

# EPIC INSIGHTS

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## *THE WEEK AHEAD*

Typically, I begin this section with a statement that leads into a discussion about events that occurred the prior week and how they will affect the market going forward. This week, I begin with a question. Following a holiday-shortened week in which the Dow Jones Industrial Average increased 1.9% on little new information and appeared to top, what would we expect over a data-filled week where some information was positive, but nothing tremendously bullish was announced? The logical answer would be for the market to sell the news and move lower as investors realized gains from the prior week. This week logic failed. Instead, we saw a similarly relentless march higher as the Dow increased 2.2%.

With the market overbought, stocks overvalued on a fundamental basis, the broad economy improving, but not yet robust, we see

the Dow 50% above its March panic low and 20.5% above the low reached on July 10. Faced with this data, what does a prudent investor do? Buy stocks.

As the market continues higher, each new purchase becomes more risky. Prices do not move in straight lines and will eventually correct. My timing model is overbought and the Dow has been higher 9 of the past 11 trading days. Eventually the momentum will cease, and the question will be if we are witnessing a pause in the continuing

trend or an ominous reversal.

As the correction occurs, many will panic and look to liquidate positions. With a price target of 10,500 for the Dow, I believe such actions will be costly. As I described in a recent [market commentary](#), until we witness a breakdown in market technicals, weakness should be bought.

Waiting for an eventual pullback, I am curious about how information will be received over the upcoming

Figure 1 Weekly Calendar

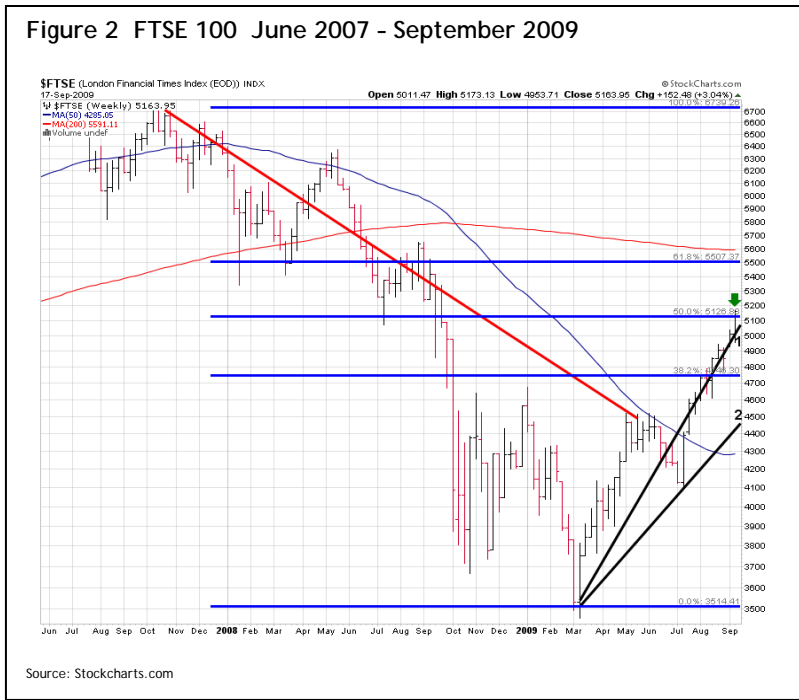
<u>Day</u>	<u>Date</u>	<u>Announcement</u>	<u>Time</u>	<u>Estimate</u>	<u>Prior</u>
Monday	9/21	Leading Indicators	10:00 AM	0.7%	0.6%
Tuesday	9/22	CCL Earnings	BMO	\$1.18	\$1.63
Wednesday	9/23	FOMC Rate Decision	2:15 PM	0.25%	0.25%
Thursday	9/24	Initial Jobless Claims	8:30 AM	550k	545k
		Continuing Jobless Claims	8:30 AM	6190k	6230k
		Existing Home Sales	10:00 AM	5.35M	5.24M
		Existing Home Sales (MoM)	10:00 AM	2.1%	7.2%
		RIMM Earnings	AMC	\$1.00	\$0.86
Friday	9/25	Durable Goods	8:30 AM	0.4%	4.9%
		Durables ex Transportation	8:30 AM	1.0%	0.8%
		New Home Sales	10:00 AM	440k	433k
		New Home Sales (MoM)	10:00 AM	1.6%	9.6%
		U. of Michigan Confidence	10:00 AM	70.5	70.2

