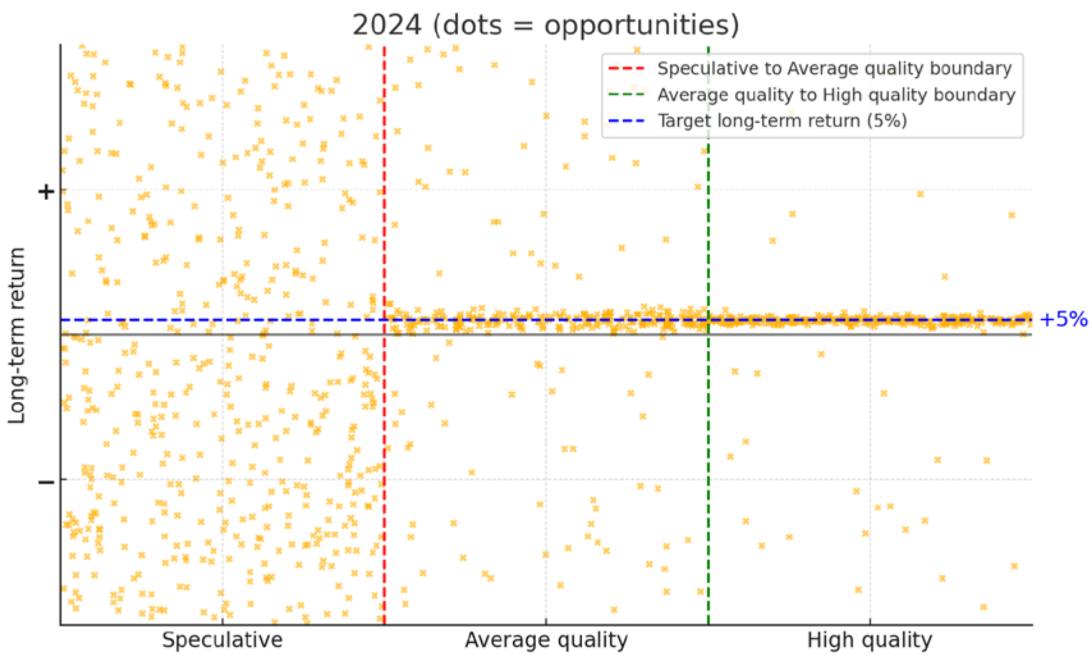
Investing vs. Speculating: The Wisdom of Graham and Buffett

November 20th, 2024
By Ian McLean



This chart represents our assessment of opportunities in 2024. There are some, but you have to do your homework, because there aren't many. The first tier represents investments where danger is greater and luck plays the biggest role. At McLean Capital, we prefer to invest in the upper right-hand quadrant at all times. There are periods when this quadrant is well populated (2009-2015, March-April 2020) and periods when this quadrant is not as well populated and we need to perfect our execution. For many investors, inexperience and complacency can sometimes lead to mixing the "Average quality" tier with the "High quality" tier. In times when opportunities are abundant, the proper investment philosophy can yield very good results, even when buying average companies. In speculative years, you have to be very careful to stay in the upper right-hand quadrant.

Benjamin Graham and Warren Buffett, two iconic figures in the investment world, taught us a fundamental truth: the difference between investing and speculating.

According to them, understanding this difference is crucial for anyone seeking to build lasting wealth. In their words, "The investor focuses on value; the speculator, on price, or short-term return."

In recent years, there's been a lot of focus on price, not value. If the price goes up, it's because the market is efficient. If it goes down, it's because the market is efficient and "this time it's different."

For Graham, investing means buying assets at a price below their intrinsic value. It's an exercise in discipline, patience and research. The aim is to protect capital and make it grow over the long term, even in stormy markets.

"An investment is an operation which, after careful analysis, promises the safety of the principal..." – Benjamin Graham

Buffett has often warned against the dangers of speculation: "It's an attempt to predict market behavior, rather than focusing on the quality of companies." Speculation is based on emotions, the hope of quick gains, strong confidence in the immediate future, not on rigorous analysis of fundamentals or the principles of a serious businessman.

