

EPIC INSIGHTS

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THE WEEK AHEAD

T.S. Eliot famously declared that April is the cruellest month. Obviously, he was not watching the stock market. For investors, September is the worst month for stocks and October has offered a number of dramatic one-day crashes. As this week marks the end of summer with the passing of the Labor Day holiday, we are now facing a historically difficult two-month stretch. With the Dow Jones Industrial Average (Dow) well off both the March capitulation low and July consolidation low, momentum has paused as the Dow declined 1.1% last week. However, the Dow has been higher six of the last eight weeks so the bullish momentum is intact.

Those looking for data-driven action will be disappointed over the coming days. Actually, the upcoming week of 9/7 to 9/11 (**Figure 1**) will be one of the more data-deprived

Figure 1 Weekly Calendar

<u>Day</u>	<u>Date</u>	<u>Announcement</u>	<u>Time</u>	<u>Estimate</u>	<u>Prior</u>
Monday	9/7	Labor Day Holiday	U.S. Markets Closed		
Tuesday	9/8	Consumer Credit	3:00 PM	-\$4.0B	-\$10.3B
Wednesday	9/9	Fed's Beige Book	2:00 PM		
Thursday	9/10	Initial Jobless Claims	8:30 AM	560k	570k
		Continuing Jobless Claims	8:30 AM	6200k	6234k
Friday	9/11	Wholesale Inventories	10:00 AM	-1.0%	-1.7%
		U. of Michigan Confidence	10:00 AM	67.5	65.7

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

weeks I have seen since I started writing this newsletter a year ago. Stock prices will move, but not because of anything on the predetermined calendar.

For the specifics of the week, Monday is Labor Day and all U.S. markets will be closed. **Tuesday** provides information on consumer credit. **Wednesday** brings the Federal Reserve's (Fed) view of the economy via the Beige Book. **Thursday** features the weekly employment report. **Friday** ends the week with readings on wholesale inventories and consumer confidence.

TECHNICAL TRADE

Support and resistance are two powerful technical barriers. Just as waves stop at the shore and then pull back out to sea, trending markets often stop when they reach certain levels and then reverse direction.

To initially draw support and resistance lines, we look for prices where trends reverse. The more reversals we see the greater the likelihood that the price point is important.

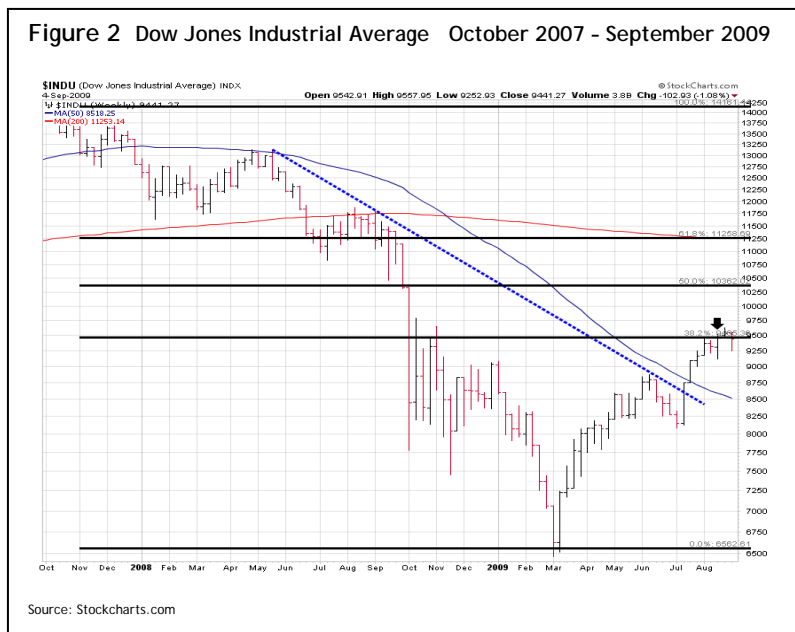
While such an approach is useful in hindsight, it does not always provide us the ability to forecast the future.

