

Investment vs Speculation

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Differences Between Investment and Speculation

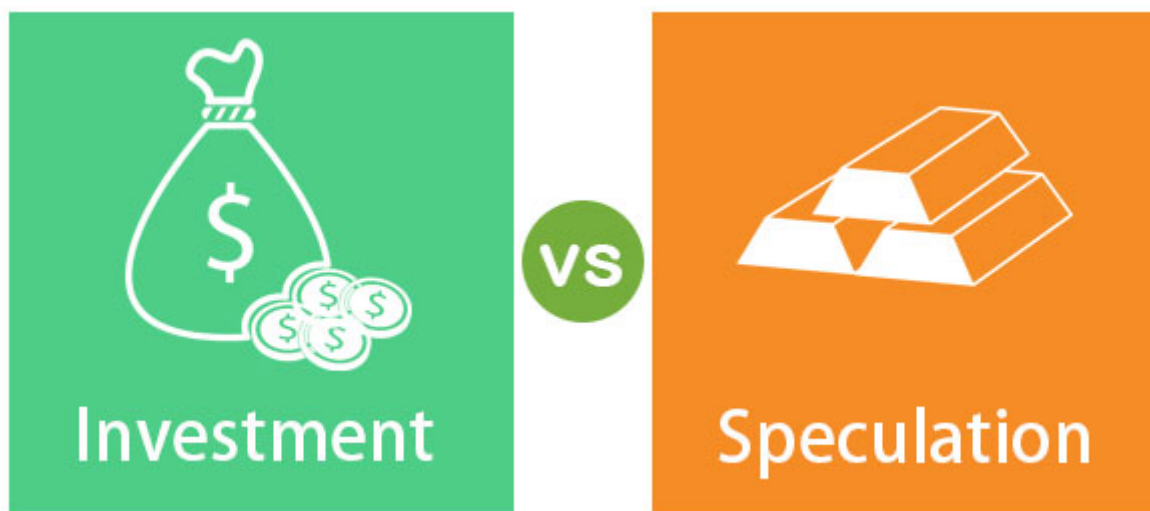
Investment is when a security or an asset is purchased with an intention of holding it for a long term period with a view that it will gradually increase in value over that period and speculation can be considered a more risk based transaction where the sole purpose is to make profit out of that transaction which is generally a short term and often a single transaction.

Both these terminologies are generally used synonymously due to specific common characteristics, but it does have a line of demarcation to distinguish them.

In simple terms, investment involves purchasing an asset or security with the hope it will generate certain returns in the future.

Speculation, on the other hand, involves an element of risk in a financial transaction and how sufficient profits can be earned from the same.

Investment is spread over a long time horizon, and the focus is on getting security and stable returns, whereas speculated activities are for activities for less than one year. In speculation, the objective is to make quick returns and may compromise on the objective of security.



This article is structured as per below –

What is Investment?

Investment involves the allocation of money towards the purchase of an asset, which is not to be consumed in the present but hoping it will generate stable income or is expected to appreciate in the future. The term is used very widely since it impacts every individual in life who desire to establish their financial future.

Investment can be used for defining any mechanism that can generate returns in the future. Financially, it will involve purchasing stocks/bonds, real estate, gold, or mutual funds are some of the common examples. E.g., one will purchase a share of Company 'A' for \$4 in the current market with the hope that after say 5 years, its value will be \$8 or more so that if an investor decides to sell, they would have made some gain than what they had purchased for.

The production of goods used as inputs for further producing other goods is also referred to as an Investment. The scope is not necessarily limited to the world of finance and can be extended to personal lives as well. For instance, learning an additional language may prove to be a fruitful investment if one gets an opportunity that requires knowing an additional language.

Economic growth can also be encouraged with the help of sound and calculated investments involving business decisions. When a firm creates or purchases utterly new equipment for production for improving the total output within the facility, this further causes the GDP of the country to rise. There are 2 forms of investment that exist, i.e., Traditional Investment and Alternative Investment. Some of the popular instances are:

Traditional Investment

- Stocks
- Bonds
- Fixed Deposits
- Provident Funds
- Gold and Jewellery

Alternative Investment

- Real Estate
- Private Equity Investments
- Antique Collectibles
- Paintings
- Hedge Fund Investments
- Structured Products

Investment is one of the most critical aspects of financial planning to ensure the money earned is not lying unproductive. The money earned today will not have the same value 5 years down the line apart from the intrinsic value. Hence, saving money alone will not be sufficient for achieving future financial goals. Some of the most important reasons for an investment of money are:

- Investing in various financial avenues ensures the growth of money instead of remaining in the bank account with very modest returns.
- The yield returns help to take care of emergency situations such as Medical expenses etc.

