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Why you should be an investor, not a gambler

By JOHN HEINZL
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The stock market is not a fast-paced casino but a place to build wealth over time

When I tell people I write about investing for a living, often the first question they ask is: "So, have you got any hot stock tips?"

"Yeah," I tell them. "Ignore hot stock tips."

From what I can tell, most lay people operate under a huge misconception about the stock market. They believe that the surest way to make money is to buy a stock just before it is about to take off, then cash in when the price has doubled or tripled. They aren't the least bit interested in incremental gains or holding for the long term. Instead, they lust after the adrenalin rush that comes with making a fast buck.

In their quest for an immediate payoff, they focus on risky stocks with a great "story" - a mining exploration company that's supposedly about to hit the motherlode, or a technology company whose latest invention promises to revolutionize (insert industry name here). It doesn't matter if the company has no earnings now; the important thing is that the cash will soon begin pouring in like Niagara Falls.

These short-term "investors" - a more accurate term is gamblers - gravitate to initial public offerings, hot sectors (think Internet shares in the late nineties or Chinese stocks a couple of year ago), takeover scenarios and anything else that promises a big payday for very little of the investor's time or effort.

Are some investors successful at this game? Sure. They're usually the ones who are privy to insider knowledge, have access to sophisticated high-frequency trading algorithms or are just plain lucky. But the vast majority of ordinary people who treat the stock market like a giant casino will get casino-like returns. Reinforced by an occasional win at the slots, they'll keep going back for more, frittering away their cash in a futile attempt to make their capital grow.

The casino mentality prevails with "anti-gamblers" as well. For every punter who sees the market as a place where quick fortunes are made, someone else sees it as a place where fortunes are lost. "Invest in stocks? You gotta be crazy!" is the familiar refrain. These two groups could not be more different in their behaviour, yet both view the stock market as largely a gambling parlour.

And they're both wrong.

Investors who "get" the stock market aren't seduced by the allure of quick profits. Nor are they scared away by risk, which they accept in measured doses because they know that without risk, there is little reward. They focus, not on short-term winnings, but on the growth of their investment over years or decades. They accept that the stock market is manic depressive in the short run, but that the key to building wealth is to buy and hold high-quality companies whose sales, earnings and dividends grow over the long term. If they can buy them at an attractive price, all the better.

Warren Buffett's words of wisdom

The stock market is merely a tool for acquiring these companies. As Warren Buffett once said: "I never attempt to make money on the stock market. I buy on the assumption that they could close the market the next day and not reopen it for five years."

One reason I am a big fan of dividend growth investing is that it is the antithesis of the casino approach. To prosper from companies whose dividends increase regularly, an investor has no choice but to buy and hold. It is a get-rich-slow strategy that rewards patience and commitment.

Knowing (or at least strongly suspecting) that a company will be increasing its dividend regularly is a powerful incentive to stay invested (assuming, of course, that the company's fundamentals haven't changed in some dramatic way), regardless of the market's inevitable ups and downs.

Investors who trade frequently, on the other hand, usually pay the price in lower returns. That's partly because taxes and commissions eat into their capital, but also because individuals often make decisions based on emotion.

In a 2000 paper titled "Trading is Hazardous to Your Wealth," Brad Barber and Terrance Odean of the University of California studied the trading activity of 66,465 households at a large discount broker between 1991 and 1996. The U.S. market returned an average of 17.9 per cent annually during this period, but households whose trading frequency was in the top 20 per cent made 11.4 per cent. In a separate paper, the authors found that 80 per cent of day traders in Taiwan lost money over a typical six-month period.

As the late value investor Benjamin Graham once said: "The investor's chief problem - and even his worst enemy - is likely to be himself."

Now that's a stock tip worth remembering.

Stats to ponder:

1 per cent: Proportion of day traders in a Taiwanese study who were "predictably profitable," according to University of California finance professor Brad Barber, quoted in The New York Times.

8.2 per cent: Annualized total return of the S&P 500 for the 20 years ended Dec. 31, 2009.

3.2 per cent: Annualized return of the average mutual fund investor over the same period, according to Dalbar Inc., reflecting fees and the tendency of investors to buy and sell at the wrong times.

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