

The Difference Between Investing and Speculating

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Do you know the difference between “investing” and “speculating?” For anyone who buys stocks, bonds or mutual funds, it is absolutely *critical* to understand this basic distinction. Today’s marketplace is overloaded with information, and much of it is meaningless and potentially harmful. If you know that investing is different from speculating, you can sort through the noise, understand market volatility and set your expectations accordingly.

So what is the difference? An **investor** is someone who purchases stocks or bonds for financial gain in exchange for funding an expanding company. In other words, investing is about owning or loaning money to businesses. Successful investors think like business owners. They are optimistic about the future, but they expect to have ups and downs. Investors use a patient, “buy and hold” approach over a period of many years. True investing can be boring because it is not concerned with the daily movements of the market.

On the other hand, a **speculator** may purchase the same stocks or bonds to profit from short term fluctuations in price. They are looking for a quick return. These are the gamblers of the stock market, not business owners. The influence of short-term speculation in the markets has grown dramatically since the 1980’s. The emergence of 401(k) plans helped investing become a new form of entertainment. Today, the globalization of financial markets, the manufacture of synthetic investments/derivatives and programmed trading have made the speculative component even greater.

Is speculating bad? Not necessarily. Short-term trading provides liquidity for all market participants. And many speculators are successful in earning high rates of return. But speculation thrives on volatility. It is a much riskier approach. A trading strategy can work wonderfully, then reverse quickly. For individuals, a speculative approach stirs emotions. “Hey this is great! I’m really good at investing. No, wait. This is terrible! I’m such an idiot!” This often leads to bad decisions and bad results.

According to John Bogle, the retired founder of Vanguard Funds, speculators trade with each other. Some win. Some lose. The net return for all players is zero, minus the cost of playing the game -- that is the commissions and fees. Just as in Vegas, the house always makes its cut. But *the speculative activity does not change the fundamentals of the business*, which is in fact what stock ownership (investing) is all about.

So ask yourself, “Which am I?” If you are truly an investor, act like a business owner. Be optimistic, think long-term, and watch your costs. Acknowledge the fact that you live among speculators, and that means living with volatility – lots of it. Be patient. You don’t get an appraisal on your home every day. Why watch the market every day?

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