

## Speculation vs investment

Contributed by Travis Morien

More than at any other time in history, mankind faces a crossroads. One path leads to despair and utter hopelessness, the other to total extinction. Let us pray we have the wisdom to choose correctly. - Woody Allen

Aus.invest is, by its very name, supposed to be about investment. In practice much of the discussion is about speculation, there is no aus.speculation newsgroup so in that case it is an appropriate forum, but nonetheless it causes plenty of confusion for readers, new and more experienced.

I define a speculator as someone that seeks to buy and sell in order to take advantage of market price fluctuations. An investor is someone who holds on to securities that provide a good income or capital gain by virtue of them being based on something of real and increasing value.

Alternatively, you could say that a speculator is someone that buys something only because they think someone else will pay more for it in the near future, as opposed to an investor, who buys things because analysis confirms that the investment is of high quality and/or good value, and worth holding. A speculator buys things because they believe a less informed person will buy it off them later at a higher price, an investor buys things because they promise both a return on capital invested, as well as a return of capital invested.

Benjamin Graham, a famous investor in his own right and also notable because he is the man that taught Warren Buffett to invest, defined the difference between speculation and investment in this famous passage from his book *The Intelligent Investor*

"Imagine that in some private business you own a small share that cost you \$1,000. One of your partners, named Mr Market, is very obliging indeed. Every day he tells you what he thinks your interest is worth and furthermore offers to either buy you out or to sell you an additional interest on that basis. Sometimes his idea of value appears plausible and justified by business developments and prospects as you know them. Often, on the other hand, Mr Market lets his enthusiasm or his fears run away with him, and the value he proposes seems to you a little short of silly.

If you are a prudent investor or a sensible businessman, will you let Mr Market's daily communication determine your view of the value of a \$1,000 interest in the enterprise? Only in case you agree with him, or in case you want to trade with him. You may be happy to sell out to him when he quotes you a ridiculously high price, and equally happy to buy from him when his price is low. But the rest of the time you will be wiser to form your own ideas of the value of your holdings, based on full reports from the company about its operations and financial position.

The true investor is in that very position when he owns a listed common stock. He can take advantage of the daily market price or leave it alone, as dictated by his own judgement and inclination. He must take cognizance of important price movements, for otherwise his judgement will have nothing to work on. Conceivably they may give him a warning signal which he will do well to heed - this in plain English means that he is to sell his shares because the price has gone down, foreboding worse things to come. In our view, such signals are misleading at least as often as they are helpful. Basically, price fluctuations have only one significant meaning for the true investor. They provide him with an opportunity to buy wisely when prices fall sharply and to sell wisely when they advance a great deal. At other times he will do better if he forgets about the stock market and pays attention to his dividend returns and to the operating results of his companies.

The most realistic distinction between the investor and the speculator is found in their attitude toward stock-market movements. The speculator's primary interest lies in anticipating and profiting from market fluctuations. The investor's primary interest lies in acquiring and holding suitable securities at suitable prices. Market movements are important to him in a practical sense, because they alternately create low price levels at which he would be wise to buy and high price levels at which he certainly should refrain from buying and probably would be wise to sell." Another way to define investment related to the way investors value things. If you cannot value something, it is a speculation. This is a broader definition, and tends to exclude most things. The share of any company about which no information is available is speculative, the share of a company that you know enough about to be able to "value" it, even if you can't do so with any great precision, is an investment if the market price is less than or equal to your valuation.