Key Differences: According to Graham and Buffett

Criterion	Investing	Speculating
Approach	Purchasing intrinsic value	Betting on price movements
Time Horizon	Long term	Short term
Focus	Quality and potential of the asset	Sentiment and market timing
Philosophy	Protection and growth of capital	Risk for quick gains

Buffett summarizes the difference as follows:

"Speculation is an attempt to be smarter than others; investing is an attempt to make yourself smarter than you were."

For Buffett, an investor looks for value, not predictions. An investor, in the tradition of Graham and Buffett, studies the fundamentals:

- The profits: A solid business generates steady income.
- Price versus value: Buy when the market is undervaluing a stock.
- Long-term vision: Short- and medium-term fluctuations don't scare or excite you either.

Example: Buying Coca-Cola shares in the 1980s, recognizing its global growth potential, steady cash flow, strength in the market and attractive price following the "New Coke" debacle. With great patience, Buffett continues to build on that decision today and has never been dependent on the mood of the markets to drive his returns. Coca Cola is a highly profitable company that doesn't need to "make its money" by creating a story that drives up its share price speculatively.

Buffett sees speculation as a threat to financial discipline. He compares it to a game: "If you don't know who the sucker is at the table, it's probably you."

"The market is a mechanism for transferring money from the impatient to the patient." – Warren Buffett

Buffett reminds us, however, that "most speculators end up losers in the long run."

Speculating: The Quest for Risk

Speculators are looking for fast, big moves. This may sound exciting, but as Graham points out:

"Speculation can be entertaining, even profitable, but it becomes disastrous when confused with investment."

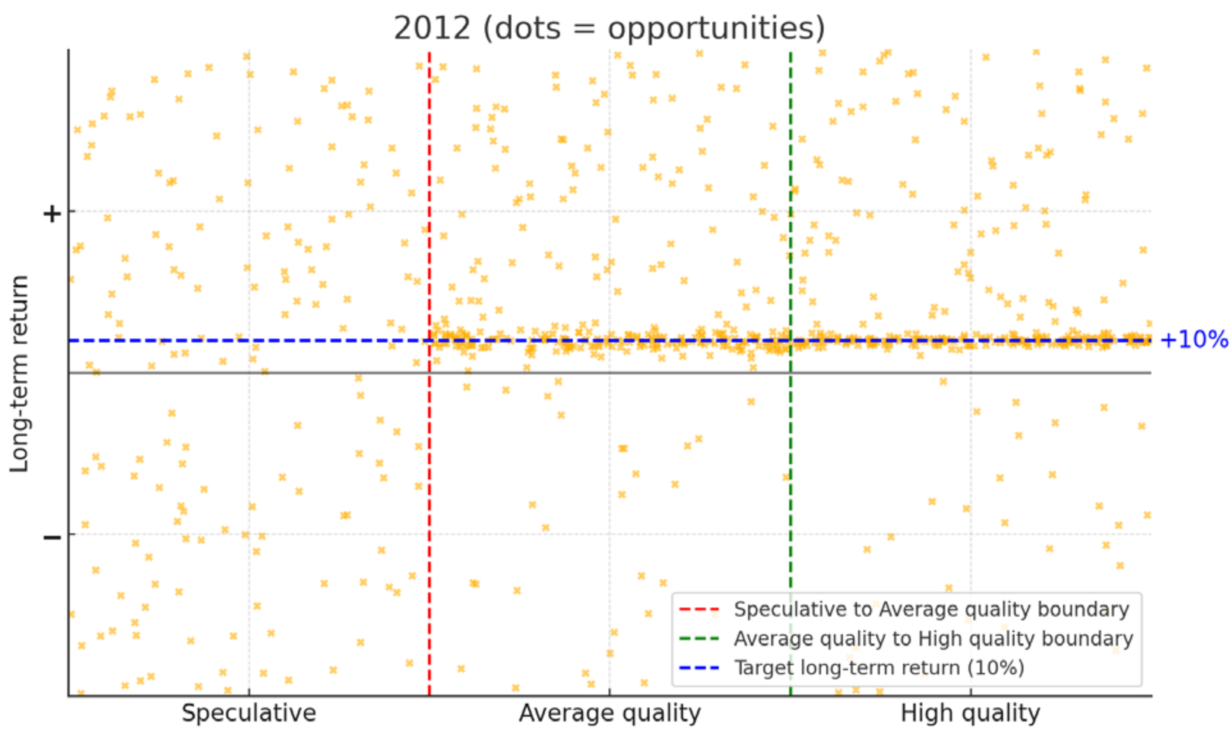
Example: Buying overvalued technology stocks during the Dot-com bubble of the 2000s, hoping that they would continue to rise, often without analyzing their fundamentals.

