

# PERSPECTIVES

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## Investing

### Investing vs. speculating: What's the difference?

By Michael Chu, Investment Advisor

#### **We often hear the words *investing* and *speculating* used interchangeably. But do they really mean the same thing?**

It's true that with both investing and speculating your intention is to make a profit. With both you incur some risk. But beyond that, there's a big difference in the process and reasoning behind a decision to invest or speculate.

Warren Buffett, who is an investor, sums it up pretty well: "If you are an investor, you're looking at what the asset or business will do. If you're a speculator, you're primarily a forecaster on what the price will do – independently of the business."

When we invest in stocks for our clients, we are indeed investing. That's because we are buying an asset, having determined after careful analysis that it is of good value and therefore worth holding on to. The asset has value because it produces earnings over time.

Let's look at some real-world examples. A grocery store buys its products in bulk and then sells them to individuals like you and me, but with a mark-up. That sounds like a pretty good business model, generating profits year after year after year. As a shareholder, you would own those profits. That's where the value comes from when we are investing.

Speculating, on the other hand, is buying assets that you hope someone else will in turn buy from you at a higher price. These assets could be commodities like gold or items like art. A piece of art might be worth \$2,000 one day. Then another day it might be up to \$3,000, or perhaps down to \$1,000. The art's value is dependent only on what someone else is willing to pay for it. The art doesn't do anything; it doesn't make any earnings.

The same goes for gold. The price of gold is linked to fear, often the fear of inflation. More fear usually results in a higher gold price. If you buy gold, you are forecasting that there will be more fear in the future so you can profit. But like art, gold does not produce anything.

Another way of looking at it is that investing and speculating differ by how you determine worth. For example, suppose I buy a rental property that I can rent for \$15,000 per year and I require a 5% rate of return. Then I can determine that the property should be worth around \$300,000. That's investing.

What is gold worth? Well, if I check the newspaper, it might say the price is \$1,300 per ounce. But what is the true worth? There's no income stream and again, the gold doesn't make anything. So I'm not sure how to determine the worth of a shiny gold coin. But if someone wants to buy it from me for \$1,500, then I'll be happy. That's speculation.

It's common to speculate with stocks, too, focusing too much on price instead of the underlying business. This could explain a lot of the volatility that we've been experiencing.

There's nothing wrong with speculation. It's just a different game and different from what we do for our clients. We're investing – focusing on the worth of a business. ■



*Michael Chu is a Portfolio Manager and Investment Advisor for the Stan Clark Financial Team at CIBC Wood Gundy. Michael is a specialist in investment research and information technology.*



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The Stan Clark Financial Team

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Phone: (604) 641-4361 Toll free: 1 (800) 661-9442 Fax: (604) 608-5211 Email: [StanClarkFinancialTeam@cibc.ca](mailto:StanClarkFinancialTeam@cibc.ca) [www.stanclark.ca](http://www.stanclark.ca)

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