

EPIC INSIGHTS

Vol. 2, No. 29

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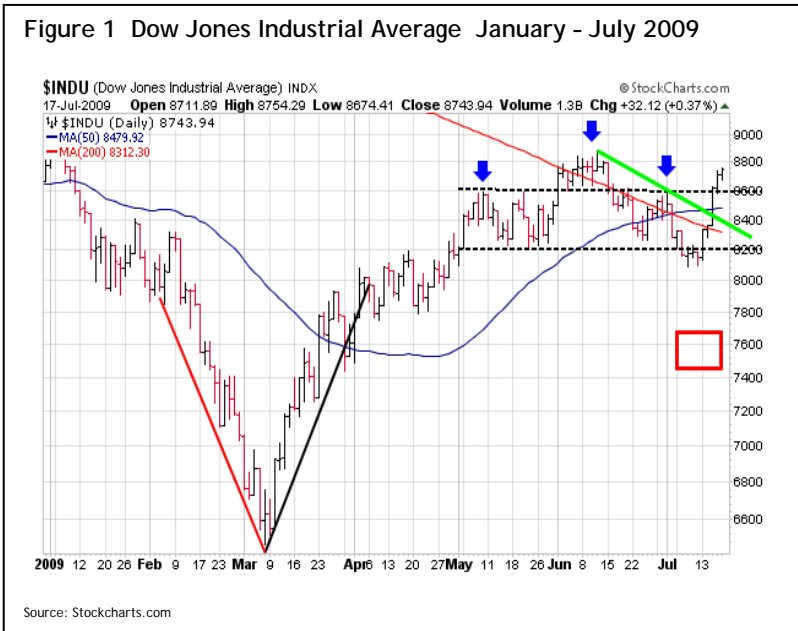
July 20, 2009

THE WEEK AHEAD

I now know how Bill Murray felt. In the movie "Groundhog Day," Murray's character Phil Connors is forced to live the same day repeatedly. No matter what he does, Connors begins each day in the same position as the last and is forced to endure the monotony. Like other stock market investors, I am beginning to feel the same.

The Dow Jones Industrial Average (Dow) closed at an interim peak of 8,574 on May 8. This past Friday it closed at 8,743. During this period, the Dow has been caught in a tight trading range with 8,200 as the floor and 8,600 as the ceiling (**Figure 1**). In fact, in only 14 of the 48 trading days since May 8 has the Dow moved outside of this range.

For investors, the frustration involves deciding how to implement a trading strategy. With such a tight range, some will choose to



buy at the lower end and sell at the higher end. However, knowing all trading ranges eventually break, this approach is destined to produce losses. Such investors will accumulate small gains when prices are static, but when the coil breaks and prices move against them, one large loss will eliminate these earnings. The other approach is to wait for a break in the range and then take positions. This is what I have done and it has proved equally futile. I was

becoming shorter as the lower end of the range fell only to watch the Dow move 7.3% higher on the week. Instead of positioning for a big breakdown, I would have been better served heading to the beach.

Following last week's massive gains, we now must consider whether the sell-off is complete and prices are prepared to run higher. Select markets say yes, but the more important question is how a broad array of indices are

behaving. When we see many markets moving to new highs at the same time, it indicates that the strength is widespread and should continue. Unfortunately, the current rally does not exhibit such strength (**Figure 2**). Instead, although the NASDAQ reached a new annual high, all the other markets remain an average of 4.1% below recent peaks. Until these markets can push higher, we should remain skeptical of the current rally and expect prices to fall back into the established trading range, forcing investors to continue living the same day over and over.

Having seen hard data move prices higher last week, investors will face more heavy information that could swing stock prices during the upcoming week of 7/20 to 7/24 (**Figure 3**). With 22 key earnings announcements, Federal Reserve Chairman Ben Bernanke appearing before Congress, and a variety of economic announcements, we will have a full plate. **Monday** starts the week quietly with a report on leading economic indicators. **Tuesday** picks up the pace with Bernanke delivering his