Another quote, from "Graham and Dodd's Security Analysis, 5th edition" by Sidney Cottle, Roger Murray and Frank Block (the modern revised edition of "Security Analysis" originally written by Ben Graham and David Dodd), had this to say about "investors" that buy things without a proper valuation:

"Valuation versus Alternative Procedures for the Analyst:

Assume that a run-of-the-mill common stock is not particularly well suited to a formal valuation because there are too many uncertainties about its future to permit the analyst to estimate its earning power with any degree of confidence. Should analysts reject the valuation technique in such cases and form their opinions about the issue by some other

approach? A common stock that cannot be valued with confidence cannot be analysed with confidence. In other words, buying or selling recommendations that cannot be related to a reasonably careful valuation are not based on analysis proper but on what might be called "pseudo-analysis" or "quasi-analysis". In such situations the underlying interest in both the analyst's and the investor's mind is likely to be the probable market action of the stock in some relatively short period in the future. The analytical work done, which may be quite comprehensive, will thus serve as an adjunct to an essentially speculative decision - disguised though it may be under some other name.

Another alternative is to do whatever everyone else is doing, even though the price of a stock appears high; this is the so-called greater fool theory. This theory is applied on the basis that "I know I am a fool to pay such a high price for a stock but I know that a greater fool will come along and pay me an even higher price."

The soundness of a common stock investment, in a single issue or a group of issues, may well depend on the ability of the investor or the analyst-advisor to justify the purchase by a process of formal valuation. In plainer language, a common-stock purchase may not be regarded as a proper constituent of a true investment program unless some rational calculation will show that it is worth at least as much as the price paid for it."

This definition does not mean investors are people who never sell (as many critics of the "buy and hold" philosophy claim), but there are differences between the reasons for an investor sale and a speculative sale. An investor sells when the investment no longer fulfills the criteria that prompted him to buy it in the first place, or if another investment comes along that should provide a superior opportunity to invest. Warren Buffett sells more than 10% of his portfolio every year, so much for the reputation he has for never ever selling a stock. A speculator sells because he anticipates the price is peaking or to realise a profit, usually for reasons unconnected with any notion of "intrinsic value".

"Buy and hold", a doctrine recommended by the majority of investors (in the Graham and Dodd sense of the word), means you buy something with the intention of holding it as long as possible. Therefore, analysis is done on the basis that the business being bought is to be held for quite some time, and there is more of a focus on valuation and the business operations of the company than the price action in the market. The share will be sold if it no longer fulfills the criteria that lead to its purchase in the first place, namely if it becomes so overvalued as to represent a great selling opportunity rather than a great buying opportunity, or if the business deteriorates. Since the characteristics of the business will be reflected in the valuation, overvaluation and business deterioration will be a part of the same phenomenon.

Many critics say that "buy and hold" means buying a stock and holding it for ever, without paying any attention to it. They point to the major companies in the index and note that very few of the companies that were leading lights 100 years ago are still around. Thus, say the critics, buy and hold is foolish. These critics are attacking a "straw man" (Shorter Oxford Dictionary definition: "an imaginary adversary invented in order to be triumphantly confuted"). I know of no book on "buy and hold" investing that advocates purchasing securities and completely ignoring them, except for those that advocate index funds. Since index funds do change their composition over time as the indexes themselves change, this argument is wholly irrelevant.

Traders, in shares, futures, property, collectibles, bonds or whatever are by their nature speculators, and if they are successful through their skills and superior insights then obviously they are competent speculators. They are out there, traders who make regular profits through an intelligent and structured program of speculation, but they are always wary of risk, in fact the basis of successful speculation is always to manage risk in the most efficient manner possible.

On the other hand, there are the punters who always want a flutter. These are the incompetent speculators. Unaware of the real risks, or perhaps aware in some vague sense of them but simply ignoring them, these people buy hot tips and securities with glamour stories, getting excited about some new venture this security is associated with, and through ownership of the security hoping to make a killing.

Professional speculators are like professional gamblers. There are people out there who play blackjack or poker for a living, taking calculated risks with enormous amounts of money, seeking to maximise their edge with sophisticated techniques and a mind that is well tuned to probabilities and risks vs rewards. Some of them make millions, there is no doubt at all that by playing a game with statistical biases, and seeking over time to take profits from these biases, one can actually make a living from gambling.

