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Are You Gambling with Your Life Savings?

By Kevin Q. Williams, Owner, Williams Financial Services Corporation

With the passing of the expanding gambling laws in Maryland, we are bombarded with advertisements from casinos in Maryland and the surrounding states. At the end of some of the commercials, there is an announcer speeding through the legalese, warning people about addictions to gambling and suggesting where to get help. But where are the warnings for individuals who gamble in the stock market? Yes, there are disclaimers that say "may lose principal," but it says the same thing for those like Warren Buffet, who invest wisely in the market.

Most casino patrons know they're going for the entertainment factor and know the risks of losing. Many stock market investors would be surprised to know what they are actually gambling. A recent study indicated that near-retirees who did not get help with their retirement plans, gambled with their life savings by taking on too much risk, and, in the end, were not adequately compensated.[i]

So what's the difference between gambling in the casino and investing in the stock market? At times, there seems to be very little difference. Before casinos came to Maryland, people referred to Wall Street as legalized gambling. Researchers often refer to stock transactions as a zero sum game, similar to betting on the Super Bowl. For each transaction or bet, there is a winner and a loser. Profit or loss reflects risk, and there will always be risk with both gambling and investing. How does the average Joe know if he is gambling with or investing his retirement money? Over a long period of time, not knowing the difference can create a significant disparity in wealth.

The first question to ask is, "Are the odds with you or against you?" Using the casino example again, the gambler playing craps is "speculating" that he will win. However, the odds are against him, even though he has better odds of winning at craps than most other casino games. On the other side of the bet is the casino or "house." The house is an "investor," as the odds, over a long period of time, are in favor of the house.

The key phrase is "long period of time." In the short run, the gambler/speculator or the house/investor are the same—either can lose. In the long run, we expect the law of averages to catch up with the speculator in favor of the investor. So how can an individual become the house and turn the odds in his/her favor? The first thing is the speculator's attitude of believing he/she has some type of intellectual advantage over others that they don't know and can't see. In other words, speculators believe they can beat the market and thus, the market becomes the foe.

Contrary to the speculator, the investor pays little attention to current market conditions or invests in spite of market conditions. The market is not the foe of the long-term investor; inflation and taxes are the enemy. Once an individual embraces the mind-set of a long-term investor, which is easier said than done, he/she can start making decisions that increase the probability of success over a long period of time.

Using the Three Factor Model[ii], the investor will tilt the portfolio to increase the probability of success. The first adjustment is weighting the portfolio toward stocks instead of bonds. While past performance is no guarantee of future results, historically, stocks have had a greater probability than bonds of providing returns that exceed inflation over long periods of time.[iii] Secondly, within the stock portion of the portfolio, the long-term investor will skew the portfolio toward value stocks over growth stocks. Value stocks generally perform better than growth stocks seven out of ten times over fifteen year rolling time periods.[iv] The third portion of the Three-Factor Model requires favoring small company stocks over large company stocks. Again, the small company stocks generally outperform large company stocks over long periods of time.[v]

Please note that there is more risk with stocks than with bonds, more risk with value stocks than growth stocks, and more risk with small company stocks than large company stocks. One has to consider if they are comfortable with the added risks for the potential for higher returns. Moreover, we don't want to exclude bonds, growth stocks, or large company stocks. In fact, the prudent long-term investor will allocate his/her portfolio in accordance with his/her risk tolerance and attitude toward the different asset classes. Finally, consider implementing a global portfolio. While the U.S. market did much better than expected in 2012, it was ranked 29th in the world in terms of return for the year then ended.[vi]

By developing the mind-set of a long-term investor, using the Three-Factor Model, and gaining exposure to international markets, the prudent investor operates like a casino and not like its patrons. A wealth manager can help determine the appropriate risk for your portfolio.

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[i] Help in Defined Contribution Plans: 2006 Through 2010 by Financial Engines and Aon Hewitt, September

[ii] Fama, Eugene F.; French, Kenneth R. (1993). "Common Risk Factors in the Returns on Stocks and Bonds". Journal of Financial Economics 33 (1): 3–56

[iii] Risks of investment in the bond portfolio include, but are not limited to, changes in the interest rates and creditworthiness of their issuers. Also, in a low interest rate market there is the risk that bonds could be called by the issuer and prepaid to maturity. They could be replaced by bonds that offer lower interest rates.

[iv] The fifteen year rolling time periods from July 1926 –December 2010. US Large Value Index is Fama/French US Large Value Index (ex utilities), provided by Fama/French

[v] The S&P data is provided by Standard & Poor's Index Services Group. CRSP data is provided by the Center for Research in Security Prices, University of Chicago. Investments will fluctuate and when redeemed may be worth more or less than when originally invested. Investments in small, mid or micro cap companies involve greater risks not associated with investing in more established companies, such as business risk, stock price fluctuations, increased sensitivity to changing economic conditions, less certain growth prospects and illiquidity.

[vi] Source: Morningstar Direct 2013. Country performance is based on respective indices in the MSCI All Country World IMI Index (for developed nations) and MSCI Emerging Markets Index. Investment risks associated with international investing, in addition to other risks, may include currency fluctuations, political, social and economic instability and differences in accounting standards when investing in foreign markets.

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