Investing versus Gambling

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There is a lot of confusion in the general population concerning the difference between investing and gambling. This is understandable because the difference can not be explained in a singular short and simplistic statement. This chapter provides a series of explanations that clearly delineate the difference.

Some people ask, “What is the difference?” with the intention of understanding the difference if only someone would explain it. This chapter is written so that those people can learn and understand the difference. Then there are those who insist that investing is no different from gambling. They will ask, “What is the difference?” with no intention of trying to understand the difference because although they have never made investments they “know” more than anyone else about it. It is a waste of time for such people to read this chapter as they already “know” that there is no difference. I have asked the question but none of those types has been willing to share their expertise about the money that can be made by investing in a Las Vegas casino, or investing at the horse track, or investing in lottery tickets. Why gamble on Wall Street or buy risky certificates of deposit at your bank if these other investments are just as good? For if investing is the same as gambling then it logically follows that gambling is the same as investing. These types often back off by saying that the odds are different. That is interesting – now all of the sudden there is a difference. It seems like I was just told that these were one in the same. However, these types are completely wrong about odds being a distinction as will be explained later in this article.

The statement that investing is no different from gambling indicates with absolute certainty that the speaker is very naïve about how economic systems work. The statement is also strongly associated with someone who is very ego centric. There is a saying that an ego is a wall built around oneself that keeps ignorance in and knowledge out. It is best to let such people live behind their wall of ignorance for there is nothing you can say that will penetrate their wall. Another applicable saying is that none are as ignorant as those who refuse to learn. There is no point in trying to explain anything to them because according to another saying, they are not aware of anything that they do not know – ergo, they must be smart. They will always say that good returns on investment are just luck – the same as gambling – they know this to be an irrefutable fact. They are very happy in their pseudo intellectual ego being smarter than everyone else. They may try to advertise their pseudo intelligence by citing the naïve saying that an investment is when you win and gambling is when you lose.

While not universally true, I have noticed over the years an interesting correlation in that liberals tend to believe in luck and are the chief advocators that investing and gambling are the same. Conversely, conservatives tend to believe that “luck” is the result of working hard and smart and thus pursue investments while abhorring gambling. It is interesting to observe that those who equate investing with gambling rarely make money while those who make wise investments and avoid gambling routinely make money –

often lots of it. So their must be a difference. A related correlation is that those who equate investing with gambling often feel they and others like them should be given money (not a handout but their "fair" share) earned by those (evil as they are purported to be) who believe in investing over gambling. A further correlation is that those who believe in investing over gambling do not want to be given anybody else's money – they prefer to earn it for themselves.

The Differentiation

So what does differentiate investing from gambling? One must understand the answer in order to make wise investments and not fall into gambling traps. Because investing and gambling encompass broad methods there is not a singular answer. Rather, there is a plurality of characteristics described as follows.

- **An investment rarely depends upon something happening by a specific time.** Examples would include purchase of a property or an equity (stock) that one might hold for many years or even decades and probably sell with considerable appreciation. An investment in a certificate of deposit or a bond does have a fixed time period by definition but the investment concept can be renewed indefinitely. For the most part, gambling always depends upon something happening by a specific time. An example would be a horse crossing the finish line first or place in a specific race. Another example would be that the spot price of some commodity would rise above or fall below (depending on how the contract is written) a target price by a certain date in the future – this is a derivative instrument known as an option – a piece of paper that derives value (or not) from a particular price change in something else. An example might be paying a dollar for the right to purchase a barrel of oil for $180 anytime over the next 90 days. Suppose the price of oil goes to $200 during that time period. The option has ***derived*** considerable value and a $5,000 gamble could return $95,000! (($200 – $180) * 5000 options) - $5000. You do not have to actually buy the oil – you can sell your option to someone who is buying oil. However, the option is worthless if the price never exceeded $180 during the period. Although the options market is pure gambling in of itself, the ***proper*** use of options can reduce risk on an investment and can become a tool of the investor. This is described in more detail in the chapter concerning hedging.

