Investing in shares should not be a gamble

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There are two broad approaches to share investing.

You can invest with the intention "becoming a part owner of a business" (**approach 1**). As a part-owner of the business, you receive your share of the profits of the business, and at an appropriate time, can sell the shares to get back your capital (i.e. let someone else receive the ongoing share of the profits of the business). The capital you extract when you sell may be more or less that what you paid when you bought, depending on whether the value of the business has gone up or down (i.e. whether the expected future profits have gone up or down) and how much the buyer will pay for the ongoing share of the profits.

Alternatively (**approach 2**), you can buy the share of a company that you believe will, over the immediate future, rise in value (i.e. someone else will want to pay more), so you can sell it to gain reward. The rise in value may be due to the increased profits of the company, or because people believe that it will make increased profits and want to buy it or because it is trendy.

When you buy shares and invest in the share market, you do not need to gamble, yet some choose to adopt a gambling approach.

Successful gambling involves understanding how many decisions prove to be right and when they are, what the gain is relative to the losses when they are not.

Over the short-term, gambling can be a very successful strategy, but for most, and generally over the long-term, gambling strategies are less efficient, with the costs and losses outweighing by the gains.

Within the two approaches there will be a range of permutations.

The first approach has at its heart, the principle of long-term "ownership" and therefore a "passive" philosophy; you are looking to capture an appropriate share of the profits of a particular commercial activity and keep your costs of doing so low. The second approach has at its core, a trading philosophy and looks to benefit from the actual or perceived growth in the company's value. Both can be successful, though for the trading approach to work for one investor (i.e. gets it right), there has to be a second investor that does less well (i.e. gets it wrong), because there is always a buyer and a seller.

Business ownership

In the first approach, what is important is the ability to assess whether the business of the company is sound (i.e. will make profits) and whether or not there will be an opportunity to realise the investment (i.e. sell), at an appropriate time. Investment decisions are made on the relative level of the expected future profitability, the timing of the profits, the contribution to the required diversification of the portfolio as a whole, and importantly, how the expected stream of cash flows (share of profits and realised sale proceeds) compare to the intended expenditure of the investor. The emphasis is the soundness of the business, because the intention is to hold the share long-term.

The legal stuff
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A subset of this approach is to choose the companies on the basis of an index (index management) and accept the market average return characteristics, as opposed to undertaking detailed research on the individual businesses and creating a targeted portfolio with specific expected return characteristics.

Active management

In the second approach, what is important is the ability to guess (forecast) the price movement and timing of the price movement. Researching individual companies and

their short-term prospects is important. But more important is to understand why others (the current seller to you and the ultimate buyer from you), will have different views to you, recognising that all investors, in most circumstances, likely believe that they are "right". In addition to guessing the likely share price rise, there also needs to be an understanding of the potential loss if the price goes down. This approach falls under the category of "active" management and so by definition creates winners and losers.

Active managers, like gamblers, therefore need to understand their "win-rate," and the potential "payout" when they win, and the loss when they lose. The win-rate and payout, hold the key to understanding the potential for outperformance and to putting the odds in favour of one particular investor, or group of investors.

Win-Rate: If 100 investments are made, what percentage of them are expected to win?

Payout: How many dollars are made on a winning investment? And how many dollars are lost when the investment goes wrong?

Some investors need a high win-rate to feel confident. Others may accept being "wrong" often if, when they win, they make significant gains. Both approaches are valid, provided the mathematical combination of win-rate and payout gives a positive result, over the long run. **Remember, not all investors can win.**

Some combinations of the win-rate and payout level do not work. For example, if you win 60% of the time and earn $0.50 when you get it right, but lose $1 every time you get it wrong, after 100 investments you'll have lost $10.00.

	Wins:	60 x $0.50	= $30
less	Losses:	– 40 x $1	= - $40
equals Profit:			= - $10.

Other combinations of win-rate and payout build wealth. For example, if you win 40% of the time and earn $2 (on your winners) for every $1 you lose (on your losers), after 100 investments you'll have earned $20.

	Wins:	40 x $2	= $80
less	Losses:	– 60 x $1	= - $60
equals Profit:			= $20.

Successful card players use math to manage the odds and consistently win money. But in reality most card players don't use math and consistently lose money. Many investors make the same mistake. To be successful through active management, you have to be the investor that has a better win-rate/payout level, than the average investor.

When investing, there is not a single "right" answer or approach. The answer for an individual depends on their total assets and their risk preference (how much you're willing to lose before cutting your losses). This applies to investors who adopt both approaches.

If an investor is going to appoint a manager that adopts active management (approach 2), understanding the manager's win rate and the payout level is important, relative to the win rate and the payout level of the market as a whole. Often it is better not to play the active game and look to invest in companies for the long-term, diversify and benefit from the share of the business profits.