To do so, we must anticipate where support and resistance will occur and then trade accordingly. Many will view this mission as nothing more than guessing at price points, but there is one key rule we can follow—when resistance is broken it immediately becomes support (and vice versa). Therefore, by looking back at prior technical levels, we can gauge our expectations for the future.

An example of this pattern is the performance of the Dow during the bear market. From a peak of 14,164 in October 2007 to a low of 6,547 in March 2009, the Dow declined 7,617 points (**Figure 2**). Using Fibonacci retracement levels, I identified 9,465 as the first level of resistance to the current rally.

When that price was bettered three weeks ago, it offered two important messages. The first was that the bullish trend remained in force and we should expect prices to continue higher.

Recognizing this, I recommended the purchase of five different ETFs that benefit from increasing markets. The second lesson is that the prior resistance



level of 9,465 must now offer support. Knowing that markets do not move endlessly in one direction, any decline in the Dow would offer an important retest of this newfound support level.

Last week's decline in the Dow provided some clear insights. When the Dow cut through this support level during a panic-driven sell-off, it caused concern. However, from there we saw a series of rallies with Friday's close coming within 24 points of reconquering this price point.

Such action will force us to train our eyes over the coming week. The ability of the Dow to move and then stay above 9,465 will indicate that the rally

continues. However, rallies that fall below that price will show us that lower prices await. Being so close to a key swing point, **no technical trade is recommended this week**. Instead, we will watch for the market to render its decision and then act accordingly.

FUNDAMENTAL TRADE

One of the most controversial topics in all of investing is how to handle positions that have moved against you. Some investors are strict believers that any position showing a loss indicates your initial theory was incorrect and therefore, after a predetermined drop (most use a 10% to 15%

loss as their trigger point), the position should be sold. Others take the opposite view and argue that if they liked a stock when the price was 15% higher, they should love it now, and are compelled to buy more shares. I land somewhere in the middle.

When we determine the value of any stock, it is an inherently imprecise process. We may do mountains of research and number crunching to derive a fair value target, but it is only that—a target. As new information becomes available, we must continually reassess our initial theory and determine whether the stock is one to hold.

As our views evolve, we watch the market. If positions continue losing money, perhaps a message is being sent that requires our attention. In order to balance the need to revisit ideas while also looking to buy inexpensive shares, I have a formal process in place for reviewing my analysis when a stock moves against me. After such a review, I either increase my holding or eliminate the position. By following such a dictum, I am taking a proactive

stance to properly position my portfolio.

The importance of a review brings us to this week's stock selection—Nokia (NOK). NOK is the largest cell phone maker in the world with current market share near 36%. It also provides equipment, solutions, and services for communications networks. While other phone makers have focused upon set product niches (i.e. – Research in Motion's focus on smart phones) or relied upon one-off products to drive growth (e.g., Motorola hit a home run with the Razr, but has not had success since then), NOK has a diversified product base that is sold throughout the world. The end result is a steady, dominant market share with less reliance upon hot products and certain segments of the world economy to drive growth.

Over the past two years, NOK's stock has been decimated. Since peaking above \$40 in December 2007, NOK has fallen to the current price of \$14.38 (a 64% drop). Despite very high levels of return on equity and market share, NOK has lagged both its peer group (the peer group

has a year-to-date gain of 43% compared to NOK's decline of 7.8%) and the S&P 500 (the S&P 500 shows a year-to-date gain of 12.5%). While the analyst community attributes the drop to shrinking margins one day and concerns over market share the next, we now find ourselves looking at a company that is cheaper than it has been in years, offers a safe, high-dividend yield, and provides tremendous upside.

From a valuation perspective, NOK trades at a 7 P/E multiple (vs. a 5-year average P/E of 16.6) and pays a 3.7% dividend. Using historical measures, the shares should be trading in the upper \$30s. Applying a conservative earnings yield methodology that assumes a 2% drop in operating margins, declining market share, and a 3% terminal growth rate, I derive a fair value estimate of \$28. With the stock trading at nearly half my fair value target, we are being offered a global leader in a key industry at valuation levels that have not been witnessed in years. We also gain the benefit of a high-dividend payment while we wait for the markets to recognize fair value.