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

*Note: All times are Eastern Standard Time (EST)*

*Source: Bloomberg*

week of 9/21 to 9/25 (Figure 1). While the amount of information delivered will be sparse, the few reports we will receive are of great significance and will have the ability to swing prices. For the specifics of the week, **Monday** features a report on the leading economic indicators. **Tuesday** provides earnings from cruise ship operator Carnival (CCL). **Wednesday** features an interest rate decision from the Federal Reserve (Fed). Although targeted interest rates are expected to be held steady, interest will be paid toward the Fed's expectation of economic direction and how it is handling its special liquidity programs. **Thursday** features the weekly employment report and existing home sales. Home sales are expected to continue rebounding from the low of 4.5 million reached in January. Additionally, many traders will be glued to the earnings announcement from Research in Motion (RIMM) after the market closes. RIMM typically offers volatile trading and I expect many to be positioned for such a move. **Friday** ends the week with more housing information via new home sales.



### TECHNICAL TRADE

One of the basic principles of profitable trading is to do more of what is working and less of what is not. Bending this theory into action can at times be confusing, but one approach is to focus on which stocks have been strongest and position for the ride.

For my investments, I often look for items that have traded strongly and then follow the trend higher. However, I hate rushing into items that have experienced sharp moves that are unsustainable. Instead, I would rather find an item that is exhibiting strength and slashing through

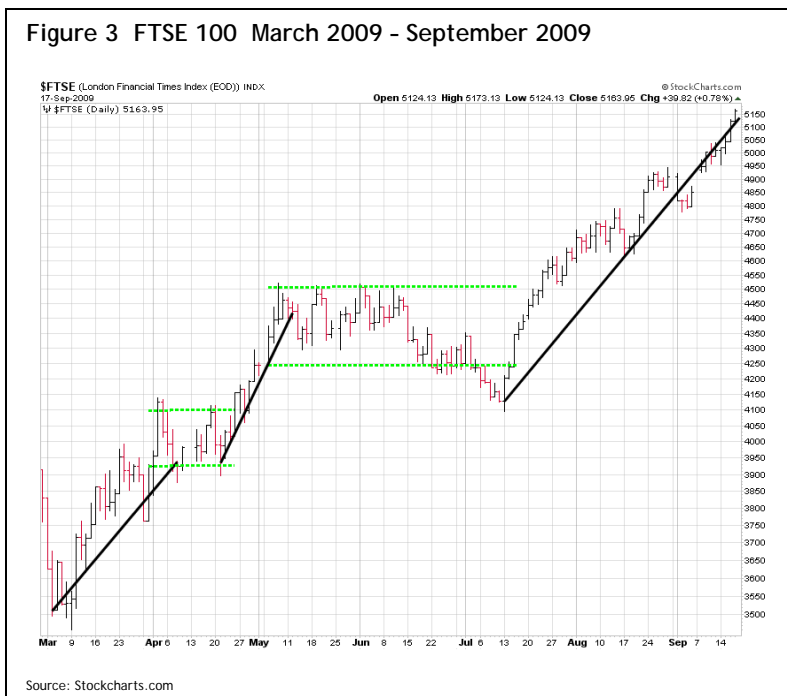
technical barriers, yet has lagged its peer group. When we find such an item, we enjoy the benefits of both strong bullish trends and mean reversion. One of these is enough for a trade, but add them together and the idea becomes even better. This week I have found something that meets all of these criteria—the FTSE 100 index.

The FTSE is a capitalization-weighted index of stocks that trade on the London Stock Exchange. Like nearly every major stock index, the FTSE has had a wild ride over the past year (Figure 2). Since the United Kingdom (UK) faced many of the same troubles that plagued U.S. markets (poor

lending standards, excessive leverage), it is not surprising to have seen the FTSE collapse from a high of 6,732 in June 2007 to a panic low of 3,512 in March (red line). Since then, the recovery started tepidly, but has since gained speed.

