TRADER OR LONG TERM INVESTOR

DOES A LONGER TERM VIEW REALLY PAY OFF?

JOHANNESBURG: One of the great debates in the investment industry is around the benefits of long term investing vs. short term trading. In the one camp you have investors like Warren Buffett as one of the champion long termers and George Soros in the opposing camp. The track record of successful long term investors cannot be ignored, however the argument in favour of traders is far more intuitive and more easily understood by outsiders. This is especially true AFTER a market crash when people wonder how long term investors remained invested when the markets were so obviously overvalued.

INVESTING IS A MYSTERY NOT A PUZZLE

My current favourite author is Malcolm Gladwell who wrote “Tipping Point” and “Outliers” amongst others. In his most recent book, “What the dog saw” he discusses the difference between a puzzle and a mystery – a discussion that is very relevant to the investment business. He suggest that puzzles can be solved simply by gaining sufficient information to solve the puzzle. Conversely mysteries are made more difficult to solve because there is too much information, much of which is contradictory. The key to solving a mystery is determining what information to use and what information to ignore. His example of a puzzle is the Watergate scandal that was solved by two inexperienced young journalists who had the courage and persistence to gather the information needed to bring down an American president. They did not need any experience or expertise to crack the case, they simply needed to gather enough information. By contrast, investing is a classic example of a mystery because there is simply so much information available that it is impossible to absorb it all and decipher it correctly. Much of this information is contradictory so simply gathering more information will not help the situation.

Gladwell argues that mysteries are best solved by experienced experts. That means investors who are successful over time are likely to be highly experienced experts who have the necessary skills to know what information to use and what to ignore. The point of this article is to determine if there is more merit to trading or long term investing and my first comment is that we cannot use one hit wonders to prove our argument. We need to realise that success in this instance is measured over decades not months.

TRADING

It is only human nature to want to make money as quickly and as easily as possible. Any investment methodology that allows you the opportunity to make returns quickly is naturally going to be more attractive at first glance. At its core, this is one of the real attractions of trading as an investment philosophy, it allows you the opportunity to make money quickly. The philosophy of a trader is more easily understood by outsiders - you can make money if you are able to buy an item cheaply and sell it to someone else at a higher price. Market crashes are almost always obvious with the benefit of hindsight. Using this hindsight one could argue that any person with a bit of savvy should have been able to anticipate the crash. This means they could have exited the market before the crash and bought in again after the crash. I am naturally simplifying the case for trading substantially but hopefully it illustrates the point that trading is simple...in principle.

In addition, traders are able to use more complex financial instruments to profit from market crashes by selling short. There are many hundreds of ways to be a trader but there is one theme that characterizes most traders – time horizon. Traders are not making investments that will only be realized after three to five years. Their timeframes are typically shorter than 12 months. This reiterates the point that trading allows you the opportunity to make money quickly. This was clearly illustrated by George Soros who made $1.1bn in a brief period by shorting the UK currency in 1992.