- For personal investment, the future of the entire family can be secured, such as the education and marriage expenses of children.
- Tax minimization is an additional advantage for Governments around the world offer benefits to individuals and companies for making investments, mainly if they are associated with the Government or Government-backed institutions.
- Inflation can be successfully dealt with. Inflation will keep on rising, and returns from savings may not necessarily be enough. The value associated with the quantum of money depreciates with rising inflation. The impact of inflation in reducing the value of assets can be controlled by investing and generating returns on the corpus.
- It is an attractive way of earning income from accumulated wealth. E.g., rent earned from a real estate investment or stocks which have been purchased.

What is Speculation?

Speculation does not have a precise definition but involves purchasing an asset to make profits from subsequent price change and possible sale. The speculators indulge in marketable assets that do not have a long life.

The speculation involves a relatively higher level of risk and more uncertainty of returns though it can be on the same lines as an investor. These speculators are generally trained and take action when the game of probabilities is high in their favor. They are very proud of their opinion and consider placing a high premium on that. Decisions are considered when the atmosphere is of Panic, Confusion, or high levels of optimism but still go against the flow.

The probability of the opposite situation is difficult to occur, but if it does, the speculators can earn a hefty amount from that. E.g., if the stock market is going through a bullish phase, and the scenario is optimistic, the chances of downfall are relatively less. Still,

speculators can predict a bearish phase to arrive soon and place their bets accordingly. If the bearish phase does occur, speculators earn a huge margin since they made a prediction when bets were against their opinion.

Many may consider speculators as dangerous gamblers though they provide the much-required liquidity in the market, which is essential for efficiency in the market. In certain sectors such as commodities, speculators provide substantial liquidity else the only participants would be the Food companies and the farmers who may have limited ability to invest and assume the risk.

With lesser participants, the bid-ask spread would be more extensive, and harder to find a counterpart in case of trade closure. The resulting illiquidity will substantially increase the risk in the market and offer an opportunity to earn more, which is where the speculator's cash in.

Speculation can also spike the short-term volatility and risk, thereby inflating prices and lead to asset bubbles similar to the 2005-06 real estate market in the USA. The interest rates were low, and speculators were betting on home prices continuing to rise as more individuals will purchase homes (with the help of leverage) to sell them when prices rise further at hefty profits. The selling of homes that followed defines a situation of a speculative market.

