

# Investment vs. Gambling

BY MIKE A. STEGEMOLLER

**Investing in financial markets is very different from gambling in important ways. Yet these activities share a common thread of risk. How can investors avoid the imprudence associated with inordinate risk-bearing that can make capital markets seem more like casinos?**

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**W**estern capital markets have been compared to a large casino, and the investment in the securities that trade on such markets to gambling. Full of presidential-candidate fervor, Ralph Nader has warned us, “Move over Las Vegas. The big time gamblers are on Wall Street and they are gambling with your money, your pensions, and your livelihoods.”<sup>1</sup> Then after the financial crisis of 2008, President Barack Obama expressed the sentiment of many market observers when he commented on the actions of some participants in the derivatives markets as “highly leveraged, loosely monitored gambling.”<sup>2</sup>

Some people, generalizing from specific instances of irrational, speculative behavior by a few financial intermediaries or investors, have claimed that “gambling” has become the norm in financial markets. Indeed, the fact that such behaviors seem to occur with increasing frequency makes such a comparison between gambling and participation in financial markets not entirely unwarranted.

Yet, I am reminded of the proverbial warning:

The lazy person says, “There is a lion in the road!

There is a lion in the streets!”

*Proverbs 26:13 (cf. 22:13)*

The simple will believe the sluggard, but the wise will look to see if there is a lion. Much of this essay is a bit technical, but it is my intent to see if there is a lion loose in the streets of western capital markets.

## **DIFFERENCES BETWEEN GAMBLING AND INVESTING**

In its simplest form, gambling is when a person gives money specifically for the mere *chance* of receiving more money. Chance is the probability that a particular outcome will occur — e.g., on a spinning roulette wheel, how likely it is that a ball lands in a red compartment marked “thirteen.” Notice that our knowledge about the gamble, about the odds of winning, is irrelevant

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**A financial investment differs from gambling in three important ways: the investor’s knowledge is relevant to the outcome, an asset is purchased, and both parties plan to benefit from the transaction.**

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to the outcome of the gamble. Thus, if we are asked to guess a number between one and twenty-four, our knowledge of the odds of guessing correctly has no influence on whether our guess is the correct one. The outcome is solely based on probabilities.

Furthermore, there is no underlying product or service exchanged in a gamble. When we walk away from a slot machine,

our pockets only contain either more or less money than when we arrived. So, there is nothing with any inherent value in a gamble.

Finally, in order for organized gambling to exist, the house (the organizers of a gambling game) must win the vast majority of the time. Put another way, the sum of gambling winnings must be less than the sum paid to gamble. This certain loss of money is why no rational person goes to the casino to fund their child’s education or earn money for groceries.

This last point cannot be overstated as it introduces the main problem with gambling: imprudence. It is imprudent to participate in a venture that requires the participants to ignore what they know to be true. In the case of gambling, this knowledge is that the gambler will, on average, lose. So, the one gambling must willingly believe a lie. Perhaps this is why casinos market themselves as entertainment (for example, the Harrah, Caesars, and Horseshoe casinos are owned by Caesars Entertainment Corporation), categorizing themselves alongside movies, water parks, and baseball games. Yet casinos are particularly adept at prostituting leisure, commonly producing despair and addiction instead of laughter and freedom.

The basic form of investment, on the other hand, consists of an investor giving money to a business manager in exchange for, at minimum, a claim on some of the future cash flows of the business. This definition stands in contrast to that of gambling in three important ways. First, knowledge is relevant to the outcome of the investment. Investors may be better off if they understand the business of their investment, and they certainly will

be better off if the manager of the business knows what he is doing. For example, one might think twice about patronizing a barbershop in which the barber claims that though he does not know how to cut hair, one out of ten haircuts turn out alright. Knowledge matters in investment, though it by no means assures monetary gain, nor does it preclude either party from being wasteful or foolish. Nevertheless, unlike gambling, investment depends upon knowledge.

