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Saturdays with Jim: A Fascination With Volatility

Saturdays with Jim

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Face it. You love volatility. Rather, you love volatility if the move is in the direction which pleases you. Just think of the infatuations you've had in your life. Wasn't the rush of "love" so titillating, so enlivening? And wasn't the eventual let down depressing, depressing? Volatility in the markets is nothing different than volatility you experience in life. There's little volatility and big volatility. You experience the former in the interval before you have your first cup of coffee and after your first few sips. You've had a "pick me upper," or a volatility experience. Big volatility comes in your life as raises and layoffs, marriages and divorces - a fact of life for many people. But what of the volatility that moves your invested money up and down is sometimes like little breezes and sometimes like a tornado sweeping through your carefully selected holdings to create chaos - for a time?

Just as you ignore "little volatility" so do you ignore relatively small (the amount varies with each person) changes in the value of your money. It's the big swings that, as on October 19, 1987, happened in a day and in most markets that happen within a year or two, prompt thoughts of flight to safety. How can we put the "big volatility" to our service rather than be frightened and imprisoned by it? The question is not, however, how we can smooth out our experience in financial markets. That is entirely another matter. Smoothing out suppresses, sucking away valuable resources you can use to make money. Hedging all of the time may give you profits, but you're always running scared and devoting precious resources to paying for "hedges", or investments which will pay off handsomely when others don't. But, the wise among you say, isn't diversification like hedging? Isn't picking securities which move according to different triggers an effective way to reduce volatility? Yep - at all times but when you REALLY need it.

Take the 2008 bear market. Security classes like stocks, bonds and commodities, which usually don't correlate with one another, all moved to almost perfect correlation in the panic that ensued after Lehman Brothers' collapse on Sept. 15, 2008. Only U.S. government securities bucked the trend. Diversification is fine in most markets, but you need something else at "the tails" - the really awful times.

Okay, this is the "bad" side of volatility. How about looking on the good side? Volatility is what gives you profit potential. In some ways, the more volatility you can pile on the more money you make. But the person who routinely seeks volatility for profit is called a trader, not an investor. The trader looks to profit from relatively short-term moves, while an investor looks to benefit from receiving income and from the

steadiness of knowing that the investment will continue to grow for months and years to come. So, how does an investor handle volatility?

We pretty much ignore it. What, you say? How can you ignore my account balance dropping like a rock? Well, we answer, would you want us to ignore your account rising in a volatile manner? You can't cut it both ways. There are a lot smarter people than us in financial markets. Our "buy" may be the smart money's sell. To this extent, the less we mess with good, solid income producing securities the better. But there are times we pay attention to volatility.

For example, when a run exhibits parabolic characteristics (goes up steeply) it inevitably crashes near to its starting point. Energy securities have been almost parabolic lately, and we took profits of more than 100% last Friday in one of them. Remember, bulls make money, bears make money and pigs get slaughtered.

And so it is that we can use volatility to our advantage. We may not be 100% prescient in our timing, but it doesn't matter. We've profited from a big run up and, even better, by selling before a crash, we've reduced overall risk. There is one more use of volatility that we should mention.

While we decried the routine use of hedges, we do indeed use them. We had market-beating results this year primarily because your accounts kept most of their balance in the swoon of May-August. We employed a hedge to help us remain mostly fully invested and at the same time mostly "whole" - not leaking money in a market correction. These heroics may sound great, if they are successful. If they are not, you've hedged profit away. If you have a hedge on and markets go up instead of down as you had thought, you don't participate in the money making and, hence, you underperform.

Bottom line - volatility is to be used but not courted. We've mentioned that, though our moderate growth account has a slightly higher percentage growth rate than has the more conservative growth account, the dollar value of the latter is higher than the dollar value of the former after 12 years of measurement. Why? The second account is less volatile. The difference is not large - about 2% - but still big percentage gains followed by big percentage losses don't make for an optimum long-term investment experience. And it's the great long-term investment experience we want to give you!

Thank you for investing with us.

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