Figure 2 2009 Index Highs

Index	2009 High	Date of High	Current Price	% From New High
Dow Jones Industrial	9,035	1/2/2009	8,744	-3.2%
Dow Jones Transport	3,717	1/6/2009	3,314	-10.8%
NASDAQ	1,887	7/17/2009	1,887	0.0%
S&P 500	946	6/12/2009	940	-0.6%
Russell 3000	552	6/12/2009	548	-0.7%
FTSE 100	4,639	1/6/2009	4,389	-5.4%
DAX Index	5,144	6/2/2009	4,978	-3.2%
CAC 40	3,396	1/6/2009	3,218	-5.2%
NIKKEI 225	10,136	6/12/2009	9,395	-7.3%
Hang Sang	18,890	6/12/2009	18,806	-0.4%
Brazil Bovespa	54,486	6/1/2009	52,072	-4.4%

Figure 3 Weekly Calendar

Day	Date	Announcement	Time	Estimate	Prior
Monday	7/20	Leading Indicators	10:00 AM	0.5%	1.2%
Tuesday	7/21	MRK Earnings	BMO	\$0.77	\$0.86
		KO Earnings	BMO	\$0.89	\$1.01
		Bernanke Before House Panel	10:00 AM		
		AAPL Earnings	AMC	\$1.17	\$1.19
		SBUX Earnings	AMC	\$0.19	\$0.13
		YHOO Earnings	AMC	\$0.14	\$0.10
Wednesday	7/22	DAL Earnings	BMO	(\$0.27)	\$0.35
		MS Earnings	BMO	(\$0.54)	\$0.95
		PFE Earnings	BMO	\$0.46	\$0.55
		STI Earnings	BMO	(\$0.63)	\$1.48
		WFC Earnings	BMO	\$0.37	\$0.53
		Bernanke Before Senate Panel	10:00 AM		
		ETFC Earnings	AMC	(\$0.30)	(\$0.24)
		EBAY Earnings	AMC	\$0.36	\$0.41
		MOS Earnings	AMC	\$0.07	\$1.89
		SNDK Earnings	AMC	(\$0.18)	(\$0.21)
		Thursday	7/23	KMB Earnings	BMO
MCD Earnings	BMO			\$0.97	\$0.94
MMM Earnings	BMO			\$0.94	\$1.39
Initial Jobless Claims	8:30 AM			555k	522k
Continuing Jobless Claims	8:30 AM			6330k	6273k
Existing Home Sales	10:00 AM			4.80M	4.77M
Existing Home Sales (MoM)	10:00 AM			0.6%	2.4%
Fed Meeting on Home Loan Rules	10:00 AM				
AMZN Earnings	AMC			\$0.48	\$0.27
BIDU Earnings	AMC			\$1.51	\$1.10
CB Earnings	AMC			\$1.29	\$1.40
MSFT Earnings	AMC			\$0.37	\$0.47
NFLX Earnings	AMC			\$0.52	\$0.42
Friday	7/24	U. of Michigan Confidence	10:00 AM	65.0	64.6

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

Note: All times are Eastern Standard Time (EST)

Source: Bloomberg

semi-annual monetary policy report before the House Financial Services Committee and earnings from Apple (AAPL), Starbucks (SBUX), and Yahoo! (YHIOO) after the markets close. **Wednesday** has bank earnings before the market opens with SunTrust (STI), Wells Fargo (WFC), and Morgan Stanley (MS) reporting. Bernanke appears before the Senate Banking Committee that morning, and eBay reports earnings after the markets close. **Thursday** brings some of the most important data of the week. Technology bellwethers Amazon.com (AMZN) and Microsoft (MSFT) report earnings, the Federal Reserve (Fed) will hold an open meeting to discuss proposed changes to the Truth in Lending regulations, and we will see a report on existing home sales. Even more important than these reports, though, is initial jobless claims, which also will be announced on Thursday. Last week, initial claims fell 43,000, or 7.6%. This drop, combined with the prior week's decline of 8%, adds up to a two-week drop of 92,000, or 15%. Historically, spikes lower of 8% or greater have marked the end of every recession

Figure 4 Weekly Jobless Claims and Recession End Dates

<u>Recession</u>	<u>Increase in Claims</u>	<u>Spike Lower</u>	<u>Spike Date</u>	<u>Recession End Date</u>	<u>Spike vs. Recession End</u>
1969 - 1970	90%	9%	12/4/70	11/27/70	1 week
1973 - 1975	147%	8%	2/14/75	3/28/75	6 weeks
1980	63%	15%	7/11/80	7/25/80	2 weeks
1981 - 1982	71%	8%	11/5/82	11/26/82	3 weeks
1990 - 1991	42%	11%	4/5/91	3/29/91	1 week
2001	63%	8%	10/5/01	11/30/01	8 weeks
2007 - 2009	115%	15%	7/16/09	?	?

