

# EPIC INSIGHTS

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## *THE WEEK AHEAD*

The bulls will be unhappy to see earnings season end. When Alcoa (AA) kicked things off with its report on July 8, the Dow Jones Industrial Average (Dow) was at 8,178 as the market prepared for abysmal news. Although AA did not see a strong rally in the days that followed and the Dow continued to retreat, few were prepared for the surge that was around the corner. Over the past two weeks, many companies beat their quarterly estimates, offered positive guidance, and saw their share prices soar higher. During this period, the Dow gained 11.6% and broke above technical resistance, and is now poised to move even higher.

As we begin to lose the stock-specific catalyst of earnings announcements, we now focus on general economic data and investor psychology. Although I continue to believe the recovery will be mild and slow, investor psychology is

Figure 1 2009 Index Highs

Index	2009 High	Date of High	Current Price	% From New High
Dow Jones Industrial	9,093	7/24/2009	9,093	0.0%
Dow Jones Transport	3,717	1/6/2009	3,536	-4.9%
NASDAQ	1,974	7/23/2009	1,966	-0.4%
S&P 500	979	7/24/2009	979	0.0%
Russell 3000	572	7/24/2009	572	0.0%
FTSE 100	4,639	1/6/2009	4,577	-1.3%
DAX Index	5,247	7/23/2009	5,229	-0.3%
CAC 40	3,396	1/6/2009	3,366	-0.9%
NIKKEI 225	10,136	6/12/2009	9,945	-1.9%
Hang Sang	19,983	7/24/2009	19,983	0.0%
Brazil Bovespa	54,486	6/1/2009	54,457	-0.1%

bullish and robust. With the recent rally, markets have confirmed one another with six of the eleven markets I follow having reached annual highs in the last two days (**Figure 1**). Further, those yet to confirm remain an average of 1.4% from new highs. Given the way this market is moving, we could see more confirmed highs early next week.

The upcoming week of 7/27 to 7/31 (**Figure 2**) offers an interesting mix of stock-specific information and broad economic data. While the number of earnings announcements decreases

from the prior two weeks, those sharing information promise to offer fireworks. **Monday** starts the week with new home sales. Although the consensus calls for an increase in sales, consider that the average number of new homes sold from 1963 to 2009 is 689,000. With the market looking for only 352,000 we remain well below average. Housing will eventually bottom, but those looking for a quick recovery are destined to be disappointed. **Tuesday** also focuses on housing with the Case Shiller index expected to show prices declining

17.9%. **Wednesday** has durable goods, the Federal Reserve's (Fed) beige book, and earnings from Visa (V). **Thursday** brings our attention to three earnings announcements that should lead to price swings—MasterCard (MA), Dryships (DRYS), and First Solar (FSLR)—and the weekly employment report. For the past three weeks, I have highlighted a conundrum. Historically, spikes lower in weekly jobless claims have closely aligned with the ends of recessions (**Figure 3**). Such a spike has occurred, but confusion reigns regarding seasonal adjustments caused by the timing of auto industry plant closings. After two weeks, we saw a 15% spike, which historically would be among the largest recession-ending events. After last week's increase in claims, the spike is now 10%—still large compared to other recession-ending events. The consensus now calls for a further increase in claims which would smooth the four-week decline to only 5%. If this pattern continues, we will be faced with an environment where the initial spike is a further false start and the recession continues to drag on. **Friday** ends the

**Figure 2 Weekly Calendar**

Day	Date	Announcement	Time	Estimate	Prior
Monday	7/27	New Home Sales	10:00 AM	352k	342k
		New Home Sales (MoM)	10:00 AM	2.9%	-0.6%
Tuesday	7/28	COH Earnings	BMO	\$0.43	\$0.50
		Case Shiller Home Price Index	9:00 AM	-17.9%	-18.1%
		Consumer Confidence	10:00 AM	49.0	49.3
Wednesday	7/29	COP Earnings	BMO	\$0.84	\$3.49
		Durable Goods Orders	8:30 AM	-0.6%	1.8%
		Durables Ex Transportation	8:30 AM	0.0%	1.1%
		Fed's Beige Book	2:00 PM		
		CLF Earnings	AMC	(\$0.33)	\$2.43
		V Earnings	AMC	\$0.65	\$0.59
Thursday	7/30	MA Earnings	BMO	\$2.42	\$2.11
		Initial Jobless Claims	8:30 AM	580k	554k
		Continuing Jobless Claims	8:30 AM	6300k	6225k
		DRYS Earnings	AMC	\$0.22	\$3.60
		FSLR Earnings	AMC	\$1.65	\$0.85
Friday	7/31	Gross Domestic Product - 2Q	8:30 AM	-1.5%	-5.5%

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

**Figure 3 Weekly Jobless Claims and Recession End Dates**

Recession	Increase in Claims	Spike Lower	Spike Date	Recession End Date	Spike vs. Recession End
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%	10%	7/23/09	?	?