2012 vs. 2024: The Evolution of Market Speculation

Comparing the financial markets of 2012 with those of 2024, a striking trend emerges: the surge in speculative investments, fuelled by changes in investor demand and the emergence of new asset classes. This development reflects both opportunities and dangers.

In 2012, we were still in a post-financial crisis (2008) situation, and investors were still cautious and less speculative.

Speculation in 2012 was more discreet and confined to specific segments.



Important note: over time, a speculative investment can become an average or high quality investment, and vice versa.

2015-2024: The gradual explosion of speculative investments

Twelve years later, the landscape has changed radically. Speculation has spread (as it always does), affecting almost every corner of the financial markets. The main drivers of this transformation include:

- No real recession for 15-16 years: The COVID recession was rapid, and government programs were major. As a result, this period did not have the psychological impact of a real recession. On the contrary, the success of technology companies right from the start of COVID caused speculation to explode. So, there's a complacency at this stage, the idea that this time it's different is very widespread at the moment (as it is every time).
- Low interest rates and massive money printing: Accommodating monetary policies and "easy" money have encouraged investment in risky assets.
- The rise in popularity of speculative assets creates a self-fulfilling loop:
    1. Increased demand: the more investors turn to crypto-currencies or high-volatility stocks, the faster their prices rise.
    2. FOMO (Fear of Missing Out) effect: This craze attracts more participants, including large institutional investors.
    3. Asset overvaluation: The prices of most assets explode beyond their real value, making the market even more unstable, but difficult to avoid, paradoxically, for the majority. Even an excellent company can become a speculative investment at too high a price.

While this explosion of speculative investments may seem promising for quick returns, it carries significant risks:

- Speculative bubbles: History shows that these bubbles eventually collapse, leading to major losses (1929, 1973, 1999, 2007).
- Lack of financial discipline: Speculation is becoming normalized and even acceptable behavior, eclipsing sound investment principles.
- Erosion of confidence: When bubbles burst, markets suffer a loss of credibility, which can be long-lasting. The NASDAQ took 15 years to recover from the 1999 tech bubble. Japan's Nikkei has yet to recover from its 1989 bubble, 35 years later (the Nikkei was selling for 63X earnings in 1989 vs. 31X earnings for the S&P 500 in 2024 and 33X earnings for the S&P 500 in 1999).

As Buffett said:

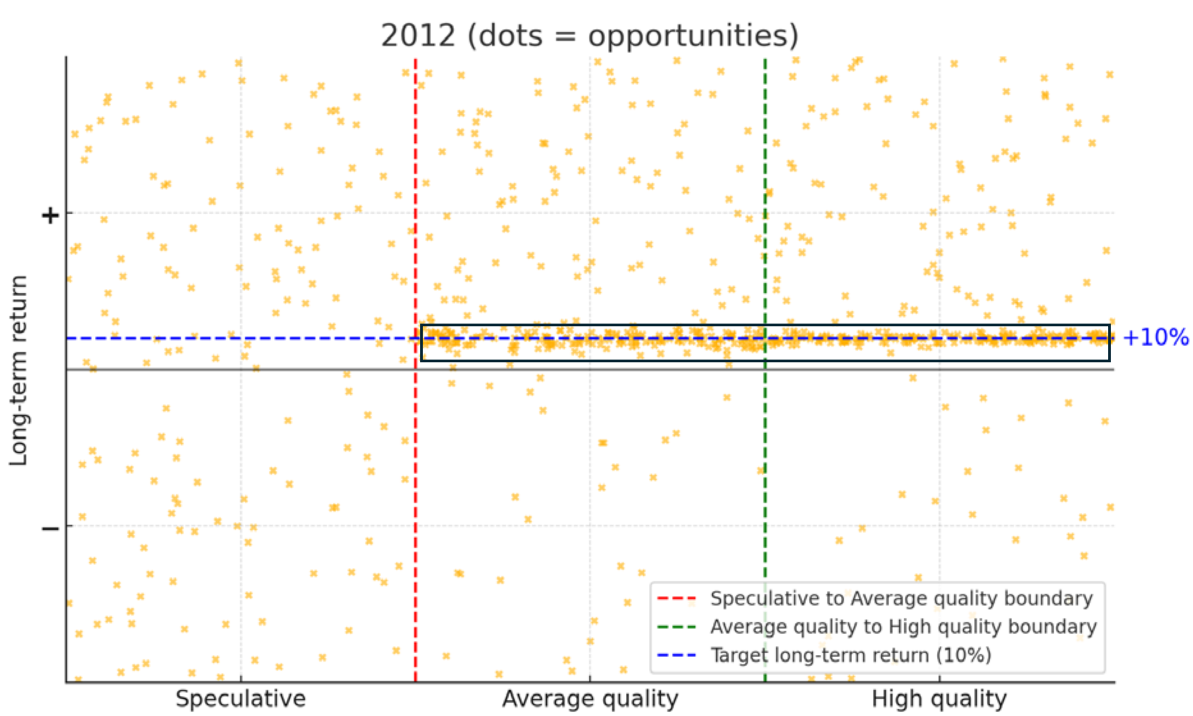
"Be fearful when others are greedy, and greedy when others are fearful."

As demand for speculative investments continues to grow, it's essential to get back to basics: seeking value, managing risk and maintaining a long-term view.

The wise investor will take advantage of opportunities without losing sight of the essentials: security and sustainable capital growth. Speculation may be tempting, but it can never replace the wisdom of thoughtful investment.

The different portfolios

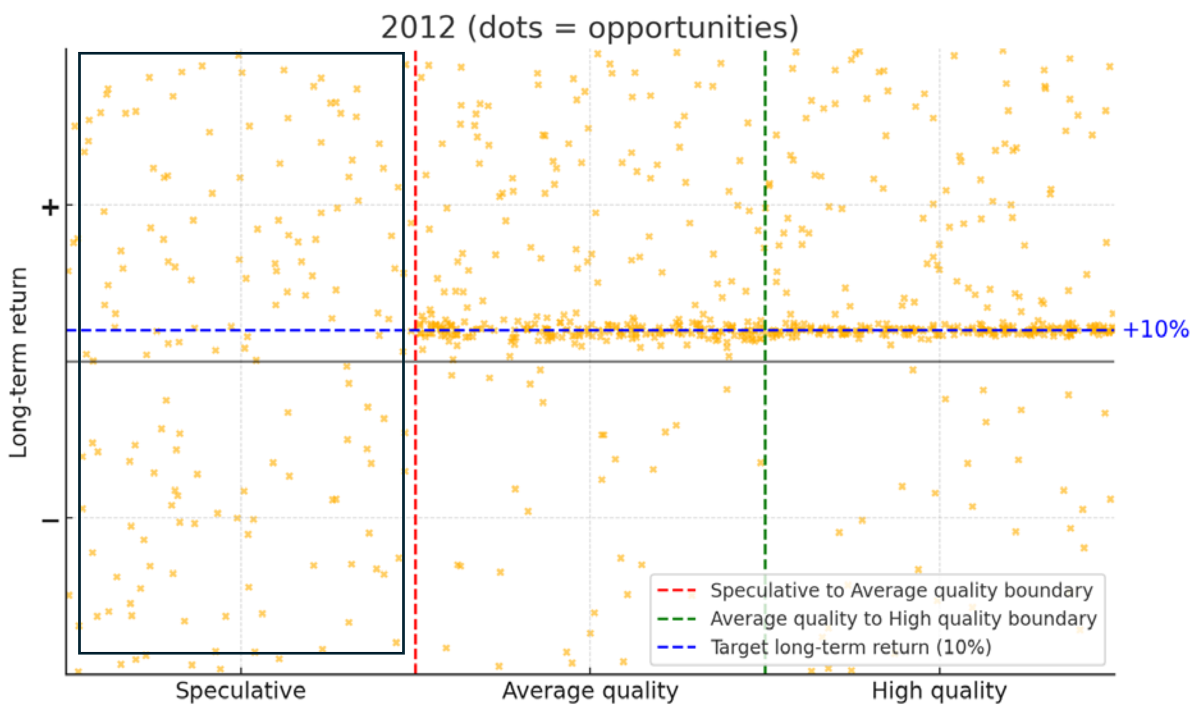
The traditional portfolio (80% to 95% of portfolios)