On the other hand, the world is full of the social wreckage caused by gambling. The unwise and impatient litter the wayside, though there is no shortage of people willing to take their place. You can only profit from gambling when your probability of winning is greater than the probability of the other side winning, and casinos employ gifted mathematicians to make sure the rules of the game favour the house.

Professional speculators are as far above the public in terms of sheer talent, dedication and intelligence as professional gamblers are above the tipsy chain-smoking denizens of the casino floor.

To become a professional speculator you have to live and breathe the market you want to speculate in. All those people

buying collectible china and antiques are up against the true connoisseurs. Those who know the market from the inside, and can spot a rare gem when it comes along, and have the cash needed to buy it, and the body of experience to know exactly what this item is worth (regardless of how aesthetically pleasing or otherwise that it may be).

Professional traders think of little else. Far from the 5-minute-a-day business that is advertised by the guru wannabes that advertise "systems", trading is a lifestyle that can be embraced by only a rare person. Traders become aware of all the pertinent fundamental information, including consensus estimates and bullish/bearish market sentiment.

Professional speculators in mining issues read all the trade journals in mining and probably know a thing or two about how to read the jargon of the analytical chemist in the labs and the geologist breaking rocks, or the meaning of the various exotic electronic sensing devices used today. A technology speculator needs to know a thing or two about science, engineering and electronics as well, so as to keep up with the state-of-the-art and separate the good ideas from the blue sky ideas.

A trader doesn't always try to forecast though. The blackjack player does not need a newsletter writer to tell him what card will be next so he just plays the probabilities and tries to control his risk, usually with some kind of mathematically based money management system. Similarly in stocks and futures, few traders know or care what the market is going to do next. They sit back, do their analysis and try to think in terms of possible upside potential and downside risk, determine where they might enter the market and where they will exit if the market should move the opposite way.

Can you do this? Well sure, there is nothing to stop someone from picking up these kinds of skills, but you won't do that by subscribing to any newsletter, or paying a thousand dollars for some kind of formula or indicator that some guy says will tell you when to buy and sell. Not that there aren't plenty of people who do sell such things though, in investment more than anything else there are plenty of people who demand such a service. Everyone wants to know what the experts think about the future direction of the market, while nothing like it appears in the newspapers, surely someone that works in an investment bank knows what is going on, or a fund manager, or some sort of pro?

To every demand there will rise a supply to meet it. Since there are no genuine and ethical people who can give an easy answer, the void can (and is) only filled with players that exploit the gullibility and ignorance of their customers.

A businessman does not seek advice on how to run his business, except in a general sense or perhaps get an expert with certain management talents who can fix a specific problem. You don't get anyone offering a service though where complete businesses are offered and you are told how to run them and it all takes only a few minutes of time per day once you pay them your money. (Except maybe for franchise businesses, but there is no parallel between a franchise and speculation, so forget it!) To those professional speculators, speculating is their business, their full time job. Most put in considerably more hours into their trading than the average person puts into their job, and unless you really love trading you certainly don't find yourself any better off as a trader.

The reality is that you can make money as a professional speculator, but it is not at all easy. No one can tell you how to do it specifically, they can only give a small amount of guidance while you have to do a huge amount of work. Traders work very hard at their trading, doing enormous amounts of research and keeping track of a huge amount of information. Don't even consider becoming a very serious trader unless that is all you want to do. Most newsletter gurus aren't traders at all, they advise on methods they have developed with only theoretical simulated testing. It is very time consuming writing a newsletter, and even more so trading. As gurus have just as many hours in their day as the rest of us, it is clear that the lifestyle they paint, with their luxury houses and heaps of free time, holidays in exotic locations and massive incomes is entirely incompatible with that of a professional trader. Not that traders haven't written books, there are a few good ones around, but one thing that is for sure is that no genuine trader would have the time to write, edit and publish a weekly newsletter.