*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 three week spike lower*

week with 2<sup>nd</sup>-quarter gross domestic product (GDP) showing the economy contracted 1.5%.

### **TECHNICAL TRADE**

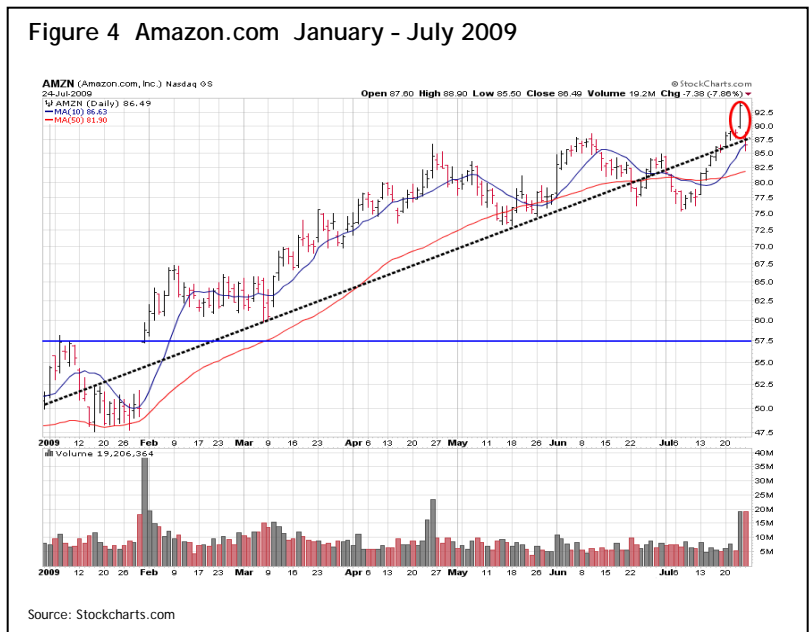
Technical analysis is based on the belief that supply and demand, viewed through the visual display

of data on a chart, allows us to predict the future path of prices. While I am not a purely technical trader, I believe incorporating this approach into your investment process can yield positive results. However, there is a bit of a catch. If we want to apply supply and demand factors,

we need the markets to act predictably and rationally. During periods of extreme fear and greed, investors run frantically in the same direction and nullify predictable moves. Luckily, we are now witnessing a level of rationality that will allow us to trade effectively.

In normal environments, we expect stocks to move higher with good news and lower on bad news. This earnings season has yielded these results. When companies beat their quarterly numbers and increase the forecast for future results, prices move higher. Conversely, negative results take stocks lower. As investors, we should buy the strong, sell the weak, and book our gains. A rational environment allows us to take such actions.

Searching for powerful technical patterns that point to predictable price movements brings me to Amazon.com (AMZN). AMZN is a stock I have never liked and am currently short of in my portfolio. Despite being a retailer with 4.4% operating margins, AMZN trades for 57 times earnings and 27 times free cash flow. Seeing the shares 68% higher on the year, many analysts applying sound



research techniques have decided the shares will be perpetually expensive and we should simply ignore valuation, buy the shares, and ride the wave. I refuse to chase value and will instead work with techniques that favor success. With last week's disappointing earnings announcement, AMZN is offering the opportunity bearish investors have awaited (**Figure 4**).

When we search for reversals, we must keep in mind the two events that constitute one. The first is the existence of a visible trend. Since January, AMZN has followed a predictable uptrend (black line). The second event to look for is a process announcing a

reversal in price. This occurred on Thursday when AMZN carved out a top island reversal (red circle). Top island reversals are rare events that require the price to gap above a prior range and then gap lower as well. AMZN completing this pattern on high volume points to weakness. Add in the fact that the current gap lower pushed the shares below the long-standing uptrend and 10-day moving average (MA), the odds of weakness increase.