The second way in which investment contrasts with gambling is that an asset is purchased in an investment. Financial assets derive value from their claim on future cash flows from a particular real asset or groups of assets. A share of Starbucks stock is an ownership claim on the cash flows of Starbucks after they pay all of their debt obligations, and the holder has the right to vote on certain issues at Starbucks' annual shareholder meetings. So when we purchase stock, we are obtaining partial ownership in a business. Similarly, a bond (or a loan) is a specific claim on the future cash flows of a firm, and if the principal or interest payments are not made, then the debtholder can force the firm into bankruptcy, thereby laying claim to the firm's real assets. Even the more complex financial assets, which are often the target of claims that investment involves gambling-like behavior, depend upon the value of some underlying asset. These derivative securities (e.g., options and futures) derive their value from an underlying asset—e.g., a farmer can sell a futures contract today that allows him to sell his cotton crop at some future date for a price agreed upon today. Therefore, when we invest we purchase the claim on an asset, but when we gamble no such underlying asset exists.

Furthermore, the intention of the investment is for both the businessperson and the investor to gain from the transaction. Both parties agree to the transaction because it is mutually beneficial. The businessperson will have the money needed to invest in some useful piece of equipment and the investor will share in the success of the business through money received in the form of interest, dividends, or appreciation in the value of the business. Capital markets depend on this arrangement. Thus, the proliferation of investment depends upon both parties gaining, while the existence of gambling depends upon one party winning at the other party's expense.

### **A COMMON THREAD OF RISK**

Though gambling and investing are dissimilar in many important ways, there is a common thread in both: risk. It is the imprudence associated with inordinate risk-bearing that makes some aspects of capital markets like casinos.

A good working definition of risk is the uncertainty regarding the difference between a present value and some future value. In general, one can assume that the more risk a transaction has, the more return is expected. A certificate of deposit (CD) at your local bank has very little risk and very little return. The probable outcome of the CD is highly concentrated around the original deposit amount plus the interest promised. There is a chance that

the bank will fail and the federal deposit insurance will fail too, but these are very low probabilities. As one invests in increasingly risky securities, the return is expected to increase.

A large knife is not risky to a chef, but can be catastrophic to a child; likewise, securities that are neither complex nor risky to the people that employ them for their original purpose can become risky for some purchasers of these securities. Indeed, many such securities were originally developed to *reduce* risk. For example, selling wheat futures is not a complex financial transaction to the manager of a large farm. The purpose it serves is to reduce the farm's risk by selling a future wheat crop at a particular price today, thereby locking in a known price today. The buyers wanting to purchase wheat in the future (e.g., bakeries that regularly purchase wheat from a grain elevator) are also reducing their risk of fluctuating wheat prices by buying the wheat today. Yet, because these futures contracts are tradable, they are often bought by people who will neither have any wheat nor want delivery of wheat when the contract comes due. Most of these people are merely speculating on wheat prices, and their behavior is not discernable from gambling.

Strictly speaking, speculation is purchasing an asset that is extremely risky. However, the way in which this term is used in reference to investment connotes unusually large risk alongside apparent ignorance about the underlying asset. Often in literature (like Charles Dickens's *Nicholas Nickleby*), speculation is associated with tremendous gain or the wholesale loss of one's wealth. So, the futures contract for wheat mentioned above is speculative if the purchaser or seller has no interest in or knowledge about the wheat. Thus, the very security that reduces risk in one set of transactions (for the farmer and the baker) can be used as speculation in another. It is not entirely unwarranted to say that a person who speculates in the futures market for wheat (or any other asset or commodity) is, in spirit, gambling. Further, it is true that capital markets not only do not restrict speculation, the businesses built around the capital markets often encourage the assumption of risk without the prerequisite of knowledge of any sort. When a recent commercial for a stock trading house features a cute baby buying and selling stock over the Internet, what exactly is such advertising saying?

