BUSINESS

Road to Retirement: The difference between gambling and investing

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What's the difference between gambling and investing? It's an age-old question that's important to understand if you want to both protect and grow your wealth. A good way to think about it is investing is when you make bets when the odds are in your favor and gambling is when you make bets when the odds are not in your favor. So to figure out if you are gambling or investing, you have to know the odds of what you are doing.

Let's start with two simple examples. If you go to the gas station and buy a Mega Millions lottery ticket, is that gambling or investing? I expect everyone would say it's gambling because the odds are one in 260 million that you'll win. You pretty much have statistically guaranteed yourself a loss.

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Conversely, let's say your sister who just graduated from medical school wants to borrow $20,000 from you to buy a car, and she says she'll repay it over five years at 3% interest. Is that gambling or investing? Most would say that's investing because the odds are pretty high your sister will have the money to pay you back.

These two examples help illustrate the point that it's about the odds. The higher the odds are, the more what you are doing looks like investing, and the lower the odds are, the more what you are doing looks like gambling.

Let’s look at another example of betting on a baseball game. Assume we have two teams that are evenly matched, and you can bet on who will win anytime between now and when they play the last out. If you bet before the game starts, the odds are 50/50. It’s pretty much a tossup. On any given day either team could win; they are evenly matched. Thus, you are just as likely to lose money as you are to win, so this looks like gambling.

But what if we are in the eighth inning and the score is 10 to 1. If you bet the team with 10 runs will win, is that gambling or investing? Well, the odds are substantially in your favor that the team with 10 runs will win, so that looks more like investing. The point of this example is to illustrate that by waiting until the odds are in your favor, you took something that looked like gambling and turned it into investing.

Now let’s look at how this concept applies to where we are with the financial markets. Right now we are probably in the second or third inning of the COVID-19 economy. It’s not really clear who is winning and how things will play out. We have many problems and a few successes. Thus, you could bet big now on a rapid recovery, or just wait until we play a few more innings and see which way things are going.

If you bet early, you are arguably acting more like a gambler. You really don’t have much data available to make an assessment of the odds. But if you wait a little, are patient, gather more data, and then bet once you understand the odds better, you are acting more like an investor. There is no hard and fast rule on this, it’s more about adopting a philosophy around how to manage risks.

Over the long run, if you act like a gambler too often, one of these days you will lose big, and then the game is over. But if you act like an investor through all market cycles, you'll stack the odds in your favor. This creates a situation where you'll likely win modestly but more consistently and avoid big losses. That's the key to managing your portfolio cycle over cycle and crisis after crisis. You have to manage the odds and wager when the odds are in your favor and pull back when they are not.

If you've ever played the game blackjack, you know that hitting on a soft 19 is considered foolish because the odds are not on your side. But every once in a while, the person sitting next to you, who knows nothing about the odds, might hit on 19 and win, while you held on an 18 and lost. Thus, you can't evaluate how you are doing based only on the outcome of a single cycle. Odds come into play over multiple cycles and time frames. And since most of us will need to invest successfully for close to 60 years as a saver and once retired, investing more in stocks when the odds are on your side helps you win modestly, more consistently, and avoid big losses.

In today's economy there are an enormous number of unknowns, yet the stock market continues to push higher. To me, this looks more like hitting on 19 than making prudent risk management decisions. Others will disagree, but I think it's fair to say the odds are low that these market levels can be sustained longer term in the face of really terrible economic numbers. So if you are a person who likes better odds, then just wait a few more innings before you make new wagers on stocks. Again, waiting can help you turn a decision that looks more like gambling into one that looks more like investing.

Charlie Farrell is a CEO of Northstar Investment Advisors LLC. This article is for information and education purposes only. Past performance is no guarantee of future returns, and all investing involves the permanent risk of loss. Consult your individual financial adviser for guidance specific to your circumstances.