The framed area above represents the type of opportunities these portfolios hold.

Who offers this portfolio?	Banks and large institutions such as IG, IA and Manulife.
Performance	Between 4-6% for 20 years. The fees you pay are the most important factor in determining your return. The higher your assets, the lower your fees.
Difficulty of execution	It's easy. Buy 5 exchange-traded funds and you can replicate this portfolio with virtually no fees.
Why is the framed area on the graph slightly below the average yield?	These institutions generally have conflicts of interest, which makes the task difficult. Here are some examples: - Banks often manage their own pooled funds and may favor these over better-performing third-party options, as these in-house funds generate higher fees. - A bank might recommend more expensive funds because they generate more income, even if cheaper index funds are better suited to the customer's objectives. - A bank could encourage its portfolio managers to buy into an IPO or bond issue, for the government or a company, where it plays the role of underwriter, thereby inflating demand and guaranteeing its underwriting fees. - A bank might favor funds from a specific manager because of a profit-sharing agreement, even if other funds offer better performance. - Customers could be encouraged to buy structured products, annuities or insurance plans that are highly profitable for the bank but not always aligned with the customer's risk and return objectives. - While holding an asset longer would be beneficial for the customer, frequent trading could be encouraged to increase the bank's commission income and reset exit fees (selling penalties).
Fees	High. Between 0.7% and 4.0%, depending on portfolio size.

