



## Saturday with Jim: Questions Thought But Not Asked

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12/19/09



Today we expose the eggheads who run Gaia, raid the closets for skeletons of questions thought but never asked and rake the muck of the obvious to the initiated but clueless to most.

Q. Why does my account balance rise and fall?

A. Because it holds investments which rise and fall with the pressures of buyers and sellers - just like prices rise and fall at auctions.

Q. Should I feel elated when my account balance rises and downcast when it falls?

A. No. Historically prices fall about a third of the time and rise about two thirds of the time. It is impossible to predict with accuracy exactly where one is in a "cycle" of movement from bottom to top and back again.

Q. Surely you have a better GPS!

A. We are focused on both income production and price movement, more on the former and less on the latter. Let's divide cycles into two regions: top and bottom. We want to buy near the bottom. Doing so will give us a margin of safety that we would not have if we bought at higher prices. This said, it is valuations that are more important than pure prices.

Q. How so?

A. A valuation is the price of an investment relative to its economic characteristics - earnings, cash flow, sales - a number of measures of value and worth. We like to buy cheaply because of the margin of safety afforded and because of the high income offered at low valuations.

Q. But what causes my account balance to rise and fall - really?

A. Markets are peopled by all kinds of investors, buying and selling hundreds of millions of shares per

day. Each investor has some sort of strategy, often complementary to other ones. A "value investor" who likes to buy cheaply sells when securities reach or slightly exceed "fair value." A momentum investor usually buys from the value investor, selling when momentum wanes and selling begins in earnest. But markets are not always orderly. Sometimes speculation and panic cause prices and values to far eclipse normal levels. It is these times that we can make a lot of money for you if we but recognize the fog over the market participants - the stars in their eyes if you will.

Q. How do I know if I am making money?

A. The \$64 million question. You have two metrics, or measures. One is the amount and growth of your income (the *raison d'être* for your account) and the other is the trajectory of your capital. Income is far more stable than the price of the issuing security, as income is set periodically by the issuer. Only the price is subject to market action. Of course, a company in danger may see its price fall long before its income dividends fall. It is our job to analyze price drops for real falling knives or just their ghosts. From our point of view, a security whose income output remains strong will not have a long-lasting price drop, if it indeed suffers any at all.

Q. So how am I to interpret my account statement?

A. We suggest that you set some financial goals and benchmarks. Goals are best, for they are personal to you. Our reports to you offer you a way to measure your progress toward your goals.

Q. For example?

A. Suppose you wanted to retire in 5 years with an income of, say, \$5,000 a month. You come to us with a portfolio worth about \$200,000 and ask us what we can do. Our accounts are generating about 8% income on their capital now, so using the back of the napkin approach we can probably get about \$16,000 a year from this portfolio, much less than the \$60,000 you need. But you are willing to save. Your target using the 8% figure is \$750,000. We work with you to devise a strategy for attaining your goal. How do you measure progress? You can look at the balance, but a far better way is to track the growth of your income. Yes, that's right. Your goal of \$750,000 is only a target - it is \$60,000 in annual income you need. We provide you with quarterly and annual statements which show income as well as other metrics like balance. Thus, if you focus on the growth and abundance of your income, you will feel that you are making progress.

Q. Why should I invest in securities in the first place? Why not just buy an annuity from an insurance company or a long-term CD from a bank?"

A. You can, but they invest much the way we do - giving you the really short end of the stick for the peace of mind that you might have in seeing your balance grow moderately with no downward fluctuation.

Q. Isn't my income contingent on the balance in some way?

A. No. The two - the dividends and interest you receive from issuers and the price of the securities you hold - are not connected. Thus, as you saw earlier this year the prices of your securities could tank while your income actually rose. If we do our job well, we will hold for you securities which will not cut nor eliminate your cash flow from dividends and interest.

Q. How should I feel when my account balance goes up?

A. Two emotions - happiness that you are richer on paper and a bit of sadness because bargains are probably getting less widely available. This said, we know that prices run in cycles, as we discussed earlier. With this knowledge and the good judgment to know when we have cheap and dear valuations, we can navigate the cycles on your behalf. In short, feel a sense of equanimity in all circumstances. We are not asking you to trust us implicitly, of course - we want you to be informed clients and to ask sometimes uncomfortable questions of us that all may be transparent. But the fluctuations in your account balance are not the true measure of your risk.

Q. Huh?

A. Risk in its pure form is the chance that an investment goes to zero. It may feel that an investment will surely do just that as it gathers downward momentum - all securities do swan dives occasionally. But prices may drop because of investor angst about something more general, not something specific to the investment in question. This "guilt by association" happens more frequently now that exchange traded funds and mutual funds have a larger market presence. Both of these vehicles can be used to control whole portfolios (collections of securities) with the click of a mouse. When you sell XYZ Exchange Traded Fund, for example, you are selling a proportionate share of each security the fund owns. Thus, willy nilly your shares in ABC Widgets goes down with BQR Dumpsters simply because the ETF owned both of them - not because of any change in the outlook for either company. Those who gauge risk from account balance movements are making a big mistake, both in gains and in drops. It is necessary to see if the security is still solid and, even, if the security in question (or the whole portfolio) is appropriate for the risk tolerance of the investor-client.

Q. Risk tolerance?

A. Right. Suppose you detested violent movement in your account and had most of the resources you need for your goals. Thus, you don't need to expose yourself to a lot of volatility to gain your target. We can buy lower volatility securities for you and you can sleep well at night, knowing that all is secure. On the other hand, if you are like the person in the example above (needing \$60K in income and presently receiving only \$16K) we'll need to find securities with higher income payouts and higher growth. Higher income and higher growth can mean higher account volatility. If we do our job well, we will prepare you in advance, so that you may expect volatility.

This concludes today's Question and Answer session. Feel free to send us your questions. We'll do our best to answer them.

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