



## Saturdays with Jim: Post Crash Mental Health

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It happened a little bit at a time. Following the 1929 stock market crash, a legion of newly-minted investors jumped back in the markets in 1930, sensing a great buying opportunity. Their hopes were dashed on the rocks of tight money and high tariffs, serious policy mistakes by government and the central bank (the Federal Reserve). 1931 brought major European bank failures which, added to the tight money and tariffs in the U.S., almost completely froze world trade and caused a massive new wave of unemployment and bank failures in the U.S. By the time the bottom of the stock market hit in 1932, there were few willing buyers left. Fortunately, there were fewer willing sellers, too. The tremendous selling pressure of 1931-32 had left everyone exhausted. The result? A solid market bottom from which a new 5-year bull market could be launched.

Unfortunately, the big gains were made by just a few. It was not until markets had regained much of what they lost in 1929-32 that the public got interested in stocks again. And the predictable happened. They again bought near the peak. The government tightening of 1937 contributed mightily to another serious recession - not back to the levels of 1932 but serious enough to swear a whole generation of investors off anything but insurance policies and bank accounts (post FDIC, of course).

We've been through our 1929-30 period. Now what? And how has the crash and subsequent almost complete recovery left you feeling? First let's deal with the latter.

Investment trauma usually results from over speculation and poor timing. The mass of public investors don't get excited about stocks, real estate or about anything else until the trend is well underway and closer to its end than its beginning. That's precisely why the crash aftermath is so devastating. Most of the late comers are novices and have no sense of risk management (selling at small losses before they can become large losses). It's perfectly natural to want to eschew something that previously hurt - think of hot ovens, matches and a whole number of things that have caused us hurt in the past. This said, matches and ovens if properly handled can be of huge help. And so can investing.

Under our direction, your accounts suffered greater volatility than we would have liked - an understatement. The issue? We failed to recognize a policy mistake which made a recession much worse. As we have said, it's the policy mistakes that cause us to run for the cover of government bonds. We failed to recognize the extent of Lehman Brothers' economic tentacles and, hence, the extent of the freezing of world trade and bank confidence following the investment bank's collapse on Sept. 15, 2008. It is the policy mistakes which cause recessions with the largest damage, but of course it's the conditions leading up to the mistakes that are the tinder for the conflagration and slow reformation to come.

Only two of you voiced serious concern to us during the fall from October 2008-March 2009, but we'll bet that we tested the confidence most of you had in us that we would guide your funds safely. Surely, some residual harm has been done which can be remedied only by time and positive experiences. We cannot control time, but it is within our power to provide the positive experiences. Here is our recipe:

- Start with roughly 50% gains that we had in 2009
- Add a stop loss provision to each account (specifying maximum drawdown)
- Continue to opportunistically "scalp" - selling and buying a bit as overbought and oversold conditions present themselves
- Manage each account in tune with client risk tolerance - not stretching it as we did in 2009
- Set specific growth targets and risk parameters for accounts, beginning with the next round of annual conferences

If we failed in 2008-2009, it was because we believe that dividend paying stocks offer the best long-term returns and the highest income of any asset class. Hence, we invested all accounts in dividend paying stocks. We took great steps to prepare you for volatility, but surely none of us were prepared for what ensued. The second mistake? We held to our positions through the October and November lows and only slowly began to unwind them in December. It was not until January and February that we realized our errors.

Now we have three investment strategies of varying risk/volatility and we no longer remain "mostly fully invested" to capture maximum income gain. We've come to the conclusion that in a time of falling balances, most of you may not believe that the high income will continue (though it did - and actually grew). Instead, we will raise cash as indicated by our perception of risk and will add effective diversification to prevent serious drawdown.

Bottom line we want each of you to be able to sleep peacefully, secure in the knowledge that you have a very high probability of maintaining the income targets we set together, without a break. And about the road ahead?

Serious stimulatory efforts by governments and central banks the world over has prevented a 1930's style depression. But the way ahead is fraught with doubt about the ability of the world economy to function well without the life support of government largesse. In developed countries like the U.S. and the U.K., consumers will be drawing down debt for a long time, perhaps years. This debt drawdown is hugely deflationary, depressing economic activity because income is being devoted to savings instead of spending. The major points of uncertainty will come when, like 1937, government feels the need to cut back (because

of high debt loads, inflation fears or whatever).

We intend to navigate the period ahead with a sense of opportunism and risk management, with the goal of steadily increasing your income and account balances within the parameters of our three investment strategies. Volatility is not to be feared, it is to be embraced and experienced to the point that you can accept, no farther. In this way we will aid time in healing any residual hurts caused by the difficulties of the fall-winter period a year past.

Thank you for investing with us!

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