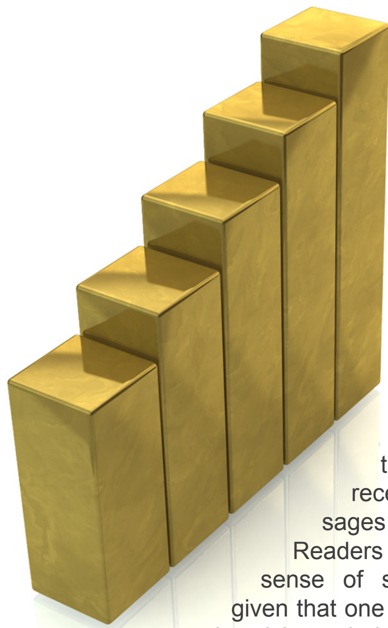

# The Universal Investor
## Speculation and Investment

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Every now and then we receive messages from our Readers about the sense of speculation given that one could simply stick to their long-term investments. In our view, **investing in the long term is a very good idea, suitable for many investors, but it's not the best idea** and the odds are that you want to treat your capital in the best possible way. In our view the best way is to combine long-term investments with short-term speculation, thus diversifying between two strategies. This essay is dedicated to explaining the logic behind this opinion.

We think that the methodology used in this article may be applied to all markets, however it might be particularly useful to precious metals investors. In our view, the precious metals sector is characterized by a specific, cyclical nature and presents unique opportunities for speculators and traders.

Usually when we take a book, brochure or even an essay written by an analyst or a salesperson who deals in investments, we see a host of hidden assumptions that are presented as facts. Some of them are easy to recognize like "this market is going to double within 3 next years" or "that company is undervalued" (based on just one method of valuation), some are much more difficult to spot. Usually author of a particular publication is advocating investing in only one time-frame. Rarely do authors combine different approaches towards investing. Partly, it's a matter of specialization, which enables individuals to focus on and master just one approach towards investing. On the other hand, however, it means that one is likely to miss out on opportunities that only combining strategies including different time-frames can provide. Authors often overlook this fact and state that "only investing long term can make you rich" or "in the long run we're all dead - investing short term is what you should do." Following analysis or advertisement is based on respective author's belief that one time-frame of investing is superior to the other. Such beliefs are exactly what was earlier described as "hidden assumptions".

Which of these assumptions are correct? Which are false? Neither? Both?

Generally they are both correct. The answer is more complex than it may seem at the first glance. There are numerous books on investing available to purchase for an individual investor. Some of them include strategies of different successful investors or speculators. Many of them made fortunes on day-trading, while others got rich thanks to buying early in the bull market and *sitting tight* all the way to the top. Some of these investors think that in the long term markets follow fundamentals, are logical and therefore predictable in that particular time-frame. Other, especially fans of the chaos theory, claim that only short-term price moves can be predicted with significant precision. The accuracy drops off substantially along with forecast's time. Both of these views seem to be supported by a group of successful investors / legendary speculators.

How can they be successful at the same time if they represent different views on such critical topic? The answer could be that some people are best in managing risk and their own emotions but on the other hand are not very patient, while others have exactly opposite skills. What is really important is how we can use techniques of both parties to optimize our own rate of return. People who speculate in the short term tend to limit the size of their position, even to a couple of percent of their total investment capital, while long term investors usually use a large share of their portfolio, keeping only a small part of money in the form of cash. Some of them invest all of their money. Again, are they really right at the same time?

One more time the answer is that **they both could be right**, depending on the potential gain of a given transaction and the probability that these gains would be realized.

For example, you might think that precious metals are going to appreciate at least for a couple of years (which is the case in our view), as there is a host of fundamental factors that give you that certainty. You can therefore invest much of your capital in silver and gold and wait for them to become more expensive. The upside is big, but not as enormous as in the short term transactions (annualized). Risk is limited as the whole transaction is based on logic and fundamental analysis. Simple, yet effective.

Short-term speculators usually do not care about fundamentals of particular market or earnings power of a given company - they use technical analysis, daily news and more often level 2 quotes. The upside potential (let's say we're considering short-term options) is usually several hundred percent in a few days or weeks, but the risk is also much greater than compared to long term investing. If you want to make money in this way, you need to keep the size of your position rather small. You might ask: "How small?" Actually, that is the key aspect here. We will answer this question shortly.

