



## The Cost of Comfort

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When it comes to investing, comfort can be costly. This principle and its antithesis -- that discomfort can be profitable -- apply to investing irrespective of asset class, as I'll demonstrate with examples from both the bond and stock market.

Everybody in the galaxy knows that U.S. treasury bonds are a better credit than junk bonds. But that's just one analytical variable when allocating capital to bonds. The attractiveness of a bond, or of *any* investment, for that matter, is determined by a comparison of price to value. It doesn't matter how "junky" it is -- as long as it's priced right (relative to value), it's fair to consider buying just about any asset.

Back in December 2008, in a *RealMoney* column, here's what I said about junk bonds:

*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. 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.*

Even though it's almost always a dumb idea to predict tenfold outperformance, this particular forecast was actually too conservative. Treasury funds have lost money since that column, while high-yield funds have returned 49%, on average.

The junk-vs.-Treasury performance disparity illustrates just how costly comfort can be. When the comfort premium is massive, as it was when Treasuries were overvalued in December 2008, and junk was dramatically undervalued, those willing to forsake comfort can generate huge returns on their capital.

### **The Same Price-to-Value Principle Applies to Stocks**

Buying comfort is just as expensive when it involves stocks. And it's especially true now, as investors in stocks seem to be interested only in well-known and widely admired companies. In the banking sector, for example, that's **J.P. Morgan** (JPM) . You'll get no argument from me that it has emerged from the chaotic credit crisis to become one of the clear leaders in banking. But that doesn't mean you should buy the stock.

Buy **Metro Bank** (METR) instead. It's a tiny little bank in central Pennsylvania that's been overlooked by investors. It's an easy call to make: Investors in Metro bank will generate returns that will be at least double, and perhaps several times, the returns to shareholders of JP Morgan. Currently trading at \$12, Metro will likely trade 2-3x higher once credit costs stabilize and margins improve to normalized levels. For long-term owners of the stock, the return may be even higher, as I'll explain.

After Commerce was sold to TD Bank in 2007, it changed its name to Metro, became an independent bank and has been busy setting up an identical *de novo* branch build-out strategy that led to a tenfold return for Commerce shareholders in 1995-2008. If

anything, the opportunity for Metro shareholders is even bigger, as the stock is selling at a fraction of tangible book and because the competition has been busy closing branches, creating a much more benign competitive environment than Commerce faced during its growth phases.

If you want to be comfortable owning a heavy equipment manufacturer, buy stock in **Caterpillar** (CAT) . Investors in CAT will generate a decent return over the next few years as the theme of worldwide infrastructure development gets a second wind. On the other hand, if you're interested in making an indecent return -- an obscene return, really -- then forgo the well-known name in the category and buy the stock of **Terex** (TEX) instead.

Terex is just a smaller version of CAT and a No.1 player in most of the niche markets in which it competes. This \$22 stock has a chance to fully recover to its 2007 high of over \$90 per share over the next 3-4 years, in my opinion. That would make it a \$10 billion (market cap) company, a growth trajectory that's infinitely more doable for Terex -- it's done it before, after all -- than it is for CAT, which would have to grow from a \$40 billion behemoth into a \$160 billion monster-sized manufacturer.

If comfort is what you seek, buy a premier retailer like **Nordstrom** (JWN) , which is impressive across the board, from the design and efficiency of its stores to nearly every one of its operating metrics. Because its success is well-known, Nordstrom currently sells for about 1x sales - a full, if not rich valuation for any retailer. As long as they don't make a misstep, you might generate a 5-10% annual return over the next five years from their stock.

Now, if making money is your goal -- and to hell with comfort -- then forget Nordstrom and buy **Sears** (SHLD) . While there's scant room for margin expansion at Nordstrom, Sears has massive margin leverage set to be unleashed, as last quarter's blowout earnings report demonstrated. Even better, Sears has multiple other value-creating levers to pull that Nordstrom doesn't have. For example, it's in the process of unlocking the value in brands such as Craftsman, Land's End and Die Hard, as well as the value in its hoard of real estate, much of which is in prime locations and carried on its books at a tiny fraction of fair value.

If comfort is your primary objective in investing, you're going to get frustrated in this cycle. In the wake of the worst stock market in 80 years, hordes of nervous investors have chased comfort, driving up prices of well-known, well-liked companies.

If you're willing to venture outside of your comfort zone, then by the time this cycle ends (which won't be for a few years), you'll be the one who's laughing all the way to the bank. And, by the way, if you live in Eastern Pennsylvania, just make sure it's Metro Bank.

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*At time of publication, Alsin and/or ACM was long METR, TEX and SHLD, 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.*

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