WHAT ARE THE ODDS? INVESTING VS. GAMBLING

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Someone once told me that the difference between gambling and investing is that gamblers intentionally assume risk, while investors work to reduce it. An interesting distinction, but it isn't true. The people who frequent casinos have the same inclination as those in the stock market. They want to win big, and they don't want to lose. This shouldn't be surprising. It is a human tendency to maximize what economists call "utility," whether that be money or pleasure.

Moreover, psychologists are armed with evidence that the dopamine rush from gambling occurs not only when the gambler wins, but before the result is known, in anticipation of a win. Think about that. The brain actually encourages risk taking by releasing the pleasure chemical whenever one takes a risk, regardless of the outcome. Being wired in this manner certainly seems like it would cause us to behave similarly in both gambling situations and investment situations.

This is more true now than at any time in my memory. Why? The simple fact that things are so uncertain and thus investment decisions are riskier. If we are rewarded with dopamine for taking risk, and most every investment decision we make these days is exceptionally risky, it stands to reason that investors are behaving more like gamblers now.

Sports or Stocks – What's the difference?

On May 22 2020, Barron's featured an article that argued the recent bear market rally is driven by actual gamblers who, faced with no sports on which to gamble, have focused their attention on the stock market instead. Citing evidence from Robinhood and other discount brokers that appeal to individuals and millennial's, the article argues that retail traders have used their stimulus checks to trade stocks and posits that the return of sports might mean the end of the rally. Perhaps, bearing in mind the addictive nature of gambling, it is plausible that those unable to get their typical "fix" need to resort to trading.

Indeed, if the appeal of gambling mirrors the appeal of investing, then it is at least conceivable that the market is being buoyed by retail traders that suddenly have 1200 additional dollars to their name and too much time on their hands. But that begs the question, are all the buyers in this market gambling? I think so.

In most gambling scenarios the odds are well known. In fact, such odds are often published and utilized as the basis for payouts. For example, if the Lakers are 7.5 point favorites over the Mavericks and the line on the Lakers is -400, I not only know that are the Lakers more likely to win, but also that I will need to bet $100 in order to win only $25. This seems fair. I know it is a gamble but it is a transparent one. If I lose, I have no one to blame but myself, and maybe Anthony Davis.

In the stock market, there is no such transparency. A CNBC talking head may tell me to wager on Amazon, but what are the odds and what is the payout? It is completely unknown. When you think about it like this, gambling starts to seem a little less irrational.

This is an unpriced risk. The common risk factors most investors rely on – beta, size, momentum etc. – are priced risks. Anyone can observe them and adjust the price they are willing to pay for the stock accordingly. As a result, by accepting these sorts of risk you expect, justifiably, a higher return.

But unpriced risks are much more insidious. These are the risks that don't provide you a higher return for accepting. You just have to accede to it. This is what I want to try to avoid.

Who Owns the Risk?

Consider an individual named "Mr. Advice Giver." And assume the stock advice he gives is correct 100% of the time. How much would you pay for this advice? The answer, for most people, is a whole lot. So much so, that the expected return should approach the risk-free rate. After all, there is no risk in taking the advice. But this is unrealistic. Now consider another individual named "Mr. Advice Pusher" who is only correct 50% of the time. Shouldn't you receive a premium as compensation for him being wrong 50% of the time? Shouldn't you be expected to pay a whole lot less to account for the risk you take bad advice?

Yet nobody does this. Time and again, we rely on the advice or guidance of people with nothing to lose by being wrong. The CNBC talking head? They're not writing you checks when their advice costs you money. They probably don't even care.

What I am talking about is pricing your downside risk. Often it is huge and is completely ignored. This is worse than gambling. With gambling you get paid when the casino loses, and you know the odds of that happening. In the stock market the downside risk is an unknown.

If you are going to invest in the market you absolutely must account for this risk. You must understand behavior, and the incentives of those giving you advice. Otherwise, you should pack your bags and head to Las Vegas, at least there you get paid for the risks you take.

Disclosures

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Nothing in this article should be considered gambling advice.

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