



Saturdays with Jim: Icarus On Investing

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Icarus is not a god. He did not even do something great. Why, then, should Icarus be elevated to godhead of the investor class?

Icarus and his father, the inventor Daedalus, assisted in the killing of the Minotaur. For their part, they were imprisoned by King Minos of Crete in a labyrinth from which there was no escape by land or sea. Daedalus crafted wings of bird feathers and wax fastened onto a twig structure. Before they flew off on their new wings, Daedalus warned Icarus to fly neither too high nor too low. Excessive elevation would place them too close to the sun, melting the wax and rendering the wings useless. Flying too low would cause wing failure from ocean moisture. You all know what happened; the youthful Icarus was smitten by an attraction to the sun, flew too high and fell into the sea which bears his name - the Icarean Sea.

Gaia caught the now-wiser Icarus in a rare pensive mood. A transcript of the interview follows.

Gaia: Welcome, Icarus. Do you use an honorific?

Icarus: It is not necessary to address one with god status with earthly titles. Icarus is fine.

Gaia: How is it that you came to be the "god of all investors"?

Icarus: I was brooding one day, beating myself up for not following my father's advice about flying too near the sun. You can imagine how much and how long an immortal being can suffer over a tragic and quite preventable incident such as that which I caused to happen. My father visited and pointed out that my experience could be a great lesson to investors and that, if they knew of my fate, they might be spared the agony I face day in and day out. Besides, he said, I might be able to escape my gloom by serving others and doing some good.

Gaia: How is your fate linked with that of investors?

Icarus: Investing carries risk, right? Risk is quite manageable if you can keep your head. But when the emotions take hold, you can do some logically silly and self-inflicted harm. The investor experience of elation and foreboding doom is not unlike what I faced.

Gaia: How is that?

Icarus: I was elated when I soared to the sun. What began as a well researched, yet untried, effort turned into disaster when my elation for the sun overwhelmed me and absconded with my reason. You have to understand. In Greek drama and mythology, the heisting of reason by the emotions is a pretty severe yet common illness which besets all humans. Your Shakespeare was a master in exploring how emotion can entrap reason with its guile.

Gaia: But you could have flown lower and risked a crash, too.

Icarus: That is right. I explain to investors that flying too high on the wings of emotion results in a spectacular crash. Lesser known is the ignominious fate a very low flying investor experiences.

Gaia: How does flying too low or being too careful cause essentially the same result as flying too high - the failure to attain a goal?

Icarus: Flying into the sun causes an investor to lose money. Flying too low causes an investor to not gain money. The former is the error of commission, the latter of omission. The result is the same - underperformance over the long run.

Gaia: What would you advise?

Icarus: Goldilocks had it right - neither too hot nor too cold. Her porridge, when it was "just right" was fulfilling and nourishing. I advocate the "Goldilocks" method for investors. First they must know themselves and their real tolerance for taking risks. If they cross the risk line on the excessive side, eventually they will suffer a fall which may impair their confidence for a long time, if not forever. Being too cold, or too cautious, will not expose a person to actual dollar loss, but it may subject her or him to the ravages of inflation and to emotional smallness - never quite "daring to dream."

Gaia: But how does a person, beyond trial and error, ascertain one's true tolerance for risk?

Icarus: Finding true risk tolerance is no easier than finding the right altitude to fly my father's wax wings. One needs to start flying, first and foremost, gaining enough altitude until the air is dry and free of ocean moisture. Then, in a series of very small and controlled moves, the investor must take measured risk. Each risk-taking maneuver should be accompanied by great observation and self awareness - checking the wings frequently for deterioration, as it were. Each maneuver should be carefully planned in advance, containing a clear exit strategy in the event of success or failure. The plan must be executed with discipline; the emotions will tug to either stay too long or get out too soon. One successful maneuver after another will bring the investor a sense of a comfort zone.

Gaia: That's fascinating. Can the comfort zone be extended?

Icarus: Absolutely. Risk tolerance is the absence of knowledge as much as it is an inherent human trait. The airplane passengers who are kept in the dark when the plane lurches to and fro are more frightened than those who are well briefed by the crew. Knowledge is not the end-all and be-all, but it does support more adventurous behavior than one would engage in without some "education" as it were.

Gaia: Can you think of an investing example where risk tolerance was stretched?

Icarus: Yes. First, there are limits to tolerance stretching. A basically conservative person will never engage in risky behavior - provided that she or she is aware of the risks. But that is another story. The market downturn of 2007-2009 was a downturn by definition because there were more sellers than buyers (selling pressure forces prices down when it can overwhelm buying pressure. Prices drop until buying pressure is more equal to selling pressure. We know more than a few of your clients who at the outset of the downturn were not at all ready for

what would ensue. However, they did not experience the downturn in a vacuum. The Gaia staff was constantly communicating the equivalent of the plane's position, the speed of headwinds, the frequency and location of market lightning bolts and so on. Clients had a sense, rightly or wrongly, that Gaia staff knew what they were doing and would guide them safely to their destination - or financial goals. You can say that their risk tolerance was stretched by Gaia's communications beyond what it would have been had they gone it alone.

Gaia: Talk more about tolerance stretching.

Icarus: If you are not aware of the risks, you are prone to do what in retrospect seems pretty silly behavior. Take dot com investing and condo flipping or take ponzi schemes like the "airplane." When you see and hear others making the big money by doing a seemingly benign thing such as dot com investing or condo flipping, you don't think twice before leaping. Everyone is making money, they say, and the sky is the limit. It's a "new paradigm."

Gaia: Right. So you're saying that people who engage in mass speculation do so on the basis of emotion alone, unaware of the risk they are taking?

Icarus: Right again. If they only knew that markets are least risky when it seems that they are the most risky and vice versa. There's a sound reason behind this observation.

Gaia: What's that?

Icarus: Remember the balance of buyers and sellers I alluded to earlier? When everyone is selling, it follows that they are at their most afraid moment - it got too much for them to hold on as prices kept dropping. Finally they "capitulated" in what is often a huge multi-day selling climax. Buying climaxes are seldom as dramatic, but they occur, too. Selling climaxes feature exhausted sellers- no one is left to sell. Ipso, prices can either stabilize or actually rise, as buyers come out of the woodwork. After a selling climax, risk is very low. It is highest near a buying climax as the pool of potential buyers thins. It's not a lot different than musical chairs. Someone eventually will not have the investing equivalent of the chair - the buying music stops and recent buyers are creamed.

Gaia: Must it always be so?

Icarus: No, but it has been so through hundreds of years of investment speculation. Despite the modern day teachings of behavioral investing and behavioral economics, new generations arise which will not have learned from the mistakes of their parents and are doomed to make their own mistakes - usually of the same cause - excessive emotion.

Gaia: Thank you, Icarus, for sharing the wisdom borne of your experiences. We wish you well in your endeavor to offer teaching and succor to investors.

Icarus: You are welcome. Though I am a god, I am occasionally given to human emotions. Thus, it is first hand when I speak of emotional excess. Thank you for investing with us!

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