Focusing solely on a graph of the FTSE's price from the March panic lows (**Figure 3**), we see an interesting pattern that speaks to further gains. Great bull markets usually operate in a staircase fashion with sharp gains leading to a consolidation pattern which eventually leads to more gains. The FTSE has done just that as each rally (black line) consolidates into a tight trading range (green dotted lines) which then leads to another rally. With the FTSE in the midst of a prolonged rally that launched from a trading range in July, the trend is clearly higher.

Since the shorter time period encourages us to buy the index, I would like to see other factors that encourage this action as well. Returning to the longer-term chart, two items offer support. First, the FTSE has recently traded above its 50% retracement level (green arrow). Bear



market rallies usually regain 50 to 63% of prior losses, and the fact that the FTSE closed above this resistance point now encourages me that the 61.8% retracement is the next price target. Also, the FTSE has lagged nearly all international indices this year and still remains below its 200-day moving average (MA). Just as nearly every other index has reclaimed its 200-day MA, the FTSE will quickly do so as well.

Believing the U.K. markets will continue higher, we should buy the shares. I will use an ETF that tracks that market—the iShares MSCI United Kingdom Index Fund (EWU). To profit from a move toward the 200-day MA, I recommend a 4%

**position in EWU as this week's technical trade. Close the entire position if the FTSE trades below 4,750.**

### ***FUNDAMENTAL TRADE***

Country singer Kenny Rogers has been called many things. Somehow I do not think stock trader is among them. However, some of the famous lines from his songs can be applied to investing. While selecting stocks and deciding what to buy is extremely important, knowing “when to fold them” is just as important.

A key premise that distinguishes me from other

professional investors, which I have employed to my advantage in the time I have been writing this newsletter, is that the discipline to sell stocks is extremely important. Many have been so hammered by the dogma of buy-and-hold investing that they never think when the proper time to exit a position is. By constantly assessing and measuring the risk of our portfolio, I have built a track record that clearly shows that adhering to a specific sell discipline is just as important in creating long-term wealth as is deciding what to buy at what time.

When it comes to selling a portfolio position, deciding when to exit is usually easy. If the stock was bought because it was trading below fair value, once fair value is reached, I sell. If the transaction was based on technical patterns, once those patterns have either completed or reversed, I exit. However, turn to another type of trade, a pair trade, and the decision is more opaque.

A pair trade involves two securities that are affected by similar events and tend to trade in tandem. When the typical relationship between the items no

longer holds, we have an opportunity to buy one item, sell the other, and allow mean reversion to restore the typical relationship.

Since broad market factors are eliminated by offsetting long and short, pair trades work well in markets that are range bound. However, when prices run dramatically in either direction, much like the situation we now face, pairs are less effective.

Looking at our current portfolio we have three pair trades—long Goldman Sachs (GS) versus short Morgan Stanley (MS), long gold (GLD) versus short oil (USO), and long UAL (UAUA) versus short Continental (CAL). Although each of these trades was constructed for different reasons, they all have one common trait in that they have delivered profits to our portfolio.

To review, I recommended buying GS and shorting MS when financial stocks were weak because I felt GS possessed a better business strategy, culture, and management. Since then, all financial stocks have been red hot with our shares in GS increasing 53% and the short MS

position moving higher 45%. Clearly, being long of banks would have been a better trade, but any time you can earn 8% in a purely hedged fashion is respectable.

I recommended buying UAUA and shorting CAL when CAL traded at a 210% price premium to UAUA. I felt the number would drop closer to 185% and the premium currently rests at 188%. By correctly calling for the price reversion, we earned 15% from this hedged trade.

Finally, inflationary pressures, an uncertain economic recovery, and oil being expensive relative to gold all called for us to buy gold and short oil. In less than a month, gold has risen above \$1,000 and this trade has returned a 5% profit.

Having seen these gains delivered, I am channeling Kenny Rogers and know that I should fold them. With the market moving relentlessly higher, hedged pair trades will not operate as expected. Further, having seen mean reversion deliver us gains, I see no need to risk our profits. Taking gains has treated us well in the past and I expect it to continue doing so in the

future. I recommend selling GS, GLD, and UAU and buying-to-cover MS, USO, and CAL as this week's fundamental trade.

### *OPTION TRADE*

Option markets live for volatility. Approaching events where the outcome is uncertain, option prices increase in anticipation of the unknown. At times that increase is unwarranted because the news will fail to drive prices widely. Other moments, the unknown sparks wide swings that allow for profits.

