Are you investing or speculating?

A necessary distinction

By: Troy Sapp, CFP®
Commencement Financial Planning LLC

Many view investing as a sort of gambling. We are constantly bombarded by the media, investment professionals, and friends with predictions of the future. These predictions are mostly wrong, but when right they are highly profitable. This certainly looks like gambling!

An objective review of such predictions made by investment newsletters, the media, and market timers has consistently shown that only 1 in 5 of them actually make correct calls over the long run. You will recall this is the same percentage as anticipated by chance alone. It certainly does look like gambling!!

We need to take a closer look at what may be actually going on.

In his book *Security Analysis*, Benjamin Graham famously states:

> "An investment operation is one which, upon thorough analysis promises safety of principal and an adequate return. Operations not meeting these requirements are speculative."

What did Mr. Graham mean by this? He seems to have drawn a line between *speculating* and *investing*. The line that Graham drew with this statement is basically this: The true value of an *investment* can largely be determined by analyzing current earnings and a reasonable prediction future earnings growth. Any value not supported by these earnings is *speculation*.

Tulip-Bulb Craze

My favorite example of an historical speculative bubble is what has come to be called the *Tulip-Bulb Craze*.

In the late 1500's, a botanist brought a few unusual plants back from Turkey hoping to sell them at a profit in his homeland of the Netherlands. Though the Dutch are now famous for their tulips, this was the first time they had seen the plant.

The Dutch people were fascinated by this new garden plant, but the botanist's asking price was simply too high for them to bear. In fact, before he was able to sell them a thief came in the night and stole them.

The thief was eventually able to sell the bulbs at a "discounted" price, and over the next few decades the tulip began to become a common, but fairly expensive, fixture in Dutch gardens.

If you know anything about tulips you know they come is some really cool variegated varieties. This is due to a nonfatal virus call *mosaic*. As with any populations, variety is bound to occur; and this is exactly what happened as tulips were increasingly propagated. The more exotic bulbs soon became highly desirable, so much so that people from every walk of life began to shun conventional *investments* to *speculate* on what would be the next year's "hot" variety. Speculators were making fortunes in the tulip bulb market. No one could imagine the demand for these spectacular garden additions could ever slow.

Financial markets are highly efficient at providing consumers what they want; and particularly efficient at supplying *speculators*. There are simply little to no start up costs associated with providing the speculators with derivatives they desire. All financial markets need is a supply of relatively low-cost capital. With tulip bulbs being such a profitable and "sure" thing, the speculators quickly had available a vast supply of derivatives to choose from.

Derivatives allow the speculator to greatly multiply his returns. They basically work like this:

	Investor 1 **No** Derivatives	Investor 2 **With** Derivatives
Cash outlay	$ 1,000	$ 1,000
Funds "borrowed" through derivatives	-	9,000
Total investment	$ 1,000	$ 10,000
30% increase in investment	300	3,000
Repayment of funds borrowed	-	(9,000)
Ending balance	$ 1,300	$ 4,000
Investor return	**30%**	**300%**

This leverage does not only work to amplify returns, but the availability of it allows many more participants to enter the marketplace. This continues to be true today as seen by the increase in number of "qualified" home buyers during the latest housing bubble. This increase in market participants pushes prices up even further adding even more support to the allusion of a new economy.

The allure of the new economy during the tulip craze was much like modern day bubbles. Like the recent housing bubble, the tulip craze lasted for over three years. Three years is a very long time to sit idly by as your friends get rich! As with the recent housing bubble, few could resist the temptation to participate.

The downside of derivatives is they can also amplify your losses. Here is an example:

	Investor 1 **No** Derivatives	Investor 2 **With** Derivatives
Cash outlay	$ 1,000	$ 1,000
Funds "borrowed" through derivatives	-	9,000
Total investment	$ 1,000	$ 10,000
30% decrease in investment	(300)	(3,000)
Repayment of funds borrowed	-	(9,000)
Ending balance	$ 800	$ (2,000)
Investor return	**-30%**	**-300%**

At the peak of the Tulip-Bulb Craze, "investors" were largely selling and borrowing against virtually everything they owned to increase their exposure. Then, in 1637, investors suddenly began to take their profits off the table and prices started to plummet. Those holding derivatives attempted to cover them by selling, but this additional selling only caused prices to tumble further. Tulip brokers then began defaulting on their agreements to purchase tulip bulbs causing the government to formulate a plan to settle all outstanding contracts for 10% of their original value. The government plan then ultimately failed when prices fell below the 10% mark. Once the marketplace priced tulip bulbs for what they were (a non-producing luxury item), the true price of them was determined: about the same value as a common onion! Those who *were* lucky enough to get out early were not spared by the ensuing prolonged depression in Holland (sound familiar?).

