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Long-Term Investor, Trader, or Speculator:

The Varying Approaches Can Create Confusion, but Opportunity for the Long-Term Investor

By Mike Gibbs

In my opinion, investors fall into three broad categories, **the long-term investor, the trader, and the speculator.** Market guidance can vary greatly depending on which is the target audience. Unfortunately, most of the popular media and financial news networks have a short-term focus and therefore deliver the opinion of the **trader or speculator** to everyone. This creates confusion for the **long-term investor** and often spurs action at the wrong point in time.

For the **long-term investor**, understanding how each category functions may lend clarity as to why the markets become so volatile from time to time. This understanding will hopefully influence portfolio moves in a positive way now and in the future.

Below are my definitions of the each of these three types of investors, along with details of how they all may interpret and react to the market volatility in different ways.

Long-term investor: This type of equity market investor is in the market for the long haul. They understand that over a long period of time the economy and markets will experience ups and downs, including recessions and bear markets. The belief that each up market will reach a level higher than the previous up market will be the catalyst for a generally growing equity portfolio over time. The odds of success for this group are high (over a long period of time) as this has been the case throughout history. Even after the worst economic conditions and worst bear market since the Great Depression, the S&P 500 is at an all-time high in just over five years.

These investors most often have diversified portfolios of stocks, bonds, cash, real estate, and other assets. This diversity allows their portfolios to produce smoother rates of return. It also allows them to avoid the need to jump in and out of the market at every negative headline. The diversity provides flexibility to make minor moves from one asset class to another if one of the asset classes goes through a major decline.

- **Traders and Speculators:**

Traders: There are generally two types of traders in the equity market. There are those that trade on behalf of others. Such traders include the **Wall Street trading desks** executing trades on behalf of others or in some cases for the firm's own account (*please note Raymond James does not trade for its own account).* The holding period for these traders can be minutes to hours or days.

Another type of **trader is executing for his or her personal account**. They most often are a fund or, in some cases, could simply be an individual investor. Their holding period is likely to be longer than the Wall Street trader but still **much** shorter than that of the long-term investor.

They seek to take advantage of short-term gyrations in the market, individual sectors, or individual securities to generate short-term profits. They will enter and leave the market rapidly.

Speculators: Speculators seek high returns in acceptance of higher risk. The speculator will be less likely to diversify, instead more likely to *concentrate* bets in individual securities or sectors. They may also choose to concentrate their capital in more speculative-type securities. Finally, they are also likely to take positions with **borrowed funds.**

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- **Day-to-day activity will be dramatically different for each group**

Long-term investors are fully aware that market pullbacks (5-9%), corrections (10-19%), and bear markets (+20%) will develop over time. They would very much like to avoid the down moves but since their portfolios are diversified they have the ability to ride them out and make asset allocation changes along the way. Yet, for the **Trader and Speculator** the game plan is **MUCH** different, due to the major impact those moves mentioned above can have on the equity of their portfolios. To illustrate:

Trader: The **Wall Street trading desks** often employ a *preserve capital* approach in weak markets. In other words, they are much less likely to hold positions for very long and in turn attempt to "get flat" or sell all holdings when uncertainty is high. The **individual trader** acts in a similar fashion. They seek to trade with the "trend," whether up or down. They also employ a preservation of capital approach when markets go against them by selling quickly, regardless of price. They will quickly re-enter trades whenever the trend reverses.

As you can see, the short-term focus and tendency of these two types of traders to get out of the way of weak markets can accelerate the downside for the general markets over the short term.