As mentioned in the first section of this newsletter, Research in Motion (RIMM) reports earnings after the market closes on Thursday afternoon. As a favorite of the momentum crowd, RIMM is subject to large price swings.

When approaching an earnings-driven option trade, there are two factors to consider. First, how much will prices move? If the option market's expectations are very different from yours you can create a trade that makes money regardless of which direction prices move.

**Figure 4 RIMM After Earnings Reports**

<u>Period</u>	<u>Pre-EPS Px Move</u>	<u>Post-EPS Px Move</u>	<u>EPS % Surprise</u>
2Q 2010	17%	?	?
1Q 2010	12%	-5%	4%
4Q 2009	5%	21%	7%
3Q 2009	-20%	11%	-17%
2Q 2009	4%	-27%	-1%
1Q 2009	4%	-13%	-2%

*Source: Bloomberg*

Looking at RIMM, the option market is expecting a price move of 13%. Over the past five option announcements, RIMM has moved an average of 16% (**Figure 4**). Typically, this would encourage me to buy a straddle and await a dramatic move, but when you consider that three of the past five post-earnings moves would have resulted in this trade losing money, I am not encouraged.

Ignoring the size of the move, we now focus on the second factor—the direction of the move. On this item I am more encouraged. Over the past five earnings announcements, RIMM has shown a repeatable pattern. Usually, the direction of the price move is dependent on whether the company exceeds its earnings

estimate or not. RIMM violates this rule. Instead, the main driver of where prices go after earnings announcements is where they have been before the reporting date. With the exception of the 4<sup>th</sup> quarter of 2009, the trend of the stock before the announcement was quickly reversed after earnings were announced.

From an option trader's perspective, this is a key data point. As the stock moves higher, more people become bullish. This encourages them to buy call options instead of puts. As the call orders increase, puts decrease in value and allow those who are bearish to buy their position more cheaply. With RIMM 17% higher over the past three

weeks, this is what we are witnessing.

Knowing that puts are becoming cheaper as the public becomes more bullish and that RIMM changes direction post-earnings, I see an excellent opportunity to speculate on the stock declining.

Focusing on the October 75 put (RFY+VT) we can speculate on a 10% move lower for the minimal cost of \$2. By allocating a small percentage of the portfolio to this trade, we put a minimal amount of our capital at risk, but stand to reap large rewards if proven correct. In search of large upside with small downside, **I recommend buying a 0.5% position in RFY+VT as this week's option trade. This equates to three contracts for my portfolio size. Adjust your trade size as needed.**

### ***CURRENT RECOMMENDATIONS***

Last week the market continued moving higher. As I stared at my computer screen each day, fleeting moments of weakness had me questioning if the long-awaited fall in stock prices was about to begin. Moments later I was disabused of this notion as



every dip, no matter how small, was purchased by eager investors and prices marched higher.

Given our low beta and limited equity exposure, you would expect our portfolio to badly lag the market. No such thing has occurred. On a week where the S&P 500 was higher four out of five trading days and increased 2.5%, our low-risk portfolio climbed 3.4%. Strong moves in our core holdings, a 10% one-week return from DRYS (Figure 5), and a strong move in First Solar all contributed to the gain. Adding last week's results to those of prior months, **since inception we show a gain of 31.3% versus a gain**

**of 10.3% for the S&P 500 (Figure 6).**

In addition to the actions recommended in this newsletter, we must also address DRYS. The shares currently trade above both resistance and their 200-day MA and are poised to move higher. Having started with a modest 1% portfolio position, I would like to increase the position, but remain wary. DRYS is a fickle stock and I have no desire to surrender hard-fought gains. Therefore, I will repeat the trading plan detailed in last week's newsletter. **If DRYS closes above \$7.50, buy an additional 2% position. Close the entire position if**

the stock trades below \$5.65.

Having delivered strong gains in this portfolio, I am optimistic about the future. Our patience is being rewarded as disciplined trading has led to large gains while we maintain great flexibility. I still believe prices will move higher over the next six months, but remain range bound for the next decade. By applying our principles, buying what is cheap, carefully monitoring risk, and clearly exiting positions when action is needed, we will stay ahead of whatever the market throws our way.