As it turns out, these "investors" weren't investors at all, they were *speculators*. They were simply hoping another speculator would purchase the asset from them at a higher price.

The recent housing bubble

A very modest house on my block sold a couple years ago for $250k. The buyer considered himself an investor. Year one cash flow for the asset was as follows:

Rents	$ 12,000
Interest payments	(15,000)
Insurance	(500)
Taxes	(1,500)
Annual Deficit	$ (5,000)

Right out of the gate this "investor" was in the *red*. In order for his cash flow to break even, the rents would need to increase by 42%! (Note that this calculation doesn't even take into account maintenance costs and compensation for his trouble!)

Not only has history shown us a 42% increase in rent levels is way beyond a reasonable expectation, locally there were a huge amount of vacancies resulting from the massive build up of new condos. Assuming a 42% increase in rents was simply out of the question!

So if the price wasn't supported by current or future earnings, what was he basing his "investment" on? Like many others he was willing to bide his time until he could find someone else to take the property off his hands at an even higher price. The future buyer would also necessarily *not* be basing his investment on current or future rents since assuming such a high level of rent inflation would be far from prudent. This meant the future buyer would be hoping for the same outcome as the first. That is, he would also be banking on finding another *speculator*.

In order for this *speculation* to work, the cycle of locating other *speculators* would need to exist perpetually into the future. This is referred to as the *greater fool theory* of "investing". That is, if there is no fundamental reason for a price to be what it is, the "investor" will need to be able to sell the asset to a "greater fool" down the line. This strategy can work in the short run, but ultimately the price of an asset will *always* be determined by its earnings and earnings growth. Eventually someone will actually want their investment to actually produce something on its own.

As we know, the population of real estate *speculators* suddenly evaporated. Investors finally decided they wanted to get paid, but real estate on its own wasn't creating the necessary income to support price levels. Housing prices began their descent back to levels supported by the income they could generate. Simply put, real estate is beginning to once again look more like an *investment*.

The house on my block has now sat vacant for two years and is bank owned. Was this person an "investor"? Of course not, he was *speculating*! Eventually the house will sell, but not before the price drops to a level supported by anticipated rents. At that point *investors* will gladly pay for it.

Calculating "true" value

When a potential investment is broken into the fundamental components of current earnings and a *prudent* forecast of future earnings growth, true value can then begin to be objectively measured. If current earnings and/or prudent assumptions about future earnings growth do not support current price levels, the prospective investment is very likely *speculation*.

It's quite difficult to stand by watching others profit handsomely from *speculation*, though. In fact, these speculative bubbles can last for years. During these times you will hear your friends talk about huge overnight profits while the more prudent

investor receives more modest ones. Being patient and looking beyond quick profits is *not* easy, but this is yet another race the tortoise consistently wins.

Speculative bubbles have consistently recurred throughout history and the story is the same each and every time: Eventually there are no more *speculators* and the value of an asset is retreats to levels supported by current earnings and future earnings growth. It amazes me that the exact same people often fall for bubbles every time they occur. I know people that were swamped by *both* the tech bubble and the real estate bubble. Both times these same people proclaimed a new economy while I and my clients sat by and steadily *invested*. Ultimately, the *investing* approach always beats the *speculative* one, but the investor must be confident with their approach and stick by it.

History always looks back at these bubbles with complete clarity. We wonder: "What were these people thinking? How could they have been so dumb?" The fact is when you are living in a bubble environment they are difficult to identify and even harder to resist. Only through a study of history do we realize bubbles continually materialize, thus we must necessarily devise a process to identify and separate out what is likely to be *speculation*.

The present and the future

History is littered with such bubbles and over-sold markets. Like clockwork, the crowd continues to get overly confident or panicked, but the *true* price is always revealed in the end. As Benjamin Graham famously said, "In the short run the market is a voting machine. In the long run it's a weighing machine."

Once we realize these events do occur, will occur in the future, and may be occurring right now (gold perhaps?), we should formulate strategies best suited to deal with them. This is accomplished by developing a well thought out investment strategy that looks beyond what the crowd is currently doing.

You should develop a strategy you fully understand and are comfortable with. This entails identifying all possible risks and then adopting strategies designed to hedge against all of them you can. The challenge is then to follow the strategy through good times and bad, making adjustments only in light of new information that can be objectively evaluated.

I cannot stress enough the importance of fully understanding your strategy. Once you understand and are comfortable with a strategy you will be more confident with it. This confidence will allow you to stick by your strategy when you need it most: During times when the crowd is in a state of false overconfidence or panic. These are the times when the true *investor's* diligence pays off handsomely and those without a well thought out strategy are eventually ruined.

In later commentary I will discuss the development of an Investment Policy Statement which provides the necessary framework for developing a winning strategy. A well constructed Investment Policy Statement will drastically increase your chance of successfully meeting your goals while minimizing your chance of failure.