Saturday with Jim: And the Price Is Volatility

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Today's newsletter is the first of three "interviews" between a panel of fictional Gaia clients and Jim Pursley, President and Chief Investment Officer of Gaia Capital Management, Inc. Today we will discuss volatility (up and down movement) as it relates to people preparing for retirement (for however long) and for those who are already retired and receiving all or most of their income extra gainful employment. Next week we'll discuss safety and durability of investment income and the week following we'll discuss matching investments with goals, needs and risk tolerance.

JP: Welcome. Would you please introduce yourselves?

JY: I'm Joan Young. I'm not yet retired and came to Gaia to help me save enough money in an intelligent manner so that I may retire comfortably in 15 years. I am 48.

DB: I'm David Barber. I retired three years ago from a major university. My wife and I live on Social Security and monthly income from Gaia. I am 68.

XS: My name is Xavier Soto. I immigrated to the States about 20 years ago, working in odd jobs until I passed the California bar. I've been a practicing attorney ever since. I came to Gaia after trying my hand – with very mixed results – at investing. I will retire someday, though I don't know when. I am 55.

JP: We've all been through the worst financial markets since the early 1930's. Tell me, were you prepared for the volatility we experienced last year and early this year? What did we do right, and what could we have done better?

XS: Last year's drop was larger than I had ever experienced, yet I felt comfortable (most times) that Gaia was guiding me where I needed to go – to a "high, safe and growing income." With income in focus, I was able to at least partially disconnect myself from the stomach-wrenching statements I got at several times during the downturn. I think that Gaia could have done a better job limiting volatility – especially between October 2008 and March 2009. This said, I felt that Gaia was keeping me well informed at key points. In all, I look back on the experience from a platform of relative safety – my account never did suffer "income volatility," notably a drop in income.

JY: I almost pulled my money out at the market low in March. I consulted with Jim, who wisely told me that we were probably at the market lows and, besides, my income was still rising. What clinched the

decision to stay was the prospect of buying low, as shares had fallen some 50% or more from their 2007 peaks, thereby increasing my income and giving me a chance at a nice gain in my capital.

JP: Joan, can you describe how you thought of higher income at the market lows?

JY: You had been stressing income's relative stability in a market storm. You showed me that, throughout the entire downturn, my income never wavered, never dropped. This discussion gave me confidence to continue.

DB: I can't say that I was nonplussed, but Jim had briefed me to expect volatility in my account balance. He noted that in providing a solid and growing income, he was torn between being invested in high-yielding securities whose prices can tumble with the rest of the pack or to seek the relative safety of a money market or government bonds, which yield little but whose prices don't move much. At this juncture, looking back, I see the wisdom of Jim's words and in the execution of his strategy.

JP: We failed to adequately prepare clients for the volatility we experienced last year, though we wrote what seems like constantly that high securities income comes with occasionally volatile account balances. This said, we can all be pleased to have survived the second worst markets since 1926, when serious measurement began. Just how volatile have markets been, and what proportion of time should one expect one's account to be "under water," recovering or going to new highs?

Michael Nairne of Tacita Capital recently mined the data and found that since 1926 investors in U.S. quality stocks spent 33% of the time "under water" or below a prior peak, 38% recovering to the old peak and 29% making new peaks. The average drop from peak to trough was 6.9%. However, there were eight episodes when draw downs were more than 20%. Changing the portfolio mix to include 35% government bonds only slightly improved the "underwater ratio" – 34% under water, 31% of the time recovering and 35% attaining new highs. The "balanced" portfolio dropped an average of 4.4%, over 1/3 less than did the all-stock portfolio.

DB: How is it, then, that stocks have outperformed bonds about 2:1 since 1926 if they are underwater or just recovering about 2/3 of the time?

JP: The key to stock market outperformance is found in the general upward growth of Gross Domestic Product (all goods and services produced) over the years. Stocks tend to follow corporate earnings fairly closely and earnings are somewhat linked to economic activity as measured by GDP. The relationship is not at all perfect, but it's good enough over long cycles to show that stocks have a general upward bias. Bonds, on the other hand, just follow interest rates. Over long periods of time, bond investors only get their interest, whereas stock investors get dividends (the equivalent of interest) and long-term price appreciation. We can't be exact with the data we are presenting today, but we can guess that the 29% of time markets hit new peaks were quite strong and that, combined with the 38% of time getting from trough to old peaks, tended to outmuscle the drops. .

JY: Why didn't income drop along with stock prices?

JP: Income is set by corporate actions in declaring dividends. Stock prices are set by the market, by the supply and demand actions of investors. As such, prices are much more prone to investor psychology than are dividends.

XS: How would you measure my account performance, then? Isn't it a lot like randomly measuring the distance between two points on a constantly changing surface? What does one measurement mean if it can look a lot different just one year later?

JP: I'm glad you asked. I don't think anything involves advisor brainpower more than looking for fair, logical and understandable "metrics" to describe account returns. For example, we recently measured account performance of a client who began investing with us near the height of the markets in 2000. Almost 10 years later, we found that he made 1.1% a year on average over the whole time. Had we measured the

same thing in late 2007, he would have made 6.8%. If we measure his account next year, he could well return to the 6.8% average annual rate. The key for the growth investor is to stay in the "game" long enough to see several peaks and several valleys. Only then can an investor truly measure progress. Using the example I just gave, the client's account indeed was notably higher (measured by the "growth of $10,000") than he was when he started, measuring from peak in 2000 to peak in 2007.

However, as income investors, you are more likely to be interested in the absolute dollar growth of your income and in its growth in percent, too. Our reports to you clearly show you both – dollar income and percent income measured against your "accumulated capital," contributions plus income minus withdrawals. If we used your account balance as a denominator we'd be all over the map, just like the person who just measures two points in determining account balance performance.

JY: How should we, then, think about volatility, as in the down variety?

JP: Your accounts are actively managed – we buy and sell securities on your behalf as conditions recommend. If we do our job well, we'll be able to raise a bit of cash at market peaks for recommitment at market troughs. We did exactly this "scalping" during the entire bear market, albeit less during the freefall, when we were as confused as anyone. Thus, I recommend that you think of down volatility as opportunity to increase your income, for that is exactly what happened in the severe bear market. In fact, markets hitting new highs can create problems for us in looking for high income yielding securities. Dividends tend to be far more stable than do prices. Sometimes we just have to ride prices up by being less than fully invested, as frustrating as it may be. It is our discipline NOT to buy overvalued stocks which gives us "ammunition" to buy stocks at far lower prices.

XS: Are you saying that my emotions, then, can betray me to rash action?

JP: Exactly. Look at Joan's experience. Just when she should be "buyin'" (paraphrasing Warren Buffet) she was actually "cryin'" – here emotions were telling her to flee the markets just when it was darkest. Prior to that, she had remained resolved to "hang in there," trusting us to guide her money safely. Professional investors have a saying "In a panic, long-term resolve is the first thing to go out the window." This said, we learned from Joan's experience and established several "programs" or investment strategies of differing volatility characteristics to match our clients better with what we are likely to encounter in markets.

Thank you all for coming today. I hope that the discussion has helped you to understand that volatility for an income investor does not equate with loss, as income tends to proceed right along and as account balance spends about 2/3 of the time rising. It's the 1/3 of the time that seems to draw the most attention. It just goes to show that fear can be a very powerful force influencing human behavior. As investors, we hopefully better understand that, by the time we are really afraid, it's too late to do anything effective about it. After all, from the bottom we have more time to adjust and can eventually look forward to a new high in our account balances. Meanwhile, our income just keeps "rollin' along," unsullied and unaffected by market turmoil.

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