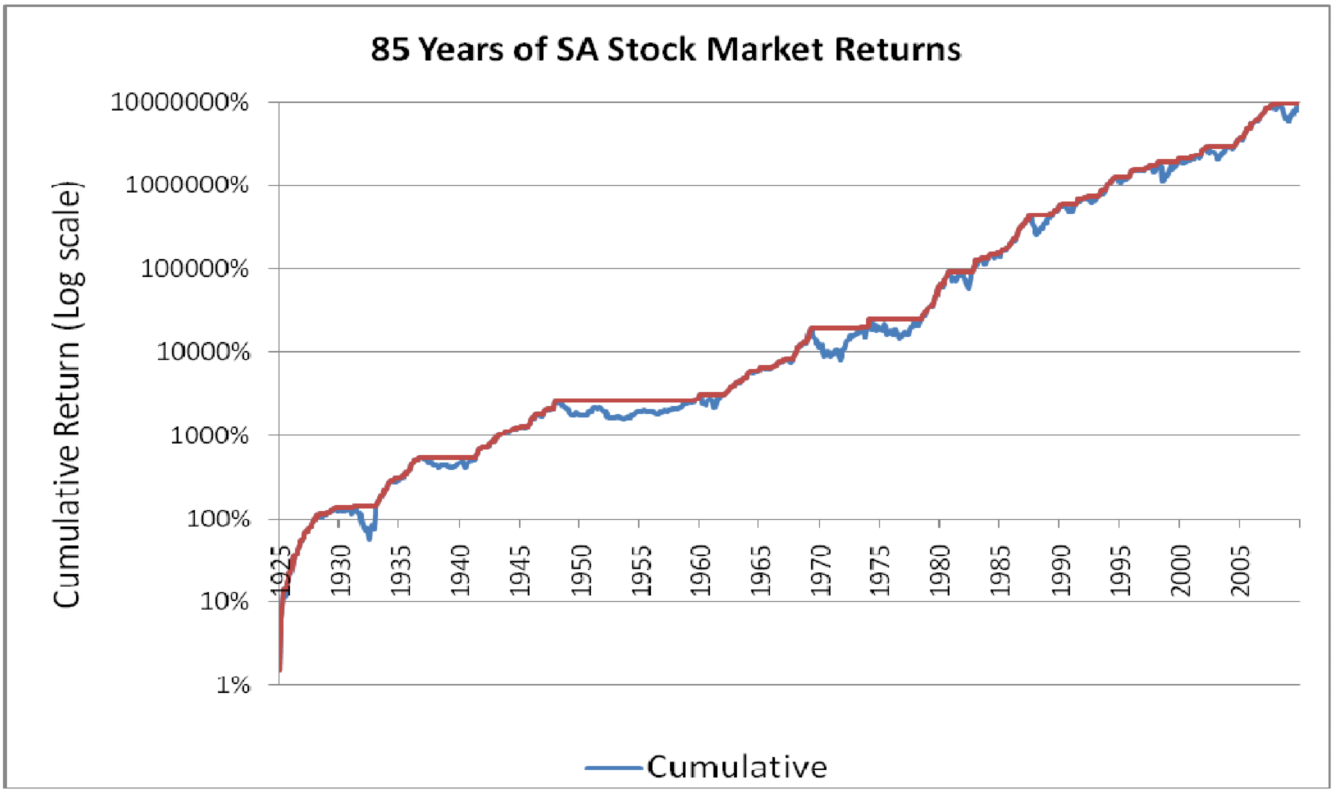
One of the most interesting traders to me is the well known author Nassim Taleb who wrote “Black Swan” and “Fooled by Randomness”. Taleb’s method is one example of a trader who does not make money regularly but makes a large profit when he does. He keeps most of his money in US Government Bonds but takes small “bets” with the balance on events which are unlikely to occur i.e. they are unpredictable and rare in occurrence. He calls these events, Black Swans. Because they are unlikely to occur, financial institutions and other traders are willing to give him healthy odds on his bets. Taleb will lose small amounts of money every day but occasionally these rare events happen and Taleb makes a killing. One could say that he invests in a similar way to someone who uses 1% of his monthly salary to buy lottery tickets and saves in the rest in Government bonds. The person is probably going to lose money on every ticket but in the unlikely event that the person wins, the payout is going to be massive in relation to the price of the ticket.

My primary concern about trading is the number of investment decisions that a trader will have to make in his lifetime. Every investment decision is an opportunity to make a mistake. This is particularly true if you are under pressure to make money all the time. This pressure is compounded when you have made a few mistakes and the market is going against you. In this situation it is very difficult to remain rational in the face of the storm. This is why we most often read about big blow ups occurring in firms that specialize in trading. Even very successful traders blow up e.g. LTCM or Victor Niederhoffer who has “blown up” twice in 1997 and 2007! One does not find that many examples of honest (as opposed to criminal) long term investors who have blown up.

LONG TERM INVESTING

This is a less intuitive method of investing but is perhaps more simple to understand. Long term investors aim to buy an investment and to hold it for an extended period until the investment reaches a specific target price at which time it is sold. They will usually aim to hold their investments for at least three to five years. This timeframe provides investors with less opportunities to make investment decisions which is actually a good thing. It means you are less likely to be influenced by short term events that could influence you into making irrational decisions. Longer timeframes allow you to have a better perspective of events. If you only expect to sell something in the next 3 years, you are less likely to react to news which might impact a share price for a 3 month period. For a trader, three months is the equivalent to a lifetime.

I am unashamedly a fan of long term equity investing. This approach was made popular by Allan Gray in South Africa although I favour Cannon Asset Managers and Foord Asset Management. A good long term investor would treat each decision to buy a share in the same way that a person would decide to buy a home. You need to look at all the defects as well as the positive factors with a view to keeping the investment for the next 10 or 20 years. Long term investors only get really rich after 10 or 15 years of investing. If you invest wisely the chances of “blowing up” (losing all your money in your investment) on a long term investment are much smaller but traders face this risk constantly. Even if the stock market does not perform over longer periods of time e.g. 10 years, you can still make money from dividend paying shares over this time. Dividends make up more than 50% of the total returns earned by equity investors over the long term. This is one of the reasons I favour value investors, they have a real focus on dividends rather than the “growth story” of a company.



Source: I-Net, compiled by Nedgroup Investments

The excellent graph above was created for me by Anil Jugmohan of Nedgroup Investments and I think it argues the case for long term investing in one simple picture. The blue line shows the performance of the JSE from 1925 to the end of 2009. The red line shows the high water mark of the market over this time. As you can see, patient investors who bought the market and held it through the bad times have always been rewarded for their patience because the market always breaks through its high-water mark again.

CONCLUSION

I acknowledge that trading as an investment philosophy has its merits, there are thousands of people who have made a fortune through trading. At the same time there are many, many more people who have lost everything and now work in other industries trying to make a living. If you are managing your own money and would like to have a higher probability of growing your capital over your lifetime then I would favour a long term approach over a trading philosophy. Consider the case of Nassim Taleb who is no longer a money manager. He has not retired to his private tropical island to count his money, instead he spends his life on aeroplanes and in hotels writing books and giving workshops – not much of a life if you ask me!