



Sweet and Lowdown

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In a column posted nearly three weeks before the Nov. 20 market low, I wrote the following:

We're at a particularly dangerous juncture in the market. We're about to split and go our separate ways. Recent homogenous performance (uniformly ugly) will go to the wayside, to be replaced by unusually wide performance spreads.

Then, about one week before the market low, I followed up with:

The bounce in the next cycle will produce disparate gains in stocks -- gains that range from modest to mind-boggling.

The evidence since Nov. 20 unequivocally points to a massive performance disparity among stocks. There's an underlying symmetry here that's beautiful to behold: The stocks that were ravaged the most in the mega-bear market are also the stocks that have bounced the most.

The stocks that I panned as "wet-noodle" stocks, destined to underperform, have barely budged during the recent bounce, with **General Mills** (GIS) , **Johnson & Johnson** (JNJ) and **Kellogg** (K) up by only 4% to 6%. On the other hand, the 13 stocks I suggested as buys in past columns, which included **Expedia** (EXPE) , **Overstock.com** (OSTK) , **CarMax** (KMX) and **Brunswick** (BC) , have bounced by 13% to 147% since Nov. 20, with an average bounce of 50%.

Let's walk through the strategy involved, because I expect it will generate exceptional performance over the next couple of years. Start with this historical fact: Bear markets are followed by rebounds that retrace 50% to 100% of the decline within two years of the low.

There are three important implications here:

1. Since the market does not retrace 100% of a bear market decline instantly (or even within a matter of months), we can safely conclude that the stock market was right; stocks, in fact, merited a discount.
2. Even though the market was correct in applying a discount, it invariably overdoes it. If the market did not overplay its hand, stocks would go down and stay down, but, without exception, the market always bounces.
3. It's important to recognize the symmetry pre- and post-bear market -- namely, baby bear markets beget baby bounces, and big bear markets beget big bounces.

Applied to the individual stock level, the above truisms hold up. Stocks deserved to be discounted in the face of a particularly difficult economy, but the decline was excessive. Remember, the value of a business equals the net present value of its cash flows over the long-term, not its cash flows over the next quarter or two.

Most important, the symmetrical relationship that the rebound shares with the decline facilitates finding the big winners in the next cycle. Kellogg barely got nicked in the mega-bear market just past. A 50% retracement of its itchy-bitsy decline will get you an itchy-bitsy profit. On the other hand, **Office Depot** (ODP) shares fell from \$20 to \$2. A 50% retracement of the decline, to \$11 per share, amounts to a 450% return.

The way to find the big winners in the next cycle is simple: Sift through stocks that have been crushed by 80% or more. There are lots of nuggets to be found in the rubble, including many profitable companies with defensible competitive positions and strong balance sheets.

Bond Market Performance Will Mirror Stocks

Similar to the stock market, massive performance disparity will be a hallmark of the bond market for the next couple of years. Also similar to stocks, huge returns can be had by venturing into segments of the bond market that have been crushed. Junk credit pays more than 20% over risk-free (Treasuries) rates. The spread is twice what we've seen in prior recessions and certain to correct. Even investment-grade debt has been slapped, with many credits trading at 70 cents on the dollar. As with stocks, areas that have been decimated only have to retrace a portion of their decline to generate enormous returns.

Over the next couple of years, high-yield funds should trounce Treasury funds, generating rates of return that are 10 times higher than Treasury funds. Fear has taken Treasury prices to extreme levels. A 2.6% yield on 10-year treasuries? The best-case scenario for Treasury holders is that they will be able to clip the coupon while not losing any principal.

Whether you're a stock or bond investor, success in the new cycle depends on your ability to recognize opportunity. Profit-making opportunities were born in the midst of abject fear. As fear gradually diminishes, over time, the fear discount applied to certain assets will evaporate as well.

At time of publication, Alsin and/or ACM was long Expedia, Overstock.com, CarMax, Brunswick and Office Depot, although holdings can change at any time.

Arne Alsin is the founder and principal of Alsin Capital Management, a California-based investment adviser. Under no circumstances does the information in this column represent a recommendation to buy or sell stocks.
