

Beware the blurred line between investing and gambling

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Risky investments and short-term trading are often likened to gambling. But there is a difference between taking a calculated risk and simply rolling the dice.

The appeal of high-risk, speculative investments is obvious. You have the chance of large, even life-changing potential returns. For example, when Bitcoin breached the USD 70,000 level in March 2024, those who bought it 10 years ago — and resisted the temptation to sell — would have experienced a more than 110-fold increase, compared to the S&P 500 index's 2.7-fold increase over the same period. But high-risk, high-reward investments can look a lot like gambling, especially when investors don't have the data they need to make an informed judgment.

The distinction between investing and gambling can be subtle and subjective, and it can be especially difficult for those who are relatively new to investing to know the difference. Indeed, there is evidence that investing and gambling often go hand in hand among younger investors. Research by CFA Institute found that 61% of Gen Z investors aged 18–25 gamble online or in-person, compared with only 29% of their age group who do not invest.

That is perhaps not surprising, given that some forms of trading and gambling elicit a nearly identical response on a neurochemical level.

How can someone know when they may be crossing the line between investing and gambling?

One way to do that is by asking themselves how rationally and systematically they have identified, measured and considered the associated risks. This

involves investors examining the time frame and motivation behind their trading, and not just what they are trading.

Investing covers a spectrum of varying degrees of risk. At one end are virtually risk-free investments such as money market instruments. At the other, instruments like leveraged derivatives and cryptocurrencies.

According to CFA Institute research, Gen Z investors who are frequent gamblers are more likely than non-gamblers to be invested in crypto, NFTs and options or derivatives (See Figure 1). They are also more likely to invest on margin, or by using borrowed money to finance their positions.

These are all widely understood to be high-risk investments, which tend to underperform less risky ones over the long run.

Listed equities, too, can be extremely unpredictable over a short time period (see Figure 2), and investing in only a few stocks, or being insufficiently diversified, can make investors more vulnerable to unforeseeable risks.

Most investors who actively trade individual stocks and options achieve significantly lower portfolio returns than those who buy and hold the market through an index fund. And in nearly all cases, staying invested beats attempts to time the market.

Why, then, do so many investors try to catch market tops and bottoms, and trade too frequently?

It could be because they are motivated by an urge to gamble, using trading and speculating in financial markets as a substitute for traditional forms of gambling, such as lotteries, casinos and sports betting.

Like gamblers, some investors buy and sell financial instruments largely because it excites them, and they enjoy regaling others with tales of their trading and investing exploits. Notably, those who gamble compulsively are also more likely to trade frequently.

Those that take this road should be aware that frequent traders tend to be in a significantly worse financial situation than other investors with a similar socio-demographic profile. Unfortunately, quitting compulsive trading can be as difficult as breaking a gambling addiction, especially considering many addicts even get a buzz from losing.

Another thing worth noting is that when financial markets become volatile, actual gambling may start looking like a safer bet. A wide-ranging study in 2018 found that risk-seeking investors chose to exit stock trading and return to conventional gambling activities following periods of high stock market volatility.

Understanding when they are actually gambling, rather than investing, could help risk-seeking investors manage their risks. Since most rational people accept that gambling comes with a high risk of loss, they usually behave accordingly. When walking into a casino, for example, smart gamblers only withdraw as much cash as they are willing to lose, set themselves realistic loss limits, and walk away once they have had enough.

If they do happen to lose control, their losses are often capped by limits on ATM withdrawals and a lack of margin facilities. Financial investors who fail to put in place similar stop-loss safeguards can face heavy losses.

Another important difference between gambling and investing is the expected return.

Over time, gambling always has a negative expected return. In casinos, the built-in mathematical “house edge” reliably leads to a transfer of money from players to the casino. In the long run, the house always wins.

Investment, on the other hand, is the allocation of capital to a business or asset in the expectation that it will generate income or appreciate in value. Over the past century, investments in stocks and bonds have reliably yielded positive

returns. In the long run, it is possible for both investors and the issuers of securities to win.

Of course, there is no such thing as a guaranteed investment. But professional investors rely on a combination of knowledge, experience and discipline to take calculated risks. They are seeking returns, not thrills from the remote chance of a big win. And that is very different from rolling the dice.

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