Investment vs. Speculation Infographics



INVESTMENT V/S SPECULATION

1#. Meaning

INVESTMENT



Purchase
of an asset/security for securing
stable returns

SPECULATION



Executing
a risky financial transaction with a
hope of profit making

2#. Time Horizon

INVESTMENT



Long Term

SPECULATION



Short
– term generally less than a year

3#. Risk Levels

INVESTMENT



Moderate

SPECULATION



High

4#. Deployment of Funds

INVESTMENT



Investor
using funds of self

SPECULATION



Borrowed
funds

5#. Investor Attitude

INVESTMENT



Cautious
and Conservative

SPECULATION



Aggressive
with an element of carelessness

6#. Decision Criteria

INVESTMENT



Fundamental
and Basic factors i.e. Financial
performance of the company/sector

SPECULATION



Technical
charts, Market psychology and
individual opinion

7#. Expectations of Returns

INVESTMENT



Fundamental
and Basic factors i.e. Financial
performance of the company/sector

SPECULATION



Technical
charts, Market psychology and
individual opinion

Critical Differences Between Investment and Speculation

1. An investment involves an asset with the hope of securing returns over the principal amount in the future. On the other hand, speculation consists in conducting a risk financial transaction to make large-scale gains from a single transaction.
2. Investments are generally held for an extended period of time, usually more than a year. Instances like real estate and life insurance are held for time horizons like 25-30 years. Speculation is held for a brief time span, usually less than a year, and can even be on a forthcoming event.
3. The amount of a risk assumed is relatively moderate as compared to speculation. Since investment is mainly done by the middle class working for the community, they would be putting the spare money of their hard work, which they expect to earn a stable return. They are ready to part with their savings if it offers a definite return. Speculation will focus on getting high returns in a relatively shorter amount of time, and thus, the quantum of risk is very high.
4. An investor will be using their own funds for investing, whereas speculators will make use of borrowed funds and luring the borrowers with attractive returns.
5. The above point also reflects the attitude of the investors and speculators. Investors will generally follow a cautious and conservative approach while considering the investment along with the risk appetite they can absorb. Speculators believe in an aggressive approach highlighting attack but careless attitude. As the returns are far too attractive, and the window of opportunity is very small, this behavior will easily get reflected.
6. The investors expect to profit from the change in the value of an asset, whereas speculators focus on extracting profits from price changes due to demand and supply forces.

7. While making decisions, investors will conduct extensive research and focus on the fundamental factors of the company, such as the financial position, ratio analytics, etc. whereas speculative decisions are based on technical charts, market dynamics and personal opinion/tips received.
8. The avenues for considering investment will focus on the Blue chip companies of the stock market, savings bank account, provident fund, etc. but speculators will focus on areas such as the commodity market, options trading, betting, etc.
9. Investment does not give rise to practices such as insider trading or possible leakage of information, which can be observed in speculative activities since the returns in them are lucrative.
10. The level of patience and sacrifice is relatively large in the case of investment but not in the case of speculation. However, the probability of losses does multiply in speculative activities.
11. Investment activities are recorded separately in the balance sheet of a firm, but speculation is not recorded separately. Depending on the returns which they offer, such activity may either be classified under-investment or under the category of 'Other Assets / Miscellaneous Income.'
12. The amount of money for investing activities is relatively less and depends on the ability of the individual/ organization, but speculation requires large funds for executing the activities.

Investment vs. Speculation – Comparative Table

Basis Of Comparison	Investment	Speculation
Meaning	Purchase of an asset/security for securing stable returns	Executing a risky financial transaction with the hope of profit-making
Time Horizon	Long Term	Short-term generally less than a year
Risk Levels	Moderate	High
Deployment of funds	An investor using funds of self	Borrowed funds

Investor attitude	Cautious and Conservative	Aggressive with an element of carelessness
Decision criteria	Fundamental and Basic factors, i.e., Financial performance of the company/sector	Technical charts, Market psychology, and individual opinion
Expectations of Returns	Modest but continuous	A high rate of return.

Important Note

One should not mix speculation with gambling. Many times both these terms will be used together, giving an impression it means the same, but it is not. Gambling involves putting in money on an event that has an uncertain outcome in hopes of winning more money without any calculation. It is purely a game of chance with the odds, not necessarily with the gambler.

For instance, a gambler will consider a game of American roulette rather than be speculating in the commodities market. However, the payout is only 35 to 1, while the odds against winning are 37 to 1.

Thus, if the bet is worth \$5 on a single number, the potential income is \$175, but a possibility of winning this amount is 1/37, and if the selected number does not arrive, the \$5 is also lost.

Conclusion

Though most of the characteristics of investment and speculation overlap each other, one should understand the differences separating each other.

One should note that all investments are speculation, but all speculations are not necessarily investments. The objective of both is to earn profits; only the method involves a difference. There is nothing correct or incorrect in the approach, but it depends on the long-term objective of the individual and the quantum of risk they are willing to bear.

The truth of the matter is every activity we perform involves speculation. The individual comes in the open and uses its judgment to forecast the future course of events and act accordingly. This peculiar psychology makes many investors avoid certain stocks or bonds due to its unforeseen possibilities making investors judge safety by the yield and stability offered. If security is paying beyond a certain threshold, it is classed as 'speculative' and is not for them.

Hence, one should be aware of the pros and cons of both these situations and keep awareness before arriving at any decision and not solely as an Investment or speculation activity. The element of gambling should also not be neglected entirely, and knowledge of the same should be kept in mind before arriving at any decision.

Recommended Articles

This article has been a guide to Investment vs. Speculation. Here we discuss the critical differences between investment and speculation along with the infographics and comparative table. You may also have a look at the following articles –