Investing Vs Gambling

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The vast majority of stock exchange participants know about the basic stock ratios like the P/E, the P/BV, the ROI etc. There are some that know technical analysis or Macroeconomic forecasting. The wrong thing about all those participants is that they devote 100% of their time and energy to try to find out the market direction.

To give an example, on 6 February 2018, we bought S&P500 futures at 2.637$. That decision was based on macroeconomic forecasting, but that decision was not the number one matter. Most investment activity is not "what's the market's direction?", but "is that position compatible with my portfolio?" There is no correct or wrong answer to the above question, but that question separates investors from gamblers.

On our way to answer the above question, we must decide what type of portfolio we have. There are 3 basic types of portfolios: 1. to fund a retirement plan, 2. to build a security capital buffer or 3. for a specific future purchase.

Any type of the above portfolios has different structure regarding liquidity, risk tolerance and asset allocation. To give an example, a portfolio designed for retirement encloses a greater share of stocks than the other two types and can undertake more risk than the others. What is more the life span of the portfolio is not clear cut. On the other hand, a portfolio designed to offer a cash buffer in case of emergency has a completely different structure. That's why a portfolio of that kind must be able to offer much liquidity on the short run.

Our second step after our compatibility test is the capital exposure to any specific position. That is what percent of our portfolio will be invested on that specific position. To do so, we must calculate the risk of the worst-case scenario if we buy the position in respect and create a plan B in case that scenario comes true. In our example above, the worst-case scenario would be the S&P500 index to deteriorate further below our open price. In that case a plan B would be a dollar averaging strategy, a stop loss, or some options positions to reduce our risk.

In parallel to our plan B assumptions we must calculate the correlation this new position has with our existing portfolio. The less correlated the new position is with our existing portfolio the more capital we are able to invest on this position and vice versa.

After all that technical stuff is over, we must implement our last test which is our emotional test. Can we withstand the loss and implement our plan B scenario without our emotion stepping in and leading us to wrong decisions? If we pass that final test, then we are ready to open that new position. If we fail, we reduce the percent of our portfolio invested to that position and we retake the test.

This process is what separates investors from gamblers. The difficult thing is that even if a participant can follow the above procedures is not necessarily deemed an investor. The level of detail in each step is so massive that cannot be explained in an article.

Investment management is a dynamic service that is continually evolving. Even certified investment managers are obliged to participate in lifelong learning programs to maintain themselves capable of providing such services.

As you can imagine, our investment counselling service has much more to do with asset allocation and risk management than market direction. It is essential that our clients' needs are 100% mutually understood before we construct a portfolio to serve those needs.