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Tuesday Talks Original Piece

The Tortoise and the Hare: *Investing vs. Trading*

Investing vs. Trading

Wall Street has always been seen as a place for investing but the success of this sector has been commonly misconstrued as the result of trading. Financially successful individuals experience success because they understand the difference between the two. On one hand, investing is the act of owning something that you understand and believe possesses the potential to grow over the long term. On the other hand, trading can be defined as the act of buying and selling based completely off of emotions and arbitrary price fluctuations. For someone who is new to the world of investing and trading, the instant returns of trading may seem appealing (especially when the differences between investing and trading aren't defined). In truth, the goal of investing is based on having a long term goal, diversifying your portfolio, and compounding over time.

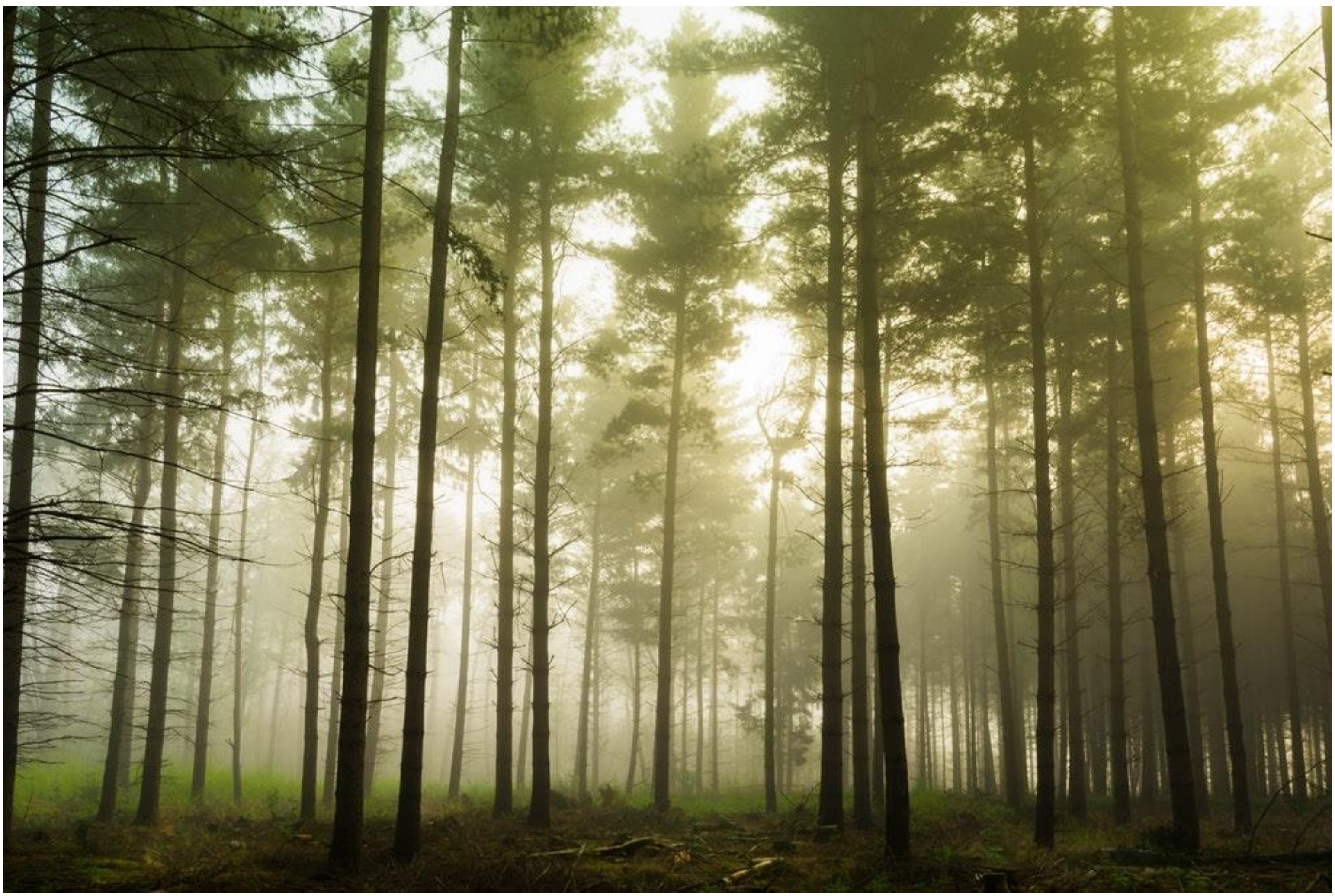
The First Step – Goal Setting

One should first start by defining financial goals. Setting financial goals is extremely important because it allows you to work towards a positive return. Think of it as having a map to plot your travel instead of using instinct to drive your journey. Trading is an involved activity that focuses on the short-term which forces individuals to abandon their long term goals.

Investing aligns with creating a reasonable plan that is respectful of long term processes and short term set-backs. According to First Trust Portfolios , a Chicago based fund family, the probability of positive returns one day after purchase of a stock (considered trading) is 53% while holding a position for 10 years (considered investing) is 97%[1]. The reason for this improved benefit can be attributed to the value of diversification and compounding (not to mention the benefits of tax implications).

The Power of Diversification

In his 2018 letter to stockholders, Warren Buffet said: "Focus on the forest – forget the trees." Think of individual stocks as trees and the entirety of a portfolio as the forest. If your forest is only made up of a singular species of tree, one disease could wipe it out. But, if your forest has a diversity of species, it would enhance the prospect of surviving the onset of disease. This is why diversification is so important; an individual stock may do badly on occasion, but holding a variety of stocks from different sectors can offset the negative effect. It is difficult to diversify a trading portfolio when trading patterns may change daily. The idea of holding for the long-term confers two major benefits onto a portfolio: compounding and lower tax consequences.



Growth through Compounding

Compounding can be described as the idea of taking money earned from interest and putting it back into the same account (which will earn more interest). One of the greatest examples of compounding is that of Warren Buffet's company Berkshire Hathaway, a multinational conglomerate that invests in and owns different corporations worldwide. Berkshire started with a capital of 22 million in 1965. Today, thanks to the power of compounding, and an astute long term selection, their capital exceeds 349 billion. If Berkshire had followed a 100% payout policy versus reinvesting, the total returns would have been reduced greatly. When Albert Einstein was asked to name the greatest invention in human history, he replied: "Compounding interest is the eighth wonder of the world. He who understands it, earns it … he who doesn't … pays it." Think of compounding interest in this way: You open an account with $100 dollars with a guaranteed ten percent interest rate per year. Additionally, you decide to put all money earned from interest back into the account. After the first year, you will have made ten dollars on your $100. You then have $110 dollars in your account. At the end of the third year you will add eleven dollars earned from interest to your account. This is because you are not earning interest on $100 dollars, but $110 dollars. This cycle can continue for however long you keep the account. At the end of six years, your account would be sitting at around $177 dollars – an attractive return on a conservative, income focused investment. When you take money out of a portfolio, you are reducing the opportunity for participation in future gain.

Compounding: the addition of interest to the original amount of a balance; interest earned on interest.

final thoughts

Successful investing requires you to set goals, diversify your portfolio, and allow compounding interest to work for you. People with financial goals invest, people who are looking to make quick money trade. In the end, we all want a secure, flourishing financial future, which can be reached through prudent and patient investment.

[1] First Trust Portfolios L.P. * Member FINRA 3/18/19

[1] The attached information was developed by First Trust, an independent third party. Source: Bloomberg. These reterns were the result of certain market factors and events which may not be repeated in the future.

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