



## The Strategic Puzzle is Coming Together

By [Arne Alsin](#)

10/12/2009 10:48 AM EDT

URL: <http://www.thestreet.com/p/rmoney/investing/10609852.html>

Don't get cute with this market. This is a bull cycle like none other in history, a cycle where you can make several times the **S&P 500** return by adhering to a surprisingly simple strategy, a strategy I've mentioned many times since late last year.

Now that the bull market is off and running, new pieces to the strategic puzzle have fallen into place, with exciting implications for investors. I'll discuss those in detail, but first I'll reiterate the strategy that has my Top 10 list for 2009 up 95% vs. an S&P gain of 21%, and my other 17 picks from a year ago up 100% vs. a 16% S&P gain.

*The way to find the big winners in the next cycle is simple: Sift through the stocks that have been crushed by 80% or more. There are lots of nuggets to found in the rubble, including many profitable companies with defensible competitive positions and strong balance sheets. (Dec. 10, 2008)*

If you want to dig deeper and fully grasp why buying smashed stocks is outperforming everything else, the hint is here, from another December column:

*How should you be positioned for the new bull market? In general, stocks that suffered the most from liquidity-induced selling will rebound the most. That means, of course, you'll make the biggest return from smaller, less liquid stocks. (Dec. 16, 2008)*

As you recall, a liquidity panic overwhelmed several types of markets last year, causing them to be dysfunctional, or even to shut down, such as the markets for commercial paper, high-yield bonds, mortgages and collateralized debt obligations (among others). Since it remained open and fully functional, the stock market suffered as much as any market, with smaller, less liquid stocks suffering exponentially more than larger, more liquid stocks.

*The bear market we witnessed was aberrational -- a one-of-a-kind cycle. A pinch in liquidity resulted in disproportionate price damage among stocks. The way to beat the indices without breaking a sweat is to fill your portfolio with stocks that were unfairly crushed during the mega-bear. (May 6, 2009)*

The key analytic point is this: Much of the carnage to smaller stocks was not because of value impairment; it was because they were less able to withstand the crushing liquidity demand. Easy money has been made, and continues to be made, by investors who recognize what I observed last year: "Stocks that deserved a 20% haircut have been blistered by 80% or more."

Bargains among smashed stocks are remarkably plentiful. The optimal portfolio strategy is to recycle capital from stocks that have rebounded quickly -- for instance, **Expedia** (EXPE) from my Top 10 list -- and invest it in companies whose rebounds are just beginning. The last four companies I've mentioned in recent columns fit the bill: **Liz Claiborne** (LIZ), **Terex** (TEX), **Manitowoc** (MTW) and **KHD Humboldt Wedag International** (KHD) are down about 80% (on average) from where they traded two years ago and are compelling buys.

As I mentioned at the outset, new pieces to the strategic puzzle have fallen into place. The first piece is the reaction of investors to the dramatic rally we've seen this year: They just don't believe it. Disbelief is both extreme and pervasive, as evidenced by flow of funds data. Despite the rally in stocks, investors have put 30 times more capital in bond funds this year than they've invested in stock funds. Pessimism is even more acute among investors in ETFs, who have invested \$30 billion of new money in ETFs that invest in bonds this year while pulling out \$30 billion from ETFs that invest in stocks.

It will take years for investors to come full circle back to enthusiasm and complacency, suggesting that the duration of this bull cycle will surprise all but the most bullish observers.

History also provides plenty of evidence to suggest that the bull cycle will be lengthy. There's a symmetry that's beautiful to behold following the mega-bear markets of the past 200 years -- that is, the resulting rebound mirrors the magnitude of the preceding decline. It should come as no surprise that the biggest bull market in the past 100 years (1932-1937) followed the most severe bear market in the past 100 years (1929-1932).

Another piece to the puzzle is the amazing improvement in corporate balance sheets. Among nonfinancial companies, cash is at the highest level in more than 50 years, as a percentage of tangible assets. Cash flow relative to inventory and capital expenditures is also startlingly high.

For investors still on the sidelines, it's not too late to get in on the party. In fact, it's still the early days. The economy is about to turn up, fueled by business spending and growth abroad. It will be years before enthusiasm reigns supreme again in the stock market. Meanwhile, there's money to be made in this barn-burner of a cycle.

*Please note that due to factors including low market capitalization and/or insufficient public float, we consider KHD to be a small-cap stock. You should be aware that such stocks are subject to more risk than stocks of larger companies, including greater volatility, lower liquidity and less publicly available information, and that postings such as this one can have an effect on their stock prices.*

---

*At time of publication, Alsin and/or ACM was long LIZ, TEX, MTW and KHD, 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.*

---