

EPIC ADVISORS, LLC

Weekly Market Commentary

September 12, 2007

Sean Hannon, CFA, CFP

With the start of college football season, Saturdays are filled with images of students and alumni coming back to campus. With homecoming and reunion events taking place over the coming months, it is a good time to reflect on our past experiences and what we learned. Most would agree that four years away from home at an impressionable age offered ample opportunities to learn and grow as an individual. From curriculum learned in the classroom to a variety of other life lessons, we hope that our college years left us with knowledge that would be useful in the future.

My college days were spent in the relative tranquility of Williamsburg, Virginia. Williamsburg is known for many different tourist attractions including Colonial Williamsburg, outlet mall shopping and world-class golf. History, commerce and peaceful recreation come to mind. However, another area attraction that is frequented by students is Bush Gardens. Tranquil? Maybe not, but the speed and thrill of some of the rides can indeed be compared to the current market environment, and what a ride it has been lately.

A popular ride at Bush Gardens is a suspended swing roller coaster known as the Big Bad Wolf. It travels nearly 50 miles per hour and has a vertical drop of over 80 feet. As a suspended swing roller coaster, the passengers will swing at wide angles during the ride. This leaves the sensation of wild movement, large climbs and steep, quick drops.

Having reread that last sentence, the Big Bad Wolf may be the perfect metaphor for today's stock market. Since the stock market set a low on August 16th, the Dow Jones Industrial Average (DJIA) has finished either up or down 100 points nine times. Considering that there have only been seventeen trading days during this time period, the DJIA has seen dramatic moves 53% of the time. In fact, Lowry's Report, the oldest continuously published Technical Investment Advisory in the United States, says that this is the most volatile market environment of the last sixty years. Given the abrupt moves and the wild swings, investors constantly question what it all means and where we are headed.

Surprisingly, this is where I like to think that years of riding a roller coaster at an amusement park can provide an important investing lesson in this market. As you board the ride and prepare for what lays ahead, keep one thing in mind - where do you end the ride? The answer- right where you started. As I mentioned in my last market letter, I believe the DJIA has entered a trading range between 12,900 - 13,500. This range represents less than a 4% move from top to bottom. Since writing about the trading range two weeks ago, we have remained firmly within the band. While the daily price action has been dramatic, it has done little to alter the current investing landscape.

An interesting aspect of volatility is that it is commonly considered a negative event.

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Perhaps it is the effect of all the quants who have decided that volatility equals risk. To them, a volatile period must be risky. I find this logic to be flawed. In my view, a volatile period does little to alter the long-term picture. If you truly believe that buying a stock is the same as buying an ownership interest of a business, why would prior volatility make your decision more or less risky? The true risk of buying a piece of a business is that the business may not perform up to expectations over the coming years. If I have done my research and due diligence, I should be comfortable making an investment regardless of the current market environment.

While I do not believe volatility equals risk, enough people out there do. This fact should be instrumental to what occurs over the coming weeks. The date everyone has circled on the calendar is next week's Federal Reserve Board (Fed) meeting on September 18th. On this day, everyone expects the Fed to cut interest rates, resuscitate the credit markets and allow the stock market to head higher. In anticipation of that event, it is likely that stocks will either rally into the meeting or trade higher after the Fed cuts rates. Since the DJIA closed Tuesday just above 13,300, this action would take us above my predetermined trading range. When this occurs, many technicians will speak of bullish break-outs. Assuming we then see a drop in volatility, all will believe the worse is behind us.

Who can blame them? Given a narrow, misguided set of assumptions, the bulls will clamor about how the market withstood the credit crunch, weathered high volatility (which to them means high risk) and lost very little ground. Stories will be run in the mainstream press that we had experienced the worse credit crunch of the past 30 years and only surrendered 2-3% from the DJIA's all-time peak. If we can get through this contagion, now have a compliant Fed and are knocking on the door of all time highs, what can stop the bulls? This unabashed optimism will lead the DJIA through 14,000. It seems like we're on a smooth ride, as the roller coaster slowly clicks its way to the top.