The Speculator: Much like the trader, the speculator will act to preserve capital in weak markets. Normal market fluctuations can inflict dire results on the speculator's portfolio due to the tendency of this group to employ leverage. To illustrate, assume a fund has $1,000,000 of equity and borrows $2,000,000 to buy $3,000,000 of securities. The securities gain 5%, or $150,000. The speculator makes a 15% return on equity ($150,000 / $1,000,000) on just a 5% move. On the downside, if the securities decline 5% the loss is $150,000 or 15% of equity. To make back the 15% equity requires a 17.26% return on equity or a 5.26% gain on the $2,850,000 available. Losses become more damaging as declines become larger. In the example above, if the securities decrease by 10% the returns needed to get to break-even double, and so on. As you can see, small fluctuations, those fully acceptable to the long-term investor, can create major problems for a speculator. Additionally, if prices slip too far, margin calls from lenders may force these investors to sell while securities are going down. To protect their equity, speculators will be quick to cut losses and sell in the short term even if securities appear to be oversold. They will quickly re-enter whenever positively trending markets resume. So, just as with the trader, periods of market weakness are amplified by these investors.

The **Trading and Speculating** investors control massive amounts of capital, so their short-term strategies can have a major impact on financial markets in the near term. The problem for the **long-term investor** is when they let the actions of the short-term traders and speculators negatively influence long-term investment decisions. When this occurs, they often make emotional portfolio moves by selling (or buying) in the heat of the moment.

- **Investors sometimes participate in all three categories**

Sometimes retail investors wish to participate in all three categories. They will have a core long-term diversified amount of capital (usually a larger percentage of capital) as well as small amounts allocated to the more aggressive trading and/or speculating strategies. There is nothing wrong with this as long as they are fully aware of what they are attempting to do and are willing to accept the risks involved. It is paramount that the investor participating in the more aggressive strategies pay close attention to the amount of capital allocated to such strategies. **Only commit capital you are willing to risk.**

To be successful investors must clearly define, to themselves and to their advisors, exactly what you are attempting to do—act as a long-term investor, trader, or speculator. The course of action in various market environments will vary greatly.

- **Current guidance is very different for each group:**

The equity market is currently mired in a pullback, with the S&P 500 off 9% from recent highs (early trading on 10/15/14). The small caps are down a little over 13% from their all-time high reached earlier this year. The short-term trend is now negative as the small caps have penetrated the key 200-day moving average. The S&P 500 sliced through the 50-day moving average and has also undercut the 200-day moving average. The abrupt change in the trend (short term) has **traders and speculators** active, with many moving into preservation

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mode until the markets calm.

The odds are high that volatility will continue in the short term as these investors reposition. In this state, the equity market is weak and vulnerable to down moves on every negative headline.

- **Traders:** The trader will be defensive (or trying to play the downside) with the market weak and vulnerable. Until prices reverse, new price breakouts occur, or a new uptrend forms, traders will stay defensive. The most aggressive traders will be opportunistic when the selling appears panicky, but will quickly cut losses if they develop. They will continue to be diligent as opportunity is created in volatile markets.

- **Speculators**: This group will also be defensive for now. They will reduce leverage on long positions. Yet, with the intermediate trend favorable they will look for opportunity once stability returns. They will also monitor favored positions (concentrated bet plays) for opportunity to add to them in periods of panic selling.

- **Long-term investors:** This is a good time to touch base with your advisor to discuss your overall strategy. If portfolios are properly diversified to meet long-term goals, then this group should do nothing (other than turn the TV off and ignore the sensationalism of the headlines). If the decline reaches significant levels, discuss with your advisor whether increasing your weighting to equities is warranted.

- For **long-term stock investors**, now is a good time to perform a **portfolio check-up. Dispose of unwanted (underperforming) positions**. Earmark this capital for favored stocks. Now is also a good time to **tax plan**. If significant realized gains have been taken this year, take a look at positions with unrealized losses to determine if they should be realized. Additionally, make a list of stocks you wish you had owned during the last run up. In market declines most stocks go down and attractive entry points are likely to surface for these previous leaders. In most cases nothing has changed fundamentally for the companies, yet the stock prices have declined. In some cases, a fundamental disappointment has developed. If this occurs, try to determine if it is likely short-term (several quarters) in nature or something structural that could last for a long period. If it is likely a short-term Issue, an attractive opportunity for the long-term investor to accumulate will be presented.

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