Going short in this market is dangerous. Therefore, we must look for opportunities, but also manage our risk appropriately. Were AMZN to fill the gap lower and rally above \$92, it would indicate that the rally was set to

continue. However, as long as the reversal remains intact, the trend remains lower. Currently, our portfolio has a 2.3% short position in AMZN. I **recommend increasing the AMZN short position to 4% of the portfolio as this week's technical trade. Use a close above \$92 as a stop-loss.**

### ***FUNDAMENTAL TRADE***

Housing remains the most elusive aspect of the economy. Its boom during the credit bubble created large imbalances as economic resources gravitated toward anything housing related. For everyone from mortgage brokers to interior designers, housing was the path to riches.

As booms lead to imbalances, so do busts. Consider Home Depot (HD). As one of the largest home improvement retailers, HD traded near \$45 during the housing boom, as low as \$18 at the market low, and now trades hands near \$25. On a relative basis, HD has rallied only 12% this year versus a peer group increase of 81%.

Turning to fair value, the shares have priced in a housing depression with no rebound insight. To model value, I have assumed that current year earnings are below consensus and will grow at a 4% rate into the future. Such assumptions derive a fair value of \$30—a 20% discount at current levels. The economic scenario surrounding this fair value estimate implies that housing will never recover and people will be reluctant to reinvest in their homes. Knowing that housing will eventually bottom, in the future HD should see enough growth to better the \$30 forecast.

Looking at all the pieces, HD fits within our recent pattern. It is a market leader whose shares trade at a discount to fair value, have underperformed their peer group, and pay a high dividend yield (3.55%).

Believing the markets will move higher and the recession has ended, I favor adding companies that will benefit from a strong increase in economic activity. When we can add them at a discount to fair value while earning decent income, the trade becomes even better. Therefore, I **recommend a 2% position**

**in HD as this week's fundamental trade.**

### ***OPTION TRADE***

When making new trades, we have two main choices. The first is to look for original ideas that provide us with a competitive edge. The other is to revisit profitable ideas to see if they work in the current market. Given the informational edge of reviewing past ideas, I prefer this approach as long as an old idea continues to work in our favor.

Two of the most profitable option trades we have done were to position for a limited price movement after First Solar (FSLR) announced earnings. The performance of FSLR around earnings announcements (**Figure 5**) is predictable and tradeable. Over the last eight quarters, the company beat estimates and usually saw its share price move sharply. During this time period, the shares typically moved 19% the day after earnings were released. If you exclude the two smallest moves, the average change has been 23%. While such data could be the basis of a trade, I find the two small moves

disheartening. Position for a large move, receive one of the smaller ones, and quick losses arrive. Instead, I focus on where the shares are one to two weeks after the announcements. On that basis, the shares moved an average of 8% in either direction. Such muted reaction leads me to our next trade—a short straddle.

A straddle is an option strategy with a put and call at the same strike price. If you buy a straddle, you believe the price of the stock will move sharply in either direction. At this point, the gain from one contract offsets the loss from the other and allows you to profit. If you feel the price will remain within the range, you would sell the straddle with the intent of watching volatility decline and prices fall.

Looking at FSLR, the shares currently trade for \$169.43. FSLR has rallied recently, but remains in a bearish chart pattern (**Figure 6**). This encourages me to take a slightly bearish view and focus on a strike which is below the current price. The August \$165 calls (HJQ+HM) trade for \$15.10 and the August \$165 puts (HJQ+TM) for \$10.50. With a total cost of \$20.60, the

Figure 5 FSLR After Earnings Reports

Period	EPS % Surprise	Stock Price Pre-Earnings	Stock Price 1 Day Later	% Move	Px in 7-10 days	% Move
1Q 2009	30%	151.67	187.29	23%	177.43	17%
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%

Figure 6 First Solar November 2008 - July 2009



\$165 straddle is pricing in an expected move of 13%.

Given FSLR's historical pattern, I recommend a short straddle on FSLR as this week's option trade. With an expected 13% post-earnings move, odds favor us closing this position quickly. However, even if FSLR moves greater than 13% the movement should quickly fade with the one-week price change being much lower.

For the specifics of the trade, short the August 165 call (HJQ+HM) and the August 165 put (HJQ+TM). I will be selling two of each contract. Adjust the trade size to conform to your portfolio.

***CURRENT  
RECOMMENDATIONS***

Last week the market continued to roll higher. As the S&P 500 increased 4.3% our portfolio rose

1.1%. Given our low equity exposure and 0.1 beta, the 1.1% gain is impressive. I have missed most of this rally as I preferred to remain defensive and not chase sharp rallies. Combining this fact with the knowledge that a hedged portfolio will always underperform during sharp rallies, I am pleased with the results. **Since inception we show a gain of 22.2% versus a gain of 1.1% for the S&P 500 (Figure 7).**

Last week was busy as we were stopped out of our positions in Potash (POT) and the iShares Brazil Index fund (EWZ). Expecting the market to remain active, we will focus on the exits and sell positions that reach fair value while covering shorts that move through technical barriers. Therefore I recommend the following actions over the coming week: sell CLF at the market Monday morning, JPM at \$40, and KSWs at \$12. Further cover the shorts at the following stop-loss price: EWA \$20.