There is just one problem with this rosy scenario - it ignores the facts that housing is deteriorating, the job market is deteriorating, the dollar is weakening and risk is still mispriced. For months, I have described how the official economic numbers from Washington, DC, are flawed and inaccurate. I see many twists and turns ahead. However, during the year, the bulls had clinged to the belief that housing was near bottom and that a strong employment picture would support the economy.

Back in the 1st quarter, the majority felt housing would be corrected by the end of 2007. As the year progressed, that date moved out. Initially it was the first half of 2008, then all of 2008. Now some are admitting that the real estate picture may not improve until much later. I think they may be too optimistic. The majority of home price forecasters see a

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drop in prices during 2007 and 2008. From there, they expect little change until 2011. The net effect will be an annualized price drop of 2-4% over a five year period. While this may be shocking to those who never thought home prices could decline, I find it to be misguided. During the housing boom, many areas of the country saw house prices triple over a six year period. This represents annualized gains of nearly 20%. If the forecasted price decline of 2-4% occurs, we would still see housing appreciate over 10% per year during this entire period. Ten percent annualized gains do not feel like a boom/bust cycle.

Turning to employment, the professional forecasters are equally misguided, and equally wrong. For months, they have trumpeted steady gains in the Bureau of Labor Statistics' (BLS) monthly employment report. Then came August. During August, the official employment number was a loss of 4,000 jobs. While this is a poor showing and well below expectations, it masks a much worse picture. The prior two months were revised lower by 81,000 jobs. More importantly, within the 4,000 job loss, the BLS birth/death model created 160,000 jobs. As mentioned in prior letters, the Birth/Death model uses time-series modeling that relies upon historical data to forecast jobs that were created today. The net effect is a model that looks backward in order to predict what happens now. All of us would agree that the boom of the past few years will look much different than what we will witness in the future. This will lead the BLS to consistently overstate the employment picture. An inaccurate view of employment will mask the weakness of the economy and catch all the goldilocks bulls off-guard.

All year, I have maintained price targets for the DJIA of 12,400 and the S&P 500 (S&P) of 1,375. Given the deteriorating economy, I have revised those to price targets of DJIA 11,900 and S&P 1,325. While the Fed will attempt to resuscitate the economy with rate cuts, they are too late to offset the economic slowdown. Ben Bernanke's (Chairman of the Fed) blind insistence to eliminate the "Greenspan put" triggered a credit crunch and eventual recession. To me, Bernake appears more interested in declaring his independence from the prior Fed regime than proactively tending to the economy. While Bernanke attempts to distance himself from his predecessor, he has created his first economic trauma. Now we will need to see how adept he is at pulling us out of recession and guiding the economy to sustained growth.

Based on my analysis, we face an interesting market. To summarize, I think we will see a quick 4-8% rally in the DJIA. This will cause the masses to turn bullish. Once they have entered the market, buying interest will evaporate and the DJIA will lose nearly 2,500 points as it sinks to my price target (a near 20% drop). Strategically, what does one do?

The increased volatility of the past month has provided a great trading opportunity. I

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have taken advantage of this environment to actively trade and reap gains. At the same time, I have realized gains on a few merger trades as the stock prices approached the merger price. The net effect is that my target 80% allocation has now slipped to 75% net long. Believing there is more upside to this market, I plan to take a 5% position in commodities. This will bring my target allocation back to 80% while adding a sector of the market that should benefit from the pending Fed action.

Long term, I am more cautious. Going into next week's Fed meeting, I will keep my trigger finger ready. At any sign of market duress, I plan to reduce my exposure to 70% long. As the DJIA rallies toward 14,000, I will aggressively reduce exposure to the equity markets. If things play out as I expect, I will reduce my exposure to *Indexed Advantage*[™] model portfolios and sell some long-term holdings that surpass my price targets. Also, as a number of mergers close this fall, I will liquidate my merger arbitrage positions. Heading into the peak, I expect to have 50% of the portfolio allocated to our long-term holdings with a number of short positions to reduce risk. Doing so will provide positive returns while minimizing risk.

A volatile market can feel like a roller coaster ride. With an educated, well thought out investment strategy one can fair the twists, turns and drops, enjoy the thrill, all while coming to a halt not too far from where one started. Ladies and gentlemen buckle up and keep your hands and feet inside the car at all times....