

Investing, Trading and Gambling

I am sometimes asked whether investing, or if not investing, trading is gambling?

Let us start by setting out some definitions. To keep it simple, I will deal only with investing and trading in the stock market. However, that said, investing in bonds, fixed interest, property or unlisted businesses would be similar and trading in any financial security would also be similar.

Investing in stocks is buying part ownership in a business. This will entitle the shareholder to any dividends and franking credits. It also gives the shareholder part ownership in the assets and retained earnings in the business, which has the potential to yield growth in capital over time.

Trading is far easier to define. It is exploiting changes in the price of shares. Mostly this is done by buying with the hope of selling later at a higher price, but it can also be done by selling the stock short with the hope of buying back later at a lower price. There are many other complex strategies.

Gambling is more difficult to define. This is because there is a technical definition of gambling, but the word gambling also has a far more general and loose usage.

First, a technical definition of gambling: Gambling is the wagering of money or something of material value (referred to as "the stakes") on an event with an uncertain outcome with the primary intent of winning additional money and/or material goods. Gambling thus requires three elements be present: **consideration, chance and prize**. Typically, the outcome of the wager is evident within a short period.

Now, the common, loose usage of gambling: To take risky action in the hope of a desired result. Example: *I gambled on finding someone to give me a lift*. Clearly, the technical definition requires the three elements to be in place, but the loose usage is simply that there was a risk in an action or activity.

An element that often pops up in discussions about gambling is skill. Skill is not one of the three elements in the technical definition of gambling, but it can be present because we know that successful gambling requires skill as well as chance. Skill can also be present in the loose usage. What might be relevant though is that where there is no skill, but only chance, that might be a situation that we loosely call a "real gamble".

Investing and trading can also be very skilful. However, there are also some people who trade or invest without any skill or experience. These people we might describe as gambling, using the loose usage of the word to denote the outcome was really pure chance. Then again, some people, who have little or no skill, may easily fool themselves into thinking a good outcome was skill, even though an objective observer would see it as pure chance.

Now, I come back to investing. Investing is usually not considered gambling, even though the investments may involve significant risk. Investments are generally not considered to be gambling when they meet the following criteria: there is a **real economic value** likely to come from the investment, the **expected returns from the investment are positive** (at least in the long term) and the **underlying value of the investment is independent of the risk** being undertaken.

That said, if an investor simply likes the name of a company and decides to buy some shares in it without any knowledge or research, then we might easily use the loose meaning to describe this as gambling, rather than investing. The same will apply to trading.

In conclusion, when we see an experienced and skilled investor or trader using detailed and knowledgeable research, they are in all probability investing or trading rather than gambling. At the other extreme, if we were to see someone buying and selling stocks based on throwing a dart into the share tables page on a wall, they are closer to the loose meaning of gambling than to any reasonable definition of investing or trading. In between these two extremes things become more difficult to define because there is a mix of analysis and chance. There is a huge grey area and where we place someone on the investing-gambling spectrum is essentially a subjective judgement. It can also reflect the moral values of the observer, who may have a prejudice against investment and trading, especially in stocks and other risky financial instruments.

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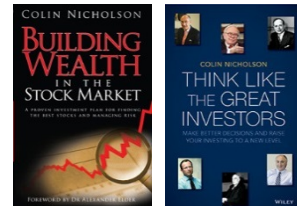
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