

EPIC ADVISORS, LLC

Weekly Market Commentary

September 30, 2009

Sean Hannon, CFA, CFP

I often write about the need for patience and discipline when investing. As we consider our stock market strategy, we must always keep in mind that the market was invented and is operated by people. Over time it has become a Frankenstein-esque creation with a life of its own. Despite the amount of study and research an investor may employ in his decisions, prices constantly move in an unexpected manner that cannot be controlled or predicted.

Because of so many random moves, the stock market appears determined to deliver one thing to investors—frustration. At times, everything we have predicted will happen and it will seem that years of hard work have finally allowed us to master investing. Unfortunately, those periods will be short lived and quickly followed by times where we stare at our computer screens and wonder what else can go wrong. This constant shift from investment glory to investment despair affects everyone. The key is determining how to manage the process so we can maximize gains and minimize losses.

Investors take many different approaches to achieve the goal of containing losses and maximizing gains. Some add to their winning trades, while mechanically applying stop-loss orders when prices drop a certain amount. Others take enormous positions in their best ideas with hopes of one or two successes delivering tremendous results.

I have always favored a more balanced approach of managing risk at the portfolio level, keeping position sizes reasonable, and allowing probabilities to work in my favor.

This strategy is clearly visible in the portfolio I manage via my weekly newsletter [EPIC Insights](#). Since I began the newsletter nearly a year ago, the portfolio has gained 32.9% versus the S&P 500's gain of 9.6% during the same time period. Interestingly, these gains have also been delivered with minimal market risk as the average beta since inception has been 0.31 and the market exposure has never been above 60%.

With such large gains and low risk, many would assume that my stock picking has been extremely accurate. These people would be incorrect. Of the 156 trades I've recommended, 93, or 59%, have been profitable. With such a modest success rate, the key is not that I've picked a lot of winners. Instead, the most telling statistics are that my winning trades have gained an average of 38%, while my losing trades have lost only 6%. The magnitude of gains is much more important than the frequency of success. Therefore, we must always manage money in a manner whereby we weigh the probability of being correct and measure the success we will achieve if prices move in our favor.

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Applying this approach to the current market, I continue believing stock prices will move higher. Everywhere you turn, market professionals offer compelling reasons why the economy is vulnerable and we will see a reversal. However, prices keep moving up. One of the metrics I use to gauge sentiment is my proprietary timing model. Since hitting a recent peak of 86% long on September 16, it has retreated to 72% long. During that time period the Dow Jones Industrial Average (Dow) has declined 79 points. When we see broad-based skepticism, markets going from overbought to neutral, yet prices refusing to decline, it points to a market that is consolidating and preparing to move higher.

Over the coming weeks we will face a tremendous amount of data that could swing prices. Starting with the September employment report this Friday, the official start of 3rd-quarter earnings season with Alcoa's release on October 7, and then continuing with a slew of companies releasing results, many key events are on the calendar. Some investors will try to out-guess others in order to predict prices. By going down this path, they will be right sometimes and wrong other times, but frustrated in the end. Instead, I recommend looking for trade ideas where the probability of success is in your favor, but the gains are large if you are correct and losses small if you are wrong. In the end, the total return on your account is what matters, and magnitude of returns will always dominate the frequency of success.