Gambling, Speculation, and Investment

The term "investment" has grown. It has grown to encompass a lot more activities as "investment" and a lot more people as "investors" than it ever did in past decades. Specifically, it has grown to absorb activities that once would have been properly identified as "speculation" and participants who would properly have been termed "speculators." With the near-disappearance of the term "speculation" from the financial media, and its replacement with "investment," it is little wonder that most people do not have a working understanding of the difference between the two. This situation can lead to serious problems, particularly when people who think they are basing their future on a foundation of investment are actually basing their future on a foundation of speculation. Previous generations discussed the difference between speculation and investment – even the earliest editions of Graham and Dodd's *Security Analysis* devoted several pages to the distinction and articulated a list of qualifications as to what should qualify as investment rather than speculation. The late Richard C. Taylor went even further, identifying a distinction between gambling, speculation, and investment. Whether intentional or not, the erasing of this distinction has made it easier for the financial world to provide speculation to "investors" who think they are getting investment! An important distinction has been lost, at a time when it is most difficult to find actual investment as opposed to speculation (or even gambling). How does an investor actually find investment? An understanding of the distinction between gambling, speculation, and investment is an important start.

In the Second Edition of *Security Analysis*, published in 1940, Graham and Dodd spend an entire chapter on the "difference between investment and speculation," which they assert "is understood in a general way by nearly everyone" (58). Perhaps it was widely understood in 1940, but today the financial media applies the term "investors" indiscriminately, from day traders on the Shanghai exchange (in a recent article in the *Wall Street Journal*) to real estate flippers in Las Vegas (in 2003). So what is the real difference? Contrary to the "cynic's definition" mentioned in Graham and Dodd, that "an investment is a successful speculation and a speculation is an unsuccessful investment" (58), money manager Richard Taylor defined an investment as the commitment of capital based upon an analysis of future cash flows, as opposed to speculation, which commits capital based upon an expected move in a market price. It is a distinction in the behavior of the participant, not in the instrument itself, since many instruments can serve for investment or for speculation. A bond, for example, or a piece of real estate, can be owned for a series of cash flows, or it can be traded (or "flipped," to use the real estate term) based on a prediction of an upcoming move in interest rates, for example. The difference between gambling and speculation, according to Taylor, was that pure gambling – like a slot machine or a roulette wheel – was almost entirely random and unpredictable, while diligent speculators can perform some form of analysis on movement in interest rates, currencies, commodity prices, or a host of other variables and can "play" the expected change.

Understanding the distinction between speculation and investment, then, requires knowledge of the difference between the cash flow mechanics of the underlying instrument, and the market price of that instrument. Market prices move up and down based on a variety of factors. Eventually, the cash flow of the instrument impacts the market prices, but only in longer time horizons. Short-term "plays" on interim market movements are speculative, while investment places greater weight on analysis of cash flows. Buying a stock because you like its

name would be gambling; buying Proctor & Gamble because your analysis of sectors suggests that money is about to pour back into consumer staples or Chevron because you think that the price of oil is due to rally would be speculation. Buying a company because you have analyzed its future earnings and would like to participate in those earnings is investment, by this definition. While speculation is not inherently bad, it is important to know when you are speculating or gambling as opposed to investing.

Speculation and gambling can both lead to quick gains, but as a long-term foundation for decades of wealth accumulation, both are very treacherous. There are two reasons why it is very difficult to stay ahead of "break even" with a long-term strategy based on speculation or gambling. The first reason is the cost of playing, and the second is the cost of losing. Most people intuitively realize that you can make money with gambling if you win early and never come back, but over time, the cost of playing will work in the favor of the house. It is no different with the various investment vehicles, which all extract a transaction cost to move into or out of. A speculator, for example, who wants to move into stocks when that market is going up, and move out of stocks and into real estate when stocks are flat and real estate is booming, and then plans to move back into stocks when he feels that the tide is about to turn again, will pay enormous costs every time he buys or sells the property, or re-finances, as well as costs to a broker to buy and sell the stocks. Thus, even without the possibility of an expensive mistake, the transaction costs or the "cost of playing" works against the speculator and the gambler in the long run. Add in the cost of making the wrong call on the next move of the dollar or the next move of the interest rate structure or the next move of the price of gold or oil, and it is clear that speculation is a very unstable foundation for long-term wealth accumulation.

