

EPIC ADVISORS, LLC

Weekly Market Commentary

October 28, 2008

Sean Hannon, CFA, CFP

With three trading days remaining, I will be happy to see the month of October pass. During this month, what had been a bad bear market turned viscous. At the beginning of October the Dow Jones Industrial Average (Dow) was 18.2% lower for the calendar year and 23.4% below the peak of 14,164 achieved in October 2007. With VIX trading near 40, investors were on alert. However, little could have prepared for the carnage. Over the past 3 weeks, we have seen the Dow drop an additional 24.7%. This brings the year to date loss to 38.4% and the drop from last October's peak to 42.2%.

While these drops have been devastating, the internals of the stock market are enough to shake the core of most investors. During October, the Dow has closed higher on 4 trading days. On those positive days, the average gain has been 5.2%. On down days, the markets has fallen an average of 3.4%. The average spread between the high point and low point in a given days has been 722 points.

I have often said that confusion presents opportunity. At current price levels, all major indices are now trading well below my fair value targets. Value Line reports the average Price/Earnings ratio (PE) of 12.1. The prior bear market low was 14.1. Many leading companies are selling at prices that are 60-80% below where the traded a year ago. From a technical perspective, stocks are as oversold as they have ever been. My timing model needs an average rebound of 55% in order to revert to a more balanced position. With markets wound this tight in one direction and values appearing across the board, the likelihood of a sharp rally increases. However, we must remember a few key lessons. When living through paradigm shifts, cheap stocks can become cheaper and oversold markets can remain oversold. Expecting the selling to cease does not translate into markets immediately moving higher.

For this reason, the next two months will be among the most important periods in stock market history. In one week, the Presidential election will end. This will remove a layer of uncertainty. Further, Treasury will be implementing additional pieces of the TARP plan and Congress has indicated they may pass an additional stimulus bill. By late November, massive amounts of liquidity will be in the system, some pieces of uncertainty will be resolved and consumers will begin focusing on the holiday season. Within this environment, stocks should behave well, unwind the oversold nature and recoup losses. To me, a rally into Dow 10,000 seems plausible and achievable. After that, bigger questions remain.

Having suffered through such a harrowing drop, investors are frightened and angry. The Dow trades near the same level as August 1997. Twice in a 10 year span investors have seen stocks rally sharply to crater just as quickly. With a 42% drop from the October 2007 peak of 14,164, many investors have seen a lifetime's savings cut in half. Those who used modest leverage have seen their wealth drop greater percentages. As the Dow has made no money in a decade, people begin

EPIC ADVISORS, LLC

Weekly Market Commentary

October 28, 2008

Sean Hannon, CFA, CFP

questioning the wisdom of a long term allocation to equities. Add in the extreme volatility and investors quickly decide that fleeing the market is a wise choice.

I easily understand the motivation and actions of investors who are scared of what lies ahead. People approaching retirement now face a situation where they must either continue working or alter their lifestyle. Investors will begin reevaluating their willingness to accept equity risk and money that is needed for expenses in short time periods will be shifted to safer havens. Combined with the deleveraging of banks and hedge funds, fewer buyers exist for the stocks traded in the market. The clear result is prices must drop to lower levels to reflect this new supply/demand balance.

The clear implication of this trend is that all rallies will stall, stocks should no longer be held as long term investment and the only people to prosper for years will be nimble traders who quickly realize gains, avoid missteps and do not allow losses to grow. This trend is logical, yet may be oversimplifying the situation. A small subset of people who can survive with low single digit returns will look toward alternative investments and bonds. However, most people need return in order to achieve their long term goals. For years, people have been assuming high rates of return in their savings calculations. Most private companies have applied returns of 8-10% in their pension calculations. In order to meet these goals, people will continue to seek higher return alternatives. While this bear market has devastated investors and shaken their confidence, a sustained move high will serve as the remedy to all their ills.

With the emotional tug between reducing risk and seeking return, we must watch the market's action over the coming weeks. To work off an oversold nature, markets will either stabilize or rally. Assuming a rally, we need to see how far the market can travel. Most expect any rally to be met with selling as investors move to a lower risk profile. If this occurs, the fears over future stock market returns will be justified. However, markets rarely behave in set, preconceived manners. A sustained rally that pushes us over Dow 10,000 could make people forget the recent past and embrace the long term potential. While the paths the markets will take are unclear, one thing is certain. Over the next two months we should begin to see a trend develop that will persist for years into the future. Successful investors need to watch this underlying trend, position accordingly and look for opportunities as they develop.