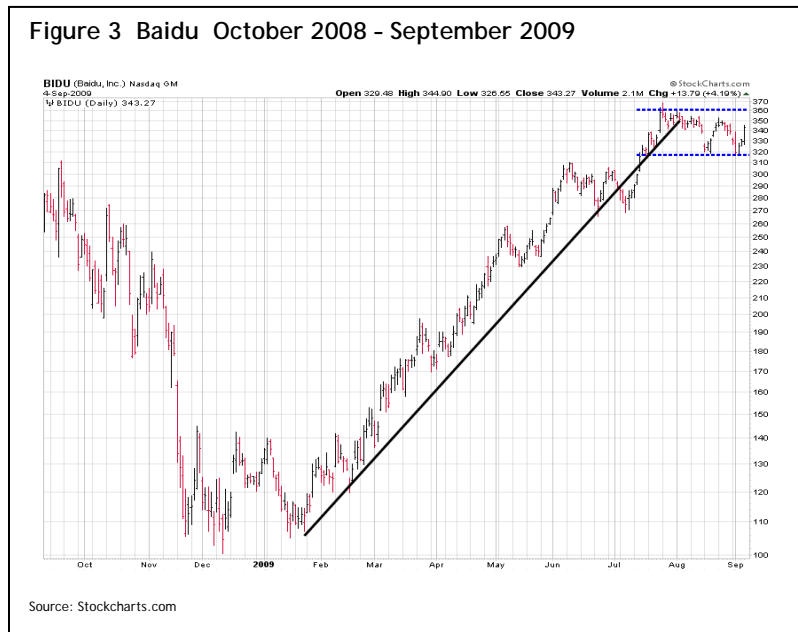
I initially purchased NOK shares in November 2008 and am currently sitting on a 12% loss. Is the market telling me I am wrong and need to exit? I think not. The rationale behind my initial decision to purchase the shares is equally compelling now. We have a 2% portfolio position in NOK at the moment. **I recommend an additional 2% long position in NOK 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 oil/gold pair trade, 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, these trades are 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 20% 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 228% higher. With

such sharp rallies, we often expect to see spikes higher. Instead, BIDU has followed a long uptrend (black line) and is now showing signs of consolidating (blue lines) (Figure 3). With the large gap higher last Friday that overtook the 10-day moving average (MA), BIDU is showing signs that it is done consolidating and is prepared to move higher.

Having identified an excellent stock to own, we turn to position size. Here, our problems mount. At nearly \$340, a 2% position in BIDU would consist of only seven 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 \$360 over the coming weeks, I will buy the September 340 calls (BDU+IG) and simultaneously sell short the September 360 calls (BPJ+IL). This trade should cost \$7.80 while providing a maximum gain of \$20 (156%). 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 1.25% position in the BIDU 340/360 bull spread as this week's option trade.** That is

two contracts for my portfolio size. Adjust your position size as needed.

CURRENT RECOMMENDATIONS

As the market succumbed to weakness, we did not. On a week where the S&P 500 declined 1.2%, our portfolio increased 0.1%. Harvesting gains from TIF and being on the right side of the gold/oil pair trade allowed us to prosper. Adding these results to those of prior months, **since inception we show a gain of 21.8% versus a gain of 4.9% for the S&P 500 (Figure 4).**

Entering a holiday shortened week, I remain bullish and believe prices are destined to move higher. Currently, we have only a 20% equity position and a beta of 0.1. This points to our risk-averse stance and is an indication of the flexibility we possess. My eyes are fixed on the Dow where a solid move above 9,465 would indicate the trend is due north. Until then, we remain patient and opportunistic. While some like to take large swings in order to generate great returns, I prefer patiently compounding steady results. As we all learned

from the famous children's story, slow and steady wins the race.