Tragically, at the very time when the distinction between gambling, speculation, and investment has faded from the vocabulary of the investor class, speculation is becoming more and more common and investment harder and harder to find. It is a verifiable fact that as money management firms have grown exponentially over the past two decades, the average turnover of their holdings has increased in step. There was slightly less than $3 trillion dollars in mutual funds in 1995. Today the number is over $10 trillion (a mark crossed in late 2006). Meanwhile, average portfolio turnover ratios for equity mutual funds have increased from around 80% in 1995 to a number between 110% and 120% for the past few years. It should be evident that buying and selling at this pace (more than a hundred percent annual turnover) indicates that many money managers are now allocating capital based on the analysis of which sectors or industries will do well over the next few months – which is primarily speculative in nature – than on how their cash flows will develop over the next few years. Further, as explored elsewhere, much of the approach to indexing and other "passive" or "insensitive" investments (such as exchange-traded funds, or ETFs) involves speculative allocation of assets first to one sector then another. And, a whole industry revolves around packaging up "investments" that have always been based on speculation alone – commodities, currencies, futures on interest rates or volatility or a variety of exotic indices – and selling them to clients, with a commission or transaction-based fee, usually in addition to an ongoing fee.

In an age of mass-managed money, then, how does an investor find a management philosophy that is not built on a foundation of speculation? Although it is rare to hear someone explaining the distinction between speculation and investment anymore, once understood, the battle is half won. Contrary to speculative strategies, real investment is simple and sound. In April of 1973, Mr. Thomas Rowe Price wrote an essay entitled, "A Successful Investment Philosophy based on the Growth Stock Theory of Investing." The first sentence of that essay is:

"The purpose of this article is to help the investor, particularly the amateur, by directing his attention to the simplicity and soundness of the growth stock theory and away from the belief of most people that you have to play the stock market in order to be successful." Real investment is not dependent on being able to predict the next move of the market or the next rate decision of the Fed. Those calls are the provenance of the speculator. The analysis of cash flows, of course, still requires making decisions under conditions of uncertainty. It also requires the ability to detect when the growth of those cash flows has come to an end. But these judgments rarely require the minute-to-minute frenzy that many people wrongly associate with the word "investment" – again, because they do not realize that speculation and gambling are not investment.

At Taylor Frigon Capital Management, we believe that something good is being lost when the distinction between gambling, speculation, and investment is forgotten. We provide clients with asset management that is founded in investment: the ownership of individual, separate portfolios of stocks in companies held for periods measured in years, not days, weeks, or months, as well as portfolios of income-producing securities that have been selected for their cash flow characteristics. Speculation is very attractive, and in fact has its place, but not as the backbone of the capital management upon which an institution or a family rests its hope for the future. We hope that an increased understanding of the distinction between gambling, speculation, and investment is a starting point for the investor to achieve greater capital growth with less erosion of principal, in an age in which most of what passes for "investment" is at best speculation, and often borders on gambling.

© 2007

Works Cited

Graham, Benjamin and David L. Dodd. *The Intelligent Investor*. Second Ed. New York: McGraw-Hill, 1940.

Price, T. Rowe. "A Successful Investment Philosophy Based on The Growth Stock Theory of Investing." Baltimore: 1973.

Please remember that past performance may not be indicative of future results. Different types of investments involve varying degrees of risk, and there can be no assurance that the future performance of any specific investment, investment strategy, or product made reference to directly or indirectly in this newsletter (article), will be profitable, equal any corresponding indicated historical performance level(s), or be suitable for your portfolio. Due to various factors, including changing market conditions, the content may no longer be reflective of current opinions or positions. Moreover, you should not assume that any discussion or information contained in this newsletter (article) serves as the receipt of, or as a substitute for, personalized investment advice from Taylor Frigon Capital Management LLC. To the extent that a reader has any questions regarding the applicability of any specific issue discussed above to his/her individual situation, he/she is encouraged to consult with the professional advisor of his/her choosing. A copy of our current written disclosure statement discussing our advisory services and fees is available for review upon request.