

EPIC ADVISORS, LLC

Weekly Market Commentary

September 23, 2008

Sean Hannon, CFA, CFP

As a value investor who takes in-depth bottoms up views of companies, I love looking at reams of data with the hopes of discovering a hidden gem. At times you find information buried in a company's financial statements. Other times you see how the general market misprices risk and look to profit from the opposite view. No matter where the data originates, you need to look, examine and determine a profitable course.

Looking at the performance of the Dow Jones Industrial Average (Dow) during the month of September, there is plenty of data to parse. During September we have seen a level of volatility that has not occurred in recent memory. Through the 22nd, the average daily move of the Dow has been 262 points (2.34%). If you eliminate the three days where the Dow moved less than 100 points, we have seen average swings of 332 points (2.97%). Digging deeper, the intraday swings have been even greater. If we look at the difference between the high price and low price for the Dow, the average intraday swing during the month of September has been 460 points (4.12%). The sums to a total of 6,670 points through September 22nd. Considering that volatility has increased over the past six trading days as the market has moved over 3% five of the past six days, there is a reasonable chance that the Dow could move a total of 10,000 points over the course of one month. Within this great volatility, the Dow has moved 172 points between September 4th and 22nd.

While staring at these statistics is fascinating, the more important mission is to derive the investment implications. There are a few key themes. The first is the extreme volatility offers ample opportunity for both profit and loss. With markets swinging wildly, yet the price level remaining stagnant, one must be patient and disciplined. Look to book profit quickly and reenter trades when the risk/return tradeoff is favorable. What may look like a foolish trade today is likely to look brilliant tomorrow.

A more important lesson we can draw from this period is to reexamine why we make the investment choices we do. Most will agree that the point of investing in the financial markets is to increase wealth over time. While there are many different options investors can choose, the basic investment choices can be broadly dissected into four major categories. Those categories are cash, bonds, commodities and equities. Within these categories the risk profile and expected return differ greatly. Given the volatility we have witnessed over the past week, now is a good time to review the four choices and ensure that our risk tolerance, investment goals and asset choices are aligned.

Cash is the easiest asset to understand. An investor can expect to receive a nominal, clearly defined rate of return with no loss of principal. Often, this rate of return is below the inflation rate and

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the investor slowly loses wealth for the privilege of knowing their asset will not lose value. For this reason, cash is often seen as a temporary safe haven as opposed to a long term asset choice.

Bonds offer similar characteristics to cash yet pose additional risks. A bond investor has many different choices that can be made. For higher interest rates, the bond investor can either commit their money for long periods of time or invest their money with a company who may have trouble repaying the debt in the future. Among safe bonds, predetermined interest rates can be used to ensure that income is adequate to offset expenses. However, inflation will erode the purchasing power of a fixed income stream and the risk of falling wealth increases.

One of the best ways to protect yourself against rising inflation is through an investment in commodities. As prices rise, commodities will increase in value. This offset allows an investor to protect their wealth. While this is an attractive feature, commodities have many drawbacks. Chief among them are heightened volatility and lack of current income. As recent action in the oil markets have shown, large swings in commodity prices are very common. Most investors have difficulty absorbing these price swings. More importantly, commodities do not generate income. An investor who bought oil 10 years ago is sitting on enormous gains. However, he has incurred expenses during this time period and has received no cash income unless the position was sold. Since most need to draw income off their portfolio, commodities lack of income is a significant drawback.

The final asset class is equities. At their core, a stock is a partial ownership in a business. As the business grows, investors can expect to see their share price increase and possibly receive current income in the form of dividends. As the economy enters recession, business declines, stock prices suffer and the income may become jeopardized. While there are risks of owning a specific business, a person with a diversified portfolio will minimize these risks while maintaining upside profit potential.

Across these four asset classes, cash offers the lowest returns and equities the highest. As one would expect, cash also offers the lowest risk while equities offer the highest risk. When deciding where to invest your money, there are many different factors people will consider. While we can run different scenarios and attempt to define people's risk tolerance, it is often difficult to determine a concrete answer. Most investors know that stocks offer higher returns than other assets. That leads them to convince themselves that volatility can be tolerated as we search for higher gains. However, as we enter chaotic markets, investors often panic, change their minds and make decisions at the worst possible time.

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For this reason, I believe the most important factor that should be considered is the amount of time until a person needs access to the money they are investing. Funds that are needed in less than one year should stick with low risk cash and fixed income alternatives. Money that is not needed in the immediate future and can be committed to financial markets for many years should be in an equity portfolio that employs strategies with which you are comfortable.

This distinction of time is one of the key traps for most investors. During the height of the dot-com stock market bubble, I knew a very successful day trader. After a tremendous 1999, the trader had accumulated large gains and an equally large tax bill. Knowing he would eventually need to pay the IRS, the trader had a certain amount of his portfolio designated for future taxes. As the internet market was hot during the 1st quarter of 2000, this trader could not bear reducing his equity position to pay taxes. Instead, he decided to employ his capital and seek more gains. Initially this plan worked. However, by mid-March he had suffered losses he was unprepared to realize. By May, he had missed filing his taxes, seen his position decimated by margin calls and was left with an outstanding tax bill he would never be able to pay. Knowing the government is not the most forgiving of creditors, this person has spent nearly a decade trying to recover from past mistakes.

How did a smart person with great experience make such a mistake? Simply, faith was put in the assumption that since equity markets offered higher rates of return, excess cash should always find its way into the stock market. This assumption is critically flawed. As the past few weeks have taught us, markets can act irrationally, oscillate wildly and cause frustration for all involved. People who have a need of capital over short time periods would be better suited to reduce risk and seek safety. Those with time on their side should develop a strategy, execute it in the markets and allow the strategy to deliver gains. Constantly reworking your risk tolerance, time horizon and investment goals will often cause you to make poor decision at inopportune times. Too many of these missteps leads to wealth erosion as opposed to wealth creation and a lot of anxiety along the way.