Note: NBER measures recession end dates on a monthly basis. I have assumed the last week of each month as the official end date for comparison with the spike lower in weekly jobless claims.

Note: 2007-2009 is a two week spike lower

on record since 1969 (**Figure 4**). While some will continue to dismiss this data as flawed because of timing differences (this year the layoffs in the auto industry occurred earlier than normal and have skewed the seasonally adjusted numbers), I believe the spike lower has occurred and the recession is over. Does this mean we should all rush into the market and buy stocks? Absolutely not. Even though the decline has ended, recovery remains years into the future as the economy adjusts to a brave new world of lower leverage, reduced consumption, and increased savings. **Friday** ends the week with the University of Michigan confidence report.

TECHNICAL TRADE

Last week was fantastic for the bulls as markets soared worldwide. The Dow moved 7.3% higher, London's FTSE 100 rallied 6.3%, and Brazil's Bovespa was 5.8% higher. As mentioned in last week's newsletter, such synchronized markets are great if you are on the right side, but they making difficult trading environments for those who prefer to remain hedged.

After the powerful move, our goal is to determine what will occur next. Examining a variety of charts, we receive mixed messages. While some companies show gaps higher that should lead to steadily increasing stock prices, others have only retraced a portion of their recent losses and remain in well-defined downtrends.

To highlight this difference, we will look at the charts of two different companies— IBM and Potash (POT). IBM (Figure 5) is an example of strength. The stock increased 14.5% during the week as a better than expected forecast allowed the shares to leap higher. Prior to this announcement, IBM was already strong. A steady uptrend (blue line) since December has allowed the shares to continuously move higher. Last week, a gap higher (black circle) occurred after earnings on increasing volume (green arrow), which should offer support to any future decline.

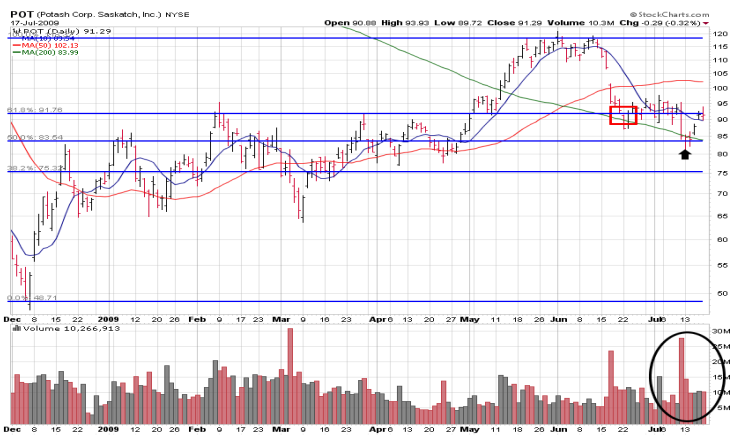
Contrast IBM with a current short position in our portfolio—POT. POT had a strong week as the shares moved 7.3% higher. However, this rally was not a show of strength, but an oversold bounce in a continued bearish pattern. A short-term chart (Figure 6) illustrates that while the stock bounced off the 50% retracement level (black arrow) it still remains below the 33% retracement point. Further, the price is below long-term resistance of \$94 (Figure 7). The inability of POT to benefit from rallying markets and move through

Figure 5 IBM December 2008 - July 2009



Source: Stockcharts.com

Figure 6 Potash December 2008 - July 2009



Source: Stockcharts.com

Figure 7 Potash May 2008 - July 2009



Source: Stockcharts.com

resistance indicates the rally is nothing more than an oversold bounce that will stall.

This assessment leads us to our next move. Currently, the short of POT is 2% of the total portfolio. If the price moves higher, we will use \$94 as a stop-loss, thus presenting a potential loss of 3%. However, if our prediction of lower prices is correct the shares should retest the 50% retracement level of \$83.50 and provide a return of 8.5%. With the risk-reward skewed in our favor, **I recommend an additional 2% short position in POT as this week's technical trade. Use a close above \$94 as a stop-loss.**

FUNDAMENTAL TRADE

When I started this newsletter, my aim was to provide both investment ideas and educational content. By explaining each week why I chose a particular trade, which factors to watch, and how I expect markets to evolve, I would equip readers with ideas and knowledge that could help them identify future investment opportunities.