Don't give up your day job if you aren't already a trader. You can start out with it by riding a few uptrends on some large cap stocks, despite what they say about trading being hard it doesn't take a genius to buy BHP when it has been steadily rising for a week or two on the back of improving commodity prices, and sell a week later at a 20% profit. If you did that and you really enjoyed it, and I mean REALLY enjoyed the market then maybe you might have the passion.

Traders get out of bed at 6am to see the close of a foreign market and the opening of another one, they read all the journals (not the tip sheets, I mean reputable financial newspapers) and track a number of markets. They watch out for opportunities and they are fast in taking them, and equally fast in getting out if they turn out to be wrong. They don't necessarily use the super-duper software or subscribe to a \$1,000 a month data service for NASDAQ day traders, but they are in there anyway, around the newsgroups and reading all the commentary (sometimes so they can go contrarian when strong consensus is obvious).

Why do traders do this? Well of course there is the money, though not as many as you would think make a very high income, they do it because they love doing it. They find the vacillations of the market to be entirely fascinating and immersive, they gain pleasure from seeing the market move with them, but don't take it personally when it doesn't so they get out quickly. They don't trade to live, they live to trade. Far from the glamorous operator pulling up to the curb

in a McLaren F1 sports car to attend a society social event, many traders are reclusive, sometimes a little nutty and definitely obsessed. Trading is their favourite thing in the whole wide world, they would not want to take a yacht to the Bahamas, as that would drag them away from their trading.

Will you be able to buy that kind of intensity? Can a software package that scans the market for some sort of trigger signal provide you with the kind of skill and knowledge to keep up with those guys? Will a \$10 a minute hotline to some guru really provide the insights you need? Bear in mind that a real trader would be too busy to talk to you during market hours, and would not welcome a bunch of whining beginners desperate for some tips. Can a few lessons turn you into a virtuoso?

At least with music you don't go broke if you don't play well at first, you have the chance to practice for many years before you get your night in the spotlight. Even paper trading isn't real practice, unless you have real money in the market you will always kid yourself, thinking as hindsight rolls in that in the real thing you would not have taken that trade at all because it was so obvious it wouldn't have worked. No!

On the other hand, investment isn't a particularly hard thing to do. Anyone, regardless of intrinsic talent can do it. The stock market has a certain long term return that beats inflation comfortably. Purchases of a conservative portfolio of leading stocks will provide returns along the same lines as the market, even better (sometimes) you could buy units in an index tracker fund. Purchasing ordinary real estate in an attractive area that has enjoyed consistent gains for decades is also a good investment, and again requires no special skill.

Is investment better than speculation? Well you won't make massive profits in a few days if you are investing, but you make respectable profits in time. Speculators don't always lose money, but the inept ones do. There is nothing inherently superior about either approach, though one thing that is for certain is that only a minute proportion of the population will ever (or could ever) be highly successful speculators, you rely on being much better than 99% of other people and you have to maintain that superiority for as long as you speculate. On the other hand, if every single person in the world was an investor, it would simply mean that wealth would be fairly and equitably shared, with all sharing in the prosperity that can be gained by living in a capitalist society.

I am not against speculation, but when I speculate I do so knowing the difference between speculation and investment. Trouble arises when people confuse the two and look for hot tips to invest. This FAQ should tell you a little bit about how to do better at both of these, but you should never ever think you are an investor if what you are doing is in fact speculation. You can be both, but not at the same time (not with the same stock anyway, though you can have two portfolios if you want to).

There are of course differing definitions of speculation. An efficient market theorist will define investment as holding a large diversified (but otherwise randomly chosen) portfolio that will give returns commensurate with the market as a whole. It defines speculation as any attempt to beat this by analysis of any form, including technical, fundamental or otherwise.

Others define speculation by the knowledgability of the investor, but this is not a very useful definition really. The dictionary defines speculation as attempting to profit from market price appreciations, this is definitely the most useful definition.