Figure 4 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>
ALL	103	\$24.06	\$28.85	\$2,478	\$2,972	2%
AMZN	(56)	\$79.18	\$78.87	(\$4,434)	(\$4,417)	-4%
CAL	(308)	\$11.97	\$13.70	(\$3,687)	(\$4,220)	-3%
CLF	(133)	\$27.96	\$25.57	(\$3,719)	(\$3,401)	-3%
COP	(54)	\$44.76	\$44.97	(\$2,417)	(\$2,428)	-2%
DELL	163	\$14.77	\$15.64	\$2,408	\$2,549	2%
EFA	48	\$51.22	\$52.47	\$2,459	\$2,519	2%
EVF	618	\$5.02	\$5.25	\$3,102	\$3,245	3%
EWA	249	\$19.64	\$20.55	\$4,890	\$5,117	4%
EWZ	80	\$60.96	\$59.92	\$4,877	\$4,794	4%
FXB	(45)	\$161.91	\$163.66	(\$7,286)	(\$7,365)	-6%
GIS	37	\$58.05	\$58.51	\$2,148	\$2,165	2%
GLD	52	\$93.14	\$97.62	\$4,843	\$5,076	4%
GS	30	\$119.34	\$162.97	\$3,580	\$4,889	4%
HD	97	\$25.25	\$27.03	\$2,449	\$2,622	2%
HYG	20	\$83.77	\$81.77	\$1,675	\$1,635	1%
IOO	88	\$55.29	\$55.76	\$4,866	\$4,907	4%
KO	72	\$42.20	\$49.95	\$3,038	\$3,596	3%
KSWS	139	\$8.79	\$9.24	\$1,222	\$1,284	1%
LQD	15	\$103.52	\$104.87	\$1,553	\$1,573	1%
MOT	490	\$4.19	\$7.73	\$2,053	\$3,788	3%
MS	(165)	\$21.60	\$27.58	(\$3,564)	(\$4,551)	-4%
MSFT	100	\$19.90	\$24.62	\$1,990	\$2,462	2%
NLS	363	\$2.83	\$1.78	\$1,027	\$646	1%
NOK	189	\$15.90	\$14.38	\$3,005	\$2,718	2%
PFE	126	\$15.76	\$16.39	\$1,986	\$2,065	2%
PG	49	\$50.33	\$52.86	\$2,466	\$2,590	2%
QQQQ	62	\$39.85	\$40.34	\$2,471	\$2,501	2%
TBT	90	\$40.19	\$47.61	\$3,617	\$4,285	4%
UAUA	645	\$5.72	\$6.31	\$3,689	\$4,070	3%
USO	(133)	\$36.57	\$35.13	(\$4,864)	(\$4,672)	-4%
V	(38)	\$63.98	\$70.25	(\$2,431)	(\$2,670)	-2%
WMT	72	\$50.18	\$51.68	\$3,613	\$3,721	3%
FSLR Sep 165 Put	(200)	\$44.00	\$44.00	(\$8,800)	(\$8,800)	-7%
MA Jan 90 Put	100	\$7.00	\$0.15	\$700	\$15	0%
SPY Sep 77 Call	(300)	\$3.50	\$24.90	(\$1,050)	(\$7,470)	-6%
SPY Sep 77 Put	300	\$13.60	\$0.05	\$4,080	\$15	0%
VIX Oct 25 Put	1,200	\$1.00	\$0.75	\$1,200	\$900	1%
Cash Position					\$93,065	76%
Portfolio Total					\$121,791	

Portfolio Metrics:

<i>Portfolio Return</i>	21.8%
<i>S&P 500 Return</i>	4.9%

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.

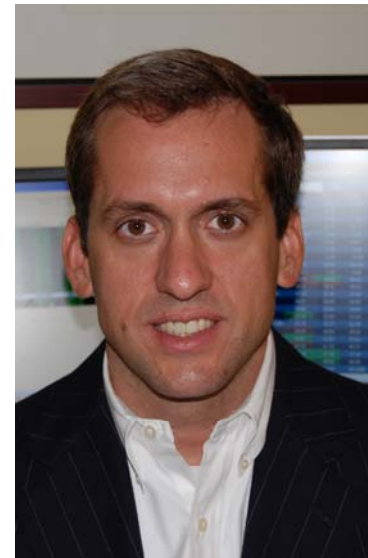
Option Trade – Based on the market environment, I will recommend option trades. In general, I prefer to write, rather than buy, options and will always look for opportunities to receive premium while hedging my risk.

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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