- **Contrary to popular myth, the degree of probability of a positive outcome does not distinguish investing from gambling.** Something might have a 1 percent chance of success and be a great investment while something else might have a 90 percent chance of success and be a pure gamble. The distinction is the amount of expected return versus the risk. A simplistic example would be that one dollar invested in something would have a one percent chance of returning three hundred dollars. On average then for every $100 dollars invested one could expect to lose $99 and make $300 for a net of $200 (minus the last dollar) – not bad. The ratio of expected return versus risk is greater than 1 (2.0 for this example) which qualifies this as an investment. A real world example of this might be a production line with some complicated process that has a very low yield (i.e. most items produced end up scrapped) but there is high demand for the product so a very high price can be obtained from the few good units. Contrast this with a game where you buy a game piece for one dollar and you win something ninety percent of the time. The entity that you win is $0.25 but to add incentive to an otherwise dumb move there is one chance in ten thousand that you will win $5,000. On average then for every $10,000 put into this scheme you could expect a net of $7,249.77 (9,999 * 0.9 * 0.25 + 5000). The ratio of expected return versus risk is less than 1 (0.725 for this example) which qualifies this as gambling. Note that there is a difference in how each is calculated so that the result is always a positive number. The last example is that of a lottery but one with an unusually high payout. For real lotteries the typical expected return versus risk is around 0.3 – thus on average one loses 70 cents out of every dollar put in – pretty pathetic but favored by "experts" who think there is no difference between investing and gambling – small wonder that they do not make much money.

- **An investment grows with time while gambling is over by some specified time.** In short, time is the friend of the investor and the enemy of the gambler. An investing example would be the value of some property or asset that appreciates over time. Some gambling examples would be the end of a race, the end of a lottery, etc.

- **Investing is a positive sum game while gambling is generally a negative sum game** – a zero sum game at best (Some quick definitions: A positive sum game distributes more than the sum of what is put in; a zero sum game distributes exactly the sum what is put in; a negative sum game distributes less than the sum of what is put in). That does not mean that every investment is a winner or that every gamble is a loser. But over time the positive or negative factors are a certainty. The gain in value over time is what makes investing a positive sum game. The fact that gambling can never make more value than is put in limits gambling to a zero sum game. Because of fees and other costs, gambling is most often a negative sum game as value is continually lost over time.

- **Contrary to popular myth, an investment gain never depends on a loss by someone else.** In gambling, gains by one are always balanced by losses of others. An investing example would be a piece of property that appreciates over time and has numerous owners over that time period. Each person sold the property for more than they paid. There were no losers. The classic gambling example is poker in which all of the winnings are the collective losses of others. Poker never grows in value – it is only a mechanism for the transfer of money. Notice that I said, "… never depends …" You may purchase an investment that someone else lost money on either because they panic sold or were forced to sell for a variety of reasons. Their loss does not become your gain unless the entity really was an investment and you can later sell the entity for profit. On Wall Street the over all value is expanding because of the expanding economy. That is where the profits come from.

- **Although not required, investing is often not a singular large effort but a variety of smaller efforts.** This is known as portfolio theory (be aware that there are numerous corruptions of this) which reduces total risk. Reducing total risk generally lowers the peak income possible but also lowers the peak loss that can occur. Real investing experts over the years have always advocated buying a portfolio to minimize risk. A well designed portfolio enhances the probability of making money while minimizing the probability of losing money.

- **Investment requires skill. Gambling requires no skill** although some degree of skill may be applied. The skill aspect can not be over emphasized. You can not blindly make “investments” with any serious belief that you will come out ahead. You can buy a lottery ticket, or bet on a horse, or place a casino bet knowing nothing about what you are doing. You might even win – but do not think you have any magical powers or you will lose all – pride comes before a fall.

- **Investment minimizes risk while gambling maximizes risk.** A common myth is that investment involves risk taking – thus the connection to gambling. That is overly simplistic. There are two kinds of risk – smart risk and dumb risk. Smart risk is good. Dumb risk is bad. The difference is that smart risk maximizes the probability of a good outcome while bad risk maximizes the probability of a bad outcome. Smart risk would be purchasing a portfolio of investments in a growing area. Dumb risk would be “betting the farm” on the outcome of the spin of the roulette wheel. Everything in life involves risk – that fact can not be escaped. There is even a risk involved in doing nothing. Risk in of itself does not equate to gambling. Investments are not guaranteed. There is always some level of risk involved. However, as long as the global economy is expanding (and it has been doing that since the beginning of time) then the risk over time diminishes towards zero if one invests wisely. Said another way, investing maximizes return for the minimum risk while gambling maximizes risk for the minimum return. The inverse of risk is certainty. If risk is bad then certainty must be good. Again, this is overly simplistic. I have known of cases where people chose the certainty of failure over the risk of success because of blind adherence to the myth that certainty is good and risk is bad.