The next question you might ask is, if and how can we make use of both strategies to boost our profits while keeping risk at the low level?

The answer is yes, we can. From a short-term trader perspective, we can use most of our cash reserves to purchase assets that have a very low risk on them. Long-term oriented investors can use several percent of their capital to speculate in the short-term. Results are the same, meaning that we get a portfolio of both short- and long-term-oriented securities.

Thanks to this approach, even if we are wrong on the short-term, we will still most likely profit on the whole transaction. Being wrong in the long term will probably not mean losing all capital employed in that transaction and possible losses are likely to be covered by profit from the short-term transactions. Both speculation and investing are time-consuming activities but profits you gain are usually well worth the effort.

The final question is how do we choose the appropriate size of the short and long-term investment positions. The answer is a bit complicated; please bear with us, as we explain.

Usually, most questions can be answered through experiments; however in the investment business learning on one's mistakes can be a costly and difficult task. One reason is that often outcome of a particular action is known after days, months or even years. If, as a kid, you played ball in your house, broke a vase or mirror, and got somehow punished, you probably understood that you really should not have

done it. However, if you played ball in your house, hit a vase, but it fell and broke 6 months later, odds are you would not associate it with the ball and would not learn your lesson. Unfortunately, investing is often the latter type of relation. **Success of a given transaction is also result of many factors, including random ones. It is extremely difficult to know which factor was responsible for a particular reaction**.

Was this decision right and this is why this transaction is successful or maybe this transaction is successful because of some random every-day noise, **despite** the wrong decision?

It's impossible to tell if you make just one transaction or even a few of them - you have to make a lot of them to test particular decision. Other factors are likely to differ between transactions, so you may decide that it is better to make some kind of simulation of transactions instead of watching the real ones (and waiting for them to happen).

It is both: possible and efficient if you can estimate the probabilities of winning and losing on a given transaction. You could then "clone" a particular transaction and check what would happen to one's capital if he/she re-invested it using the same strategy each time. Thanks to this you could see what is the long-term effect of this particular strategy. This is very important, since if you know that your approach is prudent and justified, then you will not get frightened if you occasionally lose a part of your capital. After all, if you're strategy is optimal, it means that changing it would in the end cause you not to make the most money. Without that knowledge you could easily get discouraged if a market moves temporarily against you and drop the best strategy for a least profitable one just because it will be better at this particular moment.

This methodology is even justified from a philosophical (!) point of view. German philosopher Immanuel Kant stated that you should *act that your principle of action might safely be made a law for the whole world*. As investors we may adapt this thought by making sure that our decisions are optimal in the long term. That means ensuring that if a given transaction is repeated over and over again and we make the same decision every time, we would gain most. Let's take a look at a numerical example.

For example, let's say that you have a 70% chance that you gain 100% on your capital and 30% that you lose everything. Expected value of this transaction (you can easily imagine, that this is a purchase of a short term options which you expect to double) is 70% * 200% + 30% * 0% = 140%.

Clearly it seems to be profitable on average. How much capital would you deploy to this scenario? Let's say that you have about $10,000 and decide to deploy everything.

Chance of winning is 70% so on average, 7 out of 10 transactions will be winning ones and 3 will be losing ones. We will assume that 5th, 9th and 10th transactions are the losing ones and the remaining ones are wins.

Table (Table 1) below presents likely outcome of using all of your capital each time.

| Transaction number | Gain/ Loss | Cash after transaction |
|---|---|---|
| 1 | $ 10,000 | $ 20,000 |
| 2 | $ 20,000 | $ 40,000 |
| 3 | $ 40,000 | $ 80,000 |
| 4 | $ 80,000 | $ 160,000 |
| 5 | - $ 160,000 | $ 0 |

*Table 1: Reinvesting 100% of one's capital - simulation*

As you see, the long-term (here: ten transaction) outcome of this decision is losing all your money (Table 1).

Now, let's say that you use about 30% of your money.

Although the first strategy gave you amazing $160,000 temporary, you end up with nothing. Second (Table 2), more conservative approach, gave you total gain of about 115%, which is almost 8% per one transaction.

| Transaction number | Gain/ Loss | Cash after transaction |
|---|---|---|
| 1 | $ 3,000 | $ 13,000