By actively monitoring our risk position and exiting when trades no longer favor us, we will slowly compound returns and generate wealth.

Figure 7 Portfolio Composition and Performance

Position	Quantity	Purchase Price	Current Price	Total Cost	Current Value	% Total
ABFS	98	\$23.74	\$26.36	\$2,327	\$2,583	2%
ALL	103	\$24.06	\$26.40	\$2,478	\$2,719	2%
AMZN	(32)	\$73.96	\$86.49	(\$2,367)	(\$2,768)	-2%
BZF	163	\$19.62	\$24.03	\$3,198	\$3,917	3%
CLF	177	\$20.92	\$27.54	\$3,703	\$4,875	4%
COP	(54)	\$44.76	\$44.95	(\$2,417)	(\$2,427)	-2%
DBC	164	\$21.77	\$22.65	\$3,570	\$3,715	3%
EVF	1,236	\$3.32	\$4.85	\$4,104	\$5,995	5%
EWA	(235)	\$15.84	\$17.98	(\$3,722)	(\$4,225)	-3%
GE	135	\$14.68	\$12.03	\$1,982	\$1,624	1%
GIS	37	\$58.05	\$59.08	\$2,148	\$2,186	2%
GS	30	\$119.34	\$164.72	\$3,580	\$4,942	4%
HYG	41	\$75.25	\$81.90	\$3,085	\$3,358	3%
JPM	110	\$31.86	\$37.92	\$3,505	\$4,171	3%
KO	72	\$42.20	\$49.36	\$3,038	\$3,554	3%
KSWs	139	\$8.79	\$10.53	\$1,222	\$1,464	1%
LQD	31	\$100.19	\$101.74	\$3,106	\$3,154	3%
MOT	490	\$4.19	\$6.58	\$2,053	\$3,224	3%
MS	(165)	\$21.60	\$28.25	(\$3,564)	(\$4,661)	-4%
MSFT	100	\$19.90	\$23.45	\$1,990	\$2,345	2%
NLS	363	\$2.83	\$1.24	\$1,027	\$450	0%
NOK	189	\$15.90	\$13.20	\$3,005	\$2,495	2%
PFE	126	\$15.76	\$16.48	\$1,986	\$2,076	2%
PG	49	\$50.33	\$55.84	\$2,466	\$2,736	2%
TBT	90	\$40.19	\$53.19	\$3,617	\$4,787	4%
TIF	103	\$24.07	\$29.87	\$2,479	\$3,077	3%
V	(38)	\$63.98	\$67.29	(\$2,431)	(\$2,557)	-2%
WMT	72	\$50.18	\$48.94	\$3,613	\$3,524	3%
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	\$17.00	(\$1,050)	(\$5,100)	-4%
SPY Sep 77 Put	300	\$13.60	\$0.50	\$4,080	\$150	0%
Cash Position					\$70,558	58%
Portfolio Total					\$122,249	
<i>Portfolio Metrics:</i>						
Portfolio Return						22.2%
S&P 500 Return						1.1%
Portfolio Beta						0.1
Portfolio Yield						1.4%
Equity Exposure						25%
Net Exposure						42%
Total Exposure						77%

## ***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.

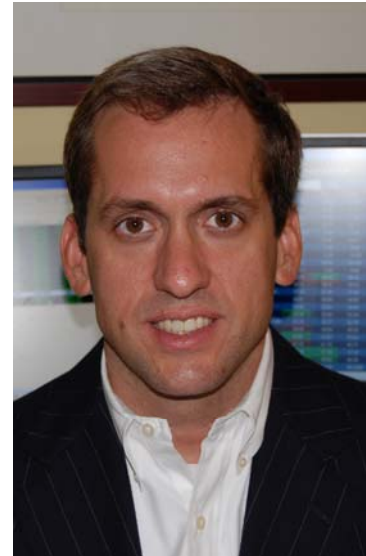
**Option Trade** – Based on the market environment, I will recommend option trades. In general, I prefer to write, rather than buy, options and will always look for opportunities to receive premium while hedging my risk.

**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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