- **Luck randomly plays a part in investing as it does in all of life. However, luck is essential for gambling.** Nothing good in life is guaranteed although a bad thing such as death is absolutely guaranteed with a perfect zero failure rate. There is always the possibility that some uncontrollable bad thing can happen that ruins the best of plans. These life altering events are rare and few of us ever experience them. It is foolish to not invest because of a fear that something could go wrong. The flip side of this is that sometimes one makes an investment only to benefit from a positive event that suddenly makes the investment worth many, many times the original amount. Again, that is a rare event that few of us ever

> experience. The most common events we will experience involve minor positives and negatives around neutral. While neutral wins over time in investing, neutral always loses in gambling because of the dependence upon an improbable series of good luck that happens on occasion – perhaps just often enough to entice people into the trap of gambling.

If I had to choose one simplistic statement to describe the difference it would that investing is the process of feeding and profiting in return from an expanding economy while gambling is only the transfer of wealth via random luck.

When gambling can become investing

It is interesting to note that a craftily set of well-placed gambles can become an investment in certain arenas. The classic example is pari-mutuel betting at a horse or dog track. This is a controversial subject that seems to bring out high emotions in people. There are those who strongly believe that this type of betting is pure and vile gambling. There are others who strongly believe that this is where a lot of money can be easily made by the average person. Then there are those quiet professionals who routinely make money. Gambling and routinely making money can not be one in the same. Something is going on and I will explain it to you. Any individual bet is pure gamble plain and simple – one is betting that a specific event will occur at a specific time. Many people go to these institutions mostly to have fun via the ambiance and placing small uneducated bets that once in a while pay off which adds some spice to the event. Even though they do not win most of the time they still have fun and that is the point. I am not against having fun. The large number of random bets causes a distortion in the payoffs. The professional gambler (that is actually an oxymoron as the professional does not actually gamble) studies the distortion and buys a portfolio of calculated bets that produce an expected net (i.e. losses plus house fees and other expenses) payback that exceeds the purchase price. He does not win every bet placed – he does not have to. But the portfolio as a whole provides him with a modest capital gain. In explaining this to people I use this example – suppose the professional only nets five percent after an afternoon at the track. That hardly seems worthwhile. But this is a per week rather than a per year return. The return over time can be substantial although the amount is limited by the available distortion in the bets. Many professionals will laugh at my five percent example as they often do much better than that. But still, five percent per week is not bad. This process only works if the number of professionals is small in comparison to the number of fun-seekers who place random bets. No one could make money on average if all bets were intelligent. If there are too many professionals at the track then none will make money as winnings will be too small to offset expenses. This is a game of skill, not chance. Only a small number of people learn the skill. Their enjoyment of the ambience of the track is enhanced by the money they routinely make. Many unskilled fun seekers will study various moronic betting schemes only to lose most of the time. It might be true that such schemes are concocted by professionals in an effort to enhance the money stupidly bet and thus available to be had. I personally do not engage in this because I have zero interest in racing and do not have time or the desire to learn the skill. I apply a different skill (honed over many years) on Wall Street where I am very interested.

I mentioned previously that the options market can be an investment tool for some even though it is pure gambling. The classic example is a manufacturer that uses some commodity and makes a fixed-price bid today to deliver some finished good in the future. The important commodity is not needed for months and might even spoil if bought too soon so there is some risk in guarantying a price today for something you will not buy until some future date. Buyers generally like fixed-price contracts to insulate them from variables in the market – i.e. shift the risk to the seller. The manufacturer will typically purchase an option to buy the commodity at a set price in the future when it is needed. This contract may cost a small percentage, give or take, of the total price. If when the time to buy the commodity comes and the price has gone down then the manufacturer pays the spot price and throws the worthless contract in the trash. However, if the price has gone up then the manufacturer pulls the contract and pays the set price. The option has insulated the manufacturer from a price increase. The price difference in this case is a loss to someone else who bet the wrong way. Make no mistake – the options market is a gambling casino. But it is a necessary market function that we all depend on to purchase goods.

How does one become an investor?

There is no simple act that makes one an investor. Becoming an investor requires years of study, observation, and experience. It is critical to have a knowledge of history of how markets work. It is critical to be able to remain calm and think clearly in times of crisis. Interestingly, many people have honed skills vital to life in general and even investing by playing games such as poker. Although I never have and never will play poker, I have studied the mental processes of the game and refer to them often as important lessons for life. Poker is really a game of skill, not chance. This is just a quick summary. Other chapters explain in detail the process for becoming an investor.