

Saturdays with Jim: The Illusion of Certainty

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By Jim Pursley
President and CIO, Gaia Capital Management, Inc.
www.gaiacapital.com
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Where else but financial markets can uncertainty lead to certainty and certainty lead to uncertainty? This is no mere rhetorical question, because in the answer lies the difference between success and failure as an investor. Our SWJ of November 6, 2010 discussed investment uncertainty in depth. Below is a capsule summary of the article followed by today's discussion of investment certainty.

Professional investors are happy so long as they can calculate a fair market price for securities in which they are interested. In being able to arrive at fair market value (FMV) they can decide whether to buy, hold or sell based on something which brings them some degree of certainty. Never mind the nasty little truth that no two professional investors arrive at the same FMV for a security. But they think they can - that is what counts. Enter uncertainty.

Suppose that something prevents professional investors from applying FMV. It could be the threat of a war, news that a country may default on its bonds, a major disaster - something which may well change the inputs of the valuation process. Facing uncertainty, professional investors stop buying and may even begin to sell securities. This puts pressure on financial market prices unless other investors step up to buy. Prices tumble until they are either low enough to surmount any uncertain event or issue or until certainty returns. Why is uncertainty or certainty important to you as a client of ours?

Uncertainty is a major portfolio management tool. The period of maximum uncertainty is a cycle's best buying opportunity. Why? Because by definition it is maximum uncertainty. From there, uncertainty remains flat or it lessens. And with reduction in buying pressure due to uncertainty, buyers may begin to step in and may push prices higher. But what can we say about uncertainty's opposite - certainty?

If uncertainty brings low prices, then certainty brings its opposite. As investors become more certain about the future, prices rise and volatility declines. Fear is a thing of the distant past. Greed is the ascendant emotion. The point of maximum uncertainty is a short time - a day, a week or a few weeks. Certainty tends to reach its peak in a long, drawn out series of tops, which may last months. Accordingly, certainty is more deceptive to the investor. The emotions are at rest, confidence is high... all of the emotional signals which guide us to action are absent. But maximum certainty surely leads to uncertainty once again; it's just a matter of calling the move correctly. This view is well supported by theory and by evidence. Hyman Minsky

(1919-1996) was an economics professor who developed an intriguing model of financial crises. Essentially, his model boiled down to "Stability leads to instability." Evidence for his view is seen in market "fear gauges" such as the Volatility Index. This index is well correlated with extreme market moves when it reaches extreme levels.

Investing with our emotions brings us the opposite of the results we aspire to achieve. Warren Buffet encapsulated this view in his oft repeated dictum, "Be greedy when others are fearful and fearful when others are greedy." In other words, Buffet is admonishing us not to follow our emotions and the emotional action of the crowd. Why is being contrarian as Buffet recommends so difficult? Because the crowd is right for a time... maybe a long time. Your contrarian resolve could get swept away in capitulation just at the wrong time. If investing were easy, there would be no markets. Markets are made because buyer and seller have different needs, maybe even different conceptions of FMV. Let's be thankful that not everyone "gets it" as we do, that enough people will continue to pursue hot tips, wealth without research - any get rich quick scheme. We love to lie in wait for a great time to pick up the pieces caused by mindless selling.

This said, we are humble enough not to take our view to excess, to believe that our view is forever and is infallible. Hubris is the cause of tragedies.

Thank you for investing with us.

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