



Saturdays with Jim: Embracing Volatility

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My first mutual fund investment in Fidelity Magellan in 1983 scared the daylights out of me. I would "lose" a penny or two per share each day, or I might gain a bit. I did not understand what caused the movements in the price and, of course, with little experience, I had no context for where the price was likely to go. I did not stay with the fund... I had no sense of how it would do in the future. In short, my long-term goals were stifled by my fear of volatility.

I now have 25 years as an investment manager under my belt, understand volatility much better, but still cannot predict where an investment will go this day, this week, or this month. I do have the longer-term view in mind and my goals are very clear in term of the income I want in 15 years. I am far more relaxed about day to day or other relatively short-term movements, as they are likely to be reversed by the longer term upward trend. Let me share a few thoughts with you.

Market investments - whether they are common stocks, bonds, real estate, stamps, gold coins or the like - move in concert with the relative pressures of supply and demand. If the forces are perfectly balanced, there will be little or no movement in the price of the item. If demand is suddenly weakened by a plethora of sellers creating supply, then the remaining few buyers are overwhelmed by the supply of the item on the market - and the price falls. Demand eventually gets into line with supply and the item can consolidate or even go up. Add the movements of buyers and sellers to all of your accounts' securities and you have movements in your balances. Your balance is just the total of all security prices times the number of shares you own tallied at a particular time of day, week or month.

When is volatility abnormal?

Each security has a "normal" or average volatility, often expressed as its Beta. When volatility exceeds this level, then my attention is drawn and I may prepare for remedial action. Or I may do nothing. To react to volatility by selling in every case is pure silliness. One who does this probably should not invest in the first place. But to hold on to a falling knife until it blows a hole in your account is even higher silliness. But how do you know when to hit the panic button? Can you assume that we are "on the job"? Can you know with confidence that we are likely to have raised some cash through sales when drops in prices happen?

Let's take the last question first. Yes, you can figure that we have taken proactive measures to defend your account against volatility of the downward kind. January 2010 was a good example. Most of your accounts actually gained while most securities fell. Why? We raised some cash and we put some of it to work in a security which went up as the markets became more volatile. Doing "hedging" as it's called presents some risk; our timing could be off and we could underperform - if not actually lose you money. But nothing is perfect and the risk of not making a gain is far less than those of making a loss for many of you. So we hedge.

Yes to question number two, also. If we were not on the job, we would violate our ethics code to always have your interest at heart.

Should you ever hit the panic button? No, if we have correctly judged your needs and your tolerance for risk taken to fulfill those needs. For example, an account which fell 8% in a year may be a disaster to someone who needs little gain to meet his/her needs and who, therefore, needs to take little risk. Contrast this with someone who needs to make about 9% a year to just make a minimum need. This person must accept more volatility than the first person. Since each security type has a normal volatility range, we can design portfolios to suit a wide range of people. The problem comes when an abnormal dispersion happens, such as is common in the aftermath of huge financial up waves. It is in those times, like 2008 and early 2009, that we need to be extra careful about defense.

In sum, volatility is not to be feared. It is to be seen as normal. However, we want you to push the panic button if your sense of balance and security is threatened by volatility in your accounts. We will make the proper adjustments.

Thank you for investing with us.

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