Among the many principles I have stressed repeatedly is the need to maintain a disciplined sales approach when it is time to exit positions. Since inception, the trades in this newsletter have returned 21%. Seventy percent of that value creation has come from the 56 fundamental trade ideas that have populated this section of the newsletter.

While a lower market has offered many opportunities to purchase excellent companies below fair value, a disciplined approach to entering and exiting positions has been key to our success. Of the 56 fundamental trades we have done, only 17 remain in the portfolio. This week that number will drop by one.

Value investing is often associated with a buy-and-hold approach where the same investments remain in the portfolio for years. I prefer to buy at a discount to fair value and wait for the markets to properly value a company. Believing that markets will ultimately recognize fair value, if I have purchased at a discount all I need is patience. At times this process takes years, other times it takes weeks. Last

week it took only a handful of days.

In last week's newsletter I documented my belief that asset manager Janus (JNS) was worth \$12 and that the market was giving us the opportunity to acquire the shares below fair value. We entered the stock Monday at \$10.38 and three days later the shares were above our fair value target. Despite a small drop Friday, the price is still above fair value and has provided a one-week return of 16%.

With fair value achieved, we have no choice but to exit. A disciplined approach has led to outstanding portfolio gains and will continue to do so in the future. **I recommend selling our position in JNS as this week's fundamental trade.**

OPTION TRADE

Reviewing successes adds to our knowledge of what is working. However, reflecting upon failure offers even greater insights. While the one-week gain garnered from our fundamental trade of JNS is noteworthy, the losses suffered in our option trade are real eye-openers.

Last week, I made the prediction that banks would

post excellent earnings as a positively sloped yield curve would allow income to flow to the bottom line. Had I stopped at buying calls on bank shares, the trade would have worked. However, I took the additional step of expecting technology stocks to perform poorly due to unrealized expectations. Instead, investors were impressed with the tech news, and IBM and Intel (INTC) saw their prices move sharply higher. The short calls on these shares led to large losses that swamped the bank gains. Together, this basket of options led to a 3.5% portfolio loss.

In spite of this slow-motion disaster, we must learn to move forward. In an effort to benefit from this poor experience, I have identified three lessons which will guide future trades.

First, price matters. Before the markets opened Monday morning, an upgrade of Goldman Sachs by highly respected banking analyst Meredith Whitney led to a sharp increase in bank shares. This made our purchase of calls on Goldman Sachs (GS), Bank of America (BAC), and JPMorgan (JPM) more expensive than when I had

recommended the trade one day earlier. As investors, we cannot lock ourselves into a set view, but need to reexamine entry price when we pull the trigger on a trade.

Secondly, with options time is not on our side. Over the coming weeks, my long banks/short technology thesis may prove correct. However, option trades depend on time as much as direction. By focusing on options that expired in less than one week, our fate was left to the swings of the market.

Finally, leverage kills. Of the six option positions we entered into as part of this trade, four were profitable with an average gain of 97%. However, the loss from Intel erased most of these gains and the devastation of being short IBM calls put the nail in our coffin. With options, large losses from a few positions can turn generally sound ideas into disastrous ones.

Absorbing these lessons will help with future trade ideas. While I acknowledge that some trades will have better outcomes than others, our goal is to steadily increase value over time. Stay focused on both what you

expect to occur and ways to efficiently position for those moves. Doing so will allow for gains while minimizing losses.

CURRENT RECOMMENDATIONS

If you owned index funds last week you did very well. If you were following our recommendations you were left frustrated. During a week where nothing seemed to work and all our ideas moved against us, the S&P 500 increased an impressive 6.8% while our portfolio fell 2%.

With a low equity weighting and option positions that benefit from falling prices, I do not expect to match the market during large rallies. However, although the loss is large and frustrating, we must always remember that one week does not make a trend. **Since inception we show a gain of 21.0% versus a decline of 3.1% for the S&P 500 (Figure 8).**

The upcoming week may offer key developments in the market. If the Dow moves above 8,800 and other markets confirm that move it indicates that prices will continue rising. However, a break lower would mean that last

week's rally was nothing more than a one-week bounce in a continued bear market. As investors we must be prepared for both possibilities. Therefore I recommend the following actions over the coming week: sell CLF at \$28, JPM at \$40, and KSWs at \$12. Further cover the shorts at the following stop-loss prices: EWA \$20, EWZ \$55, and XHB \$13.