Even though gambling and speculative investing divorced from knowledge involve tremendous risk, the risk is experienced in different ways. For the investor (or speculator), changes in the value of an investment occur over time, and there is usually ample opportunity to get out of the investment without experiencing a total loss of principal. For the gambler, the change in their monetary status is immediate and with no exit potential. Thus, though risk is present in both transactions, knowledge about the risk can be continually assessed by the investor, but not by the gambler. If I want to get to the bottom of a canyon, I can either jump from the heights or walk down. Both ways of getting to the bottom involve risk, but the former offers no time to turn around.

## TRUST AND KNOWLEDGE IN INVESTING

Many investors do not understand where their investment dollars go. Many more still do not understand the business of the firms that benefit from their investment. An illustration of this lack of knowledge can be found in the fact that many people make the majority of their investments through mutual funds, which pool investment monies and purchase securities from a broad assortment of relatively large businesses whose equity trades on public exchanges like the New York Stock Exchange or Nasdaq. Each of these businesses is widely held by tens of thousands of investors. This type of separation of business from the typical investor, who owns a miniscule amount of several hundred companies, means that investors have no incentive to carefully examine the firms in which they are invested. Indeed, they most certainly will not have the time! They will likely not know the people who manage the firms in which they invest, nor even what those firms do.

Since most investors know so little about what they are investing in, they rely instead on their belief that the financial markets – or, more precisely, the people who participate in them – are largely trustworthy. Investors trust that the people who manage the businesses that use their money will do so in a manner that considers the interests of investors (the owners). They also trust the people who mediate between business managers and investors (mutual fund managers, stock brokers, accountants, and so on) and those who regulate markets

(enforcement officials at the Securities Exchange Commission, for instance). Their trust, with occasional exceptions, has been warranted. History tells us that it is rational for investors to tie up their money for the long term in hopes of some moderate financial gain. Further, numerous agencies have protected investors from unfair play in the capital markets – even though the increasingly numerous

and complex laws and regulations that they enforce have very little power to change the character of the people participating in the market.

Thus, people rely upon capital markets in much the same way that they rely upon electricity. They trust those who work in these fields to practice their jobs with honesty and integrity and to make decisions based on knowledge. Even though most of us do not know much about electricity, we benefit

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directly from it. Likewise, consumers gain from the use of wheat futures even though they do not know what a futures contract is; and investors benefit from efficient capital markets even if they do not understand how markets work. In many aspects of life, we simply must depend upon the knowledge and good faith of others.

Nevertheless, it is wise to look where we are going because too often there *is* a lion in the street. In the realm of business related to capital markets (as in other fields of business), we receive a constant barrage of advertisements bent on creating a need where none previously existed. Several examples of such snake oil sales come to mind. I offer the following examples to help you look where you are going in regard to your investment activity.

First, a significant proportion of books on “investment” are merely stock trading tips and tricks that probably belong in a casino as much as they belong in finance. Much of what is marketed as investment advice should be ignored. A common example is short term trading strategies based on historical stock price information. There is no good evidence that such strategies consistently work. They also happen to generate trading commissions for the financial firms or brokers that encourage such behavior. So, it is important to ask, “Is this investment advice based on sound economic principles?”

In addition to the Siren song of investment tricks, investors should beware of the encouragement to speculate about the market, individual firms, financial instruments, or commodities. Speculation is easy, very risky, and does not require any special knowledge. However, when uninformed investors speculate they typically are guided more by whim than common sense, which puts them at a disadvantage to their counterparty in the transaction.

A good general guideline is to never invest in financial instruments that you do not understand. I recently received an email advertisement from a reputable investment house stating, “If all you do is invest in stocks, you may want to consider new strategies that require less cash up front.... [A certain group] will explain different strategies using stocks, LEAPS, calls, and puts for bullish, bearish, and sideways trading ideas.” There was no indication that investors would actually learn what any of those financial instruments are, only that they would be instructed how to buy and sell them with “less cash up front.” This advertisement sounds less like investment and more like a no-interest-down rip-off.

