4.9% for the S&P 500 (Figure 6).**

Academic research will tell you that a portfolio with minimal equity exposure and a 0.2 beta cannot post the returns we have enjoyed. I am glad to prove the academics wrong. By taking a simple, disciplined approach, the portfolio laid out in this newsletter has consistently generated ideas and combined them in such a way that retail investors looking at their account only once per week could enjoy gains nearly every active manager would envy.

Over the coming week, we will be making some

adjustments to our portfolio. FSLR should bounce off \$165 as its first level of support. We will use that support to cover our calls and will therefore use a limit order to **buy-to-cover the FSLR 145 calls (QHB+GI) at \$23**. Enter this as a good-until-canceled trade and you can await the market to provide the opportunity to cover the position. It may take a week, or could occur more quickly, but as FSLR continues lower we can register a gain on our position. Other than the trades recommended in this newsletter, no other actions are recommended at this time.

Figure 6 Portfolio Composition and Performance

update Position	Quantity	Purchase Price	Current Price	Total Cost	Current Value	% Total
ABFS	98	\$23.74	\$30.15	\$2,327	\$2,955	2%
AMZN	(32)	\$73.96	\$82.80	(\$2,367)	(\$2,650)	-2%
BZF	163	\$19.62	\$22.90	\$3,198	\$3,733	3%
COP	(54)	\$44.76	\$42.97	(\$2,417)	(\$2,320)	-2%
DBC	164	\$21.77	\$23.20	\$3,570	\$3,805	3%
EFA	(67)	\$31.60	\$46.81	(\$2,117)	(\$3,136)	-3%
EVF	1,236	\$3.32	\$4.73	\$4,104	\$5,846	5%
EWA	264	\$11.41	\$16.81	\$3,012	\$4,438	4%
EWC	184	\$16.34	\$21.77	\$3,007	\$4,006	3%
EWZ	88	\$34.17	\$53.04	\$3,007	\$4,668	4%
GE	135	\$14.68	\$12.12	\$1,982	\$1,636	1%
GIS	37	\$58.05	\$54.72	\$2,148	\$2,025	2%
GS	30	\$119.34	\$143.15	\$3,580	\$4,295	4%
HYG	41	\$75.25	\$78.18	\$3,085	\$3,205	3%
JPM	110	\$31.86	\$34.96	\$3,505	\$3,846	3%
KO	72	\$42.20	\$48.81	\$3,038	\$3,514	3%
KSWS	139	\$8.79	\$8.38	\$1,222	\$1,165	1%
LOD	31	\$100.19	\$98.64	\$3,106	\$3,058	2%
MOT	490	\$4.19	\$6.11	\$2,053	\$2,994	2%
MS	(165)	\$21.60	\$28.24	(\$3,564)	(\$4,660)	-4%
MSFT	100	\$19.90	\$24.08	\$1,990	\$2,408	2%
NLS	363	\$2.83	\$1.44	\$1,027	\$523	0%
NOK	189	\$15.90	\$14.64	\$3,005	\$2,767	2%
PFE	126	\$15.76	\$14.99	\$1,986	\$1,889	2%
QQQQ	(36)	\$26.09	\$36.14	(\$939)	(\$1,301)	-1%
TBT	90	\$40.19	\$54.40	\$3,617	\$4,896	4%
V	(38)	\$63.98	\$61.35	(\$2,431)	(\$2,331)	-2%
WMT	72	\$50.18	\$48.20	\$3,613	\$3,470	3%
XHB	(197)	\$12.12	\$11.53	(\$2,387.64)	(\$2,271)	-2%
DIA July 83/86 Strangle	500	\$6.85	\$6.00	\$3,425	\$3,000	2%
FSLR July 145 Call	(300)	\$31.00	\$31.00	(\$9,300)	(\$9,300)	-8%
MA Jan 90 Put	100	\$7.00	\$1.20	\$700	\$120	0%
SPY Sep 77 Call	(300)	\$3.50	\$16.00	(\$1,050)	(\$4,800)	-4%
SPY Sep 77 Put	300	\$13.60	\$1.30	\$4,080	\$390	0%
VIX July 32.50 Call	500	\$4.40	\$2.70	\$2,200	\$1,350	1%
Cash Position					\$79,459	65%
Portfolio Total					\$122,689	
<i>Portfolio Metrics:</i>						
						22.7%
						-4.9%
						0.2
						1.9%
						18%

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.

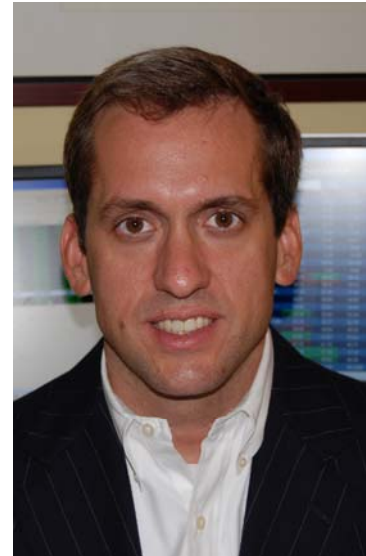
Option Trade – Based on the market environment, I will recommend option trades. In general, I prefer to write, rather than buy, options and will always look for opportunities to receive premium while hedging my risk.

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

Circulation
BLAIN REINKENSMAYER

sean.hannon@epicadvisorsllc.com

Design & Layout
CSP RESEARCH

www.epicadvisorsllc.com