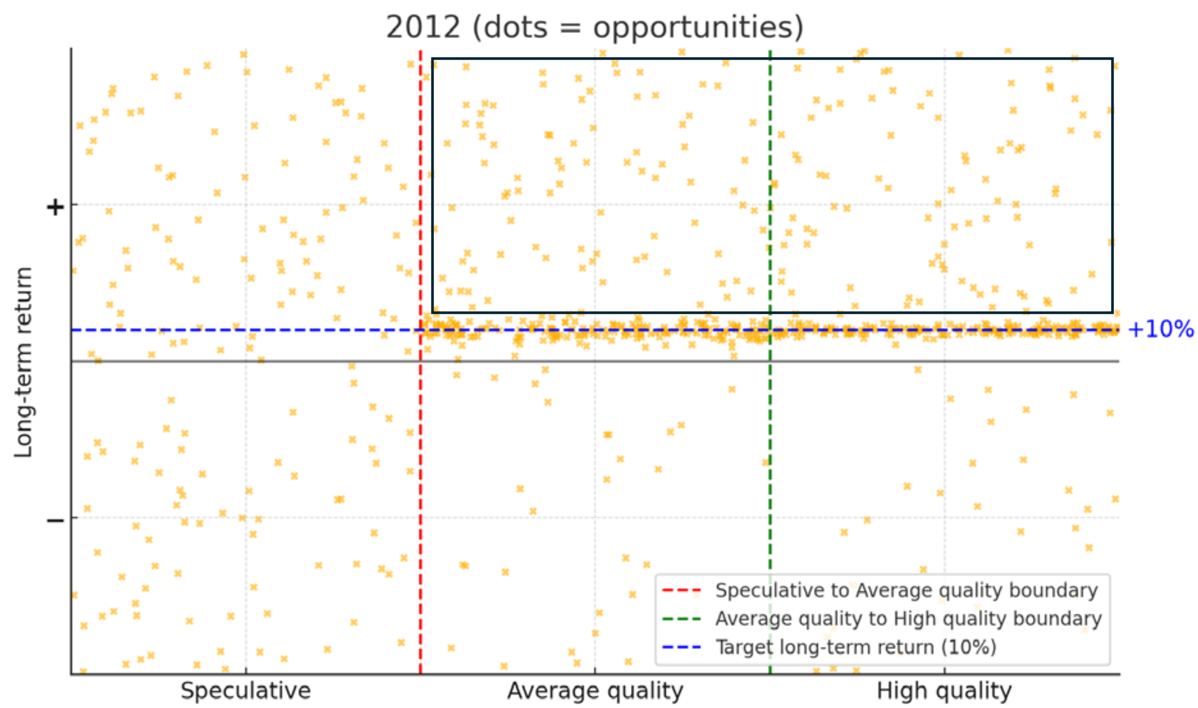
Speculative portfolio (2% to 15% of the market)



The framed area above represents the type of opportunities these portfolios hold.

Who offers this portfolio?	Some speculative funds. Often self-managed.
Performance	Highly variable over short periods, but not ideal over 20 years. Periods like 2000, 2008 and 2022 can be disastrous. Luck is the most important factor in determining your return.
Difficulty of execution	As we're not basing ourselves on fundamentals, but rather on hopes and narratives, it's difficult to comment on this point.
Why are both the top and the bottom areas framed on the graph above?	This may be a debate, but I don't think speculative investing is predictable in the long term.
Fees	High. Frequent trading and exotic investments such as derivatives can be very expensive.

The intelligent portfolio (3% of the market)



The framed area above represents the type of opportunities these portfolios hold.

Who offers this portfolio?	Some lesser-known firms, generally of modest size, as it's easier to execute this philosophy if you manage smaller amounts. Sometimes self-managed.
Performance	Highly variable over short periods, but higher over 20 years. Periods such as 2000, 2008, 2020 and 2022 may offer exceptional opportunities for these investors. Quality of execution and patience are the most important factors in determining your return.
Difficulty of execution	Relatively easy in periods like 2010-2015 or April 2020, when markets are cheap and opportunities are present. More difficult (but feasible with the right structure in place) in periods like 2021 to 2024 when markets are at historic highs and opportunities less frequent.
Why are both the medium and the safe areas framed on the graph above?	At McLean Capital, we prefer high quality investments. On the other hand, some investors have had great success with mid-sized companies selling at deep discounts and even "turnarounds".
Fees	Variable. Generally, less frequent transactions help. Long-term investment horizons reduce taxes.

Conclusion: Be an Intelligent Investor

Benjamin Graham and Warren Buffett offer us a compass in the tumultuous ocean of financial markets. Their message is clear: prioritize patience, discipline and the search for value.

"It's not the timing of the market that counts, but the time spent in the market." - Warren Buffett

So, the next time you approach an investment, ask yourself, "Is this an act of patience or a leap into the unknown?"

Graham and Buffett's advice

1. **Buy companies, not shares: Each share represents a part of a company. Analyze its products, management and competitive advantage.**
2. **Margin of safety: Buy at a price low enough to protect you from mispricing.**
3. **Ignore market forecasts: Graham and Buffett reject predictions, preferring to focus on quality assets.**
4. **Know your limits: If you don't understand an investment, avoid it. Buffett refused to invest in technology for years, for lack of understanding.**

By Ian McLean
www.mcleancapital.ca/