The predominance of mutual funds provides ample opportunity for the exploitation of investors’ ignorance. Many money managers encourage their clients to purchase multiple redundant mutual funds under the guise of diversification. This not only generates sales commissions for the managers, it also creates a layer of complexity that keeps their clients woefully ignorant and dependent on them for advice. Investors should ask their money manager to explain what types of securities they are invested in, and if they own more than one mutual fund the manager should state clearly to the client’s satisfaction why this is a good idea. In addition,

actively managed mutual funds that charge high management fees known as loads have yet to earn their pay. Evidence suggests that investors would be better off investing in funds with no such fees. Though there are exceptions, such practices as these that provide no benefit to investors while fund managers earn enormous fees are what warrant capital markets being likened to casinos.

## HEARTS WITHOUT GUARDS

We have examined the difference between gambling and investment from a technical perspective, which is important because it gives us more careful definitions with which to work. But it is also insufficient for the same reason. What these definitions cannot address is the heart, or intentions, of persons. While investing can essentially be rational behavior (as opposed to the irrationality of gambling), it has the potential to become idolatrous and thus irrational as well. The safeguard for our hearts is to root ourselves in what we know to be true about the good life which God intends and to resist the barrage of messages that are put before us with regard to money and investing.

The first question we should ask ourselves as investors is: Am I content with what I have? The answer to this question is important because it will inform how we respond to the marketing of discontentment. Advertisement for financial products and money management is no different than any other advertisement: it aims to create a desire where none previously existed. Many “instructional” books on investing have the same aim, teaching us to “learn to make millions” or “create your new American dream.” Even when the advice given by these services and in these books is sound, the roots are nourished by discontentment. The thesis of such thinking is that the good life is dreamy and loaded with cash, which is dangerously out of step with the teachings of Scripture that the good life is marked by generous contentment in the present and freedom from the servitude of wealth.

A fundamental question is: Is my security in God? A common rationale for investment is to secure one’s future, and so many of the characteristics used to describe a proper portfolio are actually characteristics of God. For example, one advertisement suggests that investing with a particular firm is a path to “recovering your feeling of financial invincibility.” When we con-

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sider our future, we are tempted to consider how a portfolio might secure it instead of how our lives are a vapor and hidden in Christ. Then it is not difficult to see how investment can become idolatrous.

More dangerous than risking and losing everything in the financial markets is having all of our security in something that is powerless to save. A basic tenet of investment is that the past is no certain predictor of the future. A best-selling book on investments deploys this fact to scare people into a particular investment strategy: “discover titanic, uncontrolled forces driving market chaos...[and] find rational strategies for profiting in this terrifying new environment!” This inherent uncertainty in markets is a good reminder of the contrast between the reliability of a portfolio and the One who promised, “I will never leave you or forsake you” (Hebrews 13:5, citing Deuteronomy 3:6-8 and Joshua 1:5).

The good life, then, is a life without fear of the future, and no investment portfolio or gold stockpiling can provide such freedom. Indeed, where the Spirit of the Lord is, there is freedom.

Who “knows” when it comes to investing? Simply stated, Christ does. It is not logical to confess Christ as Lord and believe that he does not know more about investing than anyone else. As Dallas Willard rightly puts it, “how could he be what we take him to be and not be the best-informed and most intelligent person of all?”<sup>3</sup> Therefore, congregations can be places where the body of Christ forms investors, stockbrokers, and investment bankers in preparation for their interaction with financial markets. The education provided by such a community is poised to offer valuable knowledge in a way that is unrivaled among all others that claim to know.

## NOTES

1 Ralph Nader, “Wall Street Gamblers,” *CounterPunch* (June 11, 2008), available online at [www.counterpunch.org/nader06112008.html](http://www.counterpunch.org/nader06112008.html), accessed May 5, 2011.

2 Eugene Robinson, “How Obama Found His Mojo on Wall Street,” *WashingtonPost.com* (April 23, 2010), available online at [www.washingtonpost.com/wp-dyn/content/article/2010/04/22/AR2010042205127.html](http://www.washingtonpost.com/wp-dyn/content/article/2010/04/22/AR2010042205127.html), accessed May 5, 2011.

3 Dallas Willard, *The Divine Conspiracy: Recovering Our Hidden Life in God* (New York: HarperCollins, 1998), 94.

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