Figure 6 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	\$30.66	\$2,478	\$3,158	2%
AMZN	(56)	\$79.18	\$89.96	(\$4,434)	(\$5,038)	-4%
CAL	(308)	\$11.97	\$15.93	(\$3,687)	(\$4,906)	-4%
CLF	(133)	\$27.96	\$33.75	(\$3,719)	(\$4,489)	-3%
COP	(54)	\$44.76	\$46.90	(\$2,417)	(\$2,533)	-2%
DELL	163	\$14.77	\$16.65	\$2,408	\$2,714	2%
DRYS	192	\$6.60	\$7.24	\$1,267	\$1,390	1%
EFA	48	\$51.22	\$55.58	\$2,459	\$2,668	2%
EVF	618	\$5.02	\$5.54	\$3,102	\$3,424	3%
EWA	249	\$19.64	\$22.14	\$4,890	\$5,513	4%
EWZ	80	\$60.96	\$65.20	\$4,877	\$5,216	4%
FXB	(45)	\$161.91	\$162.07	(\$7,286)	(\$7,293)	-6%
GIS	37	\$58.05	\$60.31	\$2,148	\$2,231	2%
GLD	52	\$93.14	\$98.75	\$4,843	\$5,135	4%
GS	30	\$119.34	\$182.79	\$3,580	\$5,484	4%
HD	97	\$25.25	\$28.16	\$2,449	\$2,732	2%
HYG	20	\$83.77	\$85.74	\$1,675	\$1,715	1%
IOO	88	\$55.29	\$58.76	\$4,866	\$5,171	4%
KO	72	\$42.20	\$53.69	\$3,038	\$3,866	3%
KSW	139	\$8.79	\$9.56	\$1,222	\$1,329	1%
LQD	15	\$103.52	\$105.79	\$1,553	\$1,587	1%
MS	(165)	\$21.60	\$31.38	(\$3,564)	(\$5,178)	-4%
MSFT	100	\$19.90	\$25.26	\$1,990	\$2,526	2%
NLS	363	\$2.83	\$1.70	\$1,027	\$617	0%
NOK	350	\$15.53	\$15.70	\$5,436	\$5,495	4%
PFE	126	\$15.76	\$16.51	\$1,986	\$2,080	2%
PG	49	\$50.33	\$57.32	\$2,466	\$2,809	2%
QQQQ	62	\$39.85	\$42.40	\$2,471	\$2,629	2%
TBT	90	\$40.19	\$46.81	\$3,617	\$4,213	3%
UAUA	645	\$5.72	\$8.48	\$3,689	\$5,470	4%
USO	(133)	\$36.57	\$37.15	(\$4,864)	(\$4,941)	-4%
V	(38)	\$63.98	\$73.79	(\$2,431)	(\$2,804)	-2%
WMT	72	\$50.18	\$50.11	\$3,613	\$3,608	3%
MA Jan 90 Put	100	\$7.00	\$0.05	\$700	\$5	0%
VIX Oct 25 Put	1,200	\$1.00	\$1.15	\$1,200	\$1,380	1%
Cash Position					\$84,318	64%
Portfolio Total					\$131,299	
<i>Portfolio Metrics:</i>						
						31.3%
						10.3%
						0.1
						1.9%
						33%

## ***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.

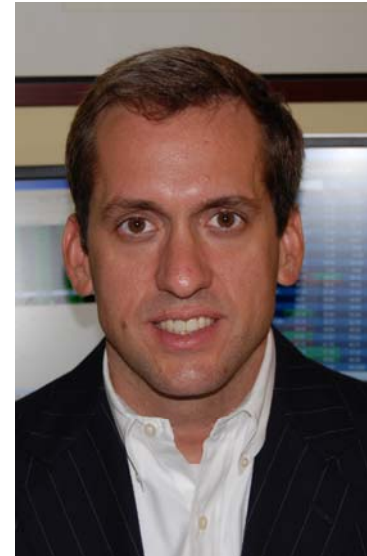
**Option Trade** – Based on the market environment, I will recommend option trades. In general, I prefer to write, rather than buy, options and will always look for opportunities to receive premium while hedging my risk.

**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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