You are probably an investor if:

- You are buying a portfolio of quality issues at a reasonable price.
- You either content yourself with returns that are average for the investment type, or focus on the best value issues of the type for superior returns.
- The portfolio is made up of issues with a strong track record, or is managed by people with a strong track record.
- You can justify your purchase with reasonable projections of profits that are not out of line with historical returns for ventures of this type.
- You buy something because the price has fallen so the yield (dividend, rent or otherwise) has risen to the point that it is superior to alternative investments, and you have substantial reason to believe that the investment won't completely go bust.
- You buy because you notice the stock is trading at a price below fundamental valuations.
- You sell because of deteriorating fundamentals in the investment, or you need the cash for something meeting your buy criteria even more closely.
- Market quotations are there only for your convenience, you may choose to sell if the investment looks absurdly expensive, or to buy when you see the opposite, but other than that you ignore volatility.
- You keep a close eye on those who manage your investments (including managers of the company you hold shares in), looking for prudence, logical capital allocation and conservative expansion. You would rather not invest with a high profile celebrity CEO that promises huge growth with a series of rapid takeovers.
- Tax efficiency is important, and you take after-tax returns into account when weighing up various options.

You are probably a good speculator if:

- You understand the risk and are taking positive measures to limit that risk. In fact risk management is your bread and butter.
- You are taking steps to bring about a higher return than average by keeping a close eye on your stocks and constantly riding the ups in price but selling out and waiting for the end to the downs.
- Of the many issues you are watching this one seems to have the highest probability of doing well over the time frame of your trading style.
- You anticipate a price increase but have a plan in place in case it doesn't.
- You track a large amount of information that may have an effect on prices, and get ready to act if this information doesn't seem to be already reflected in the price.
- You are well tuned with the pulse of the market you are in, and ready to leave before the herd does.
- You buy at the early signs of upturn after the price has fallen, but are ready to close your position rapidly if you turn out to be wrong.
- You are mindful of the overall trend in prices.
- You buy the best value investment of its type during a boom.
- You buy something with the strongest upward price momentum.
- You sell because you notice a trend change.
- Market quotations are your bread and butter, you want the very latest information and lots of it.
- You don't trust anyone else with your money, the stupid cattle on the opposite side of the trade from you don't know what they are missing and all those gurus are just crooks.
- Tax effective investments probably don't interest you as they are too long term and you can make more money trading. You don't trust the promoters of these schemes anyway.

You are probably a mug speculator if:

- You verbally acknowledge risk but ignore it, allocating a large proportion of your money to this one venture.
- Risk management simply amounts to nodding your head saying you realise that there is of course a risk, but doing absolutely nothing to take steps to limit, or even properly identify risk.
- You are trying to bring about a very high return by buying something that looks exciting, but you aren't too sure how the business works.
- You are buying something because someone you know told you it was good.
- You have absolutely no idea what else is out there because you haven't really checked, but this one looks good.
- You think it is a sure thing to go up.
- You buy something that has fallen a lot because you don't think the price can go any lower.
- You find out the price crashed a week after it happens in a conversation with your friend that "understands this sort of thing".
- Rene Rivkin says on TV that he "likes it a lot" so you buy it.
- You don't understand how people make money in the investment.
- You are trying to pick the very bottom to buy, or the exact top to sell.
- You will pay anything for an investment because prices are booming.
- You buy because it has gone up a lot.
- You sell because you want to take a profit.
- Rises in the price excite you, but as terrifying as it is to you, you don't take any action during the dips because it is just a "paper loss" and you know it isn't really a loss unless you sell. If it gets back in the black though you'll rapidly sell out and pocket the cash so you won't lose face over it.
- You want someone to tell you what to buy next, and even though the last 20 newsletters you subscribed to cost you lots of money, you haven't quite given up on newsletters just yet, you also own the latest and greatest automatic software to free you from all that dull boring analysis.
- You buy any investment that promises to save you tax.