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	\$25.83	\$2,327	\$2,531	2%
ALL	103	\$24.06	\$24.24	\$2,478	\$2,497	2%
AMZN	(32)	\$73.96	\$85.33	(\$2,367)	(\$2,731)	-2%
BZF	163	\$19.62	\$24.77	\$3,198	\$4,038	3%
CLF	177	\$20.92	\$24.54	\$3,703	\$4,344	4%
COP	(54)	\$44.76	\$42.38	(\$2,417)	(\$2,289)	-2%
DBC	164	\$21.77	\$21.75	\$3,570	\$3,567	3%
EVF	1,236	\$3.32	\$4.75	\$4,104	\$5,871	5%
EWA	(235)	\$15.84	\$17.28	(\$3,722)	(\$4,061)	-3%
EWZ	(73)	\$50.97	\$54.02	(\$3,721)	(\$3,943)	-3%
GE	135	\$14.68	\$11.62	\$1,982	\$1,569	1%
GIS	37	\$58.05	\$58.81	\$2,148	\$2,176	2%
GS	30	\$119.34	\$156.52	\$3,580	\$4,696	4%
HYG	41	\$75.25	\$78.95	\$3,085	\$3,237	3%
JNS	238	\$10.38	\$12.03	\$2,470	\$2,863	2%
JPM	110	\$31.86	\$36.78	\$3,505	\$4,046	3%
KO	72	\$42.20	\$50.32	\$3,038	\$3,623	3%
KSWs	139	\$8.79	\$10.17	\$1,222	\$1,414	1%
LQD	31	\$100.19	\$100.07	\$3,106	\$3,102	3%
MOT	490	\$4.19	\$6.30	\$2,053	\$3,087	3%
MS	(165)	\$21.60	\$28.03	(\$3,564)	(\$4,625)	-4%
MSFT	100	\$19.90	\$24.22	\$1,990	\$2,422	2%
NLS	363	\$2.83	\$1.07	\$1,027	\$388	0%
NOK	189	\$15.90	\$13.36	\$3,005	\$2,525	2%
PFE	126	\$15.76	\$14.92	\$1,986	\$1,880	2%
PG	49	\$50.33	\$55.76	\$2,466	\$2,732	2%
POT	(27)	\$91.20	\$91.47	(\$2,462)	(\$2,470)	-2%
TBT	90	\$40.19	\$53.52	\$3,617	\$4,817	4%
TIF	103	\$24.07	\$27.97	\$2,479	\$2,881	2%
V	(38)	\$63.98	\$64.00	(\$2,431)	(\$2,432)	-2%
WMT	72	\$50.18	\$48.49	\$3,613	\$3,491	3%
XHB	(197)	\$12.12	\$12.46	(\$2,388)	(\$2,455)	-2%
DIA Aug 83 Puts	300	\$3.60	\$0.90	\$1,080	\$270	0%
MA Jan 90 Put	100	\$7.00	\$0.40	\$700	\$40	0%
SPY Sep 77 Call	(300)	\$3.50	\$17.50	(\$1,050)	(\$5,250)	-4%
SPY Sep 77 Put	300	\$13.60	\$0.50	\$4,080	\$150	0%
VIX July 32.50 Call	500	\$4.40	\$0.00	\$2,200	\$0	0%
Cash Position					\$76,959	64%
Portfolio Total					\$120,960	
<i>Portfolio Metrics:</i>						
Portfolio Return			21.0%			
S&P 500 Return			-3.1%			
Portfolio Beta			0.1			

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.

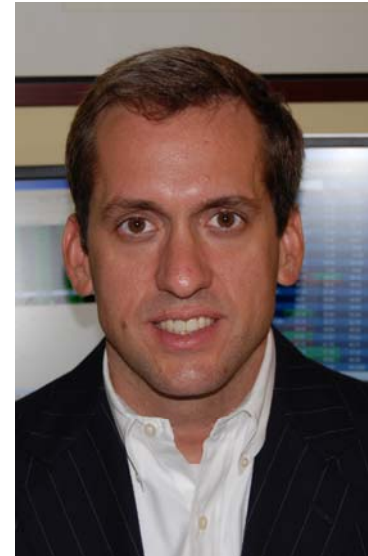
Option Trade – Based on the market environment, I will recommend option trades. In general, I prefer to write, rather than buy, options and will always look for opportunities to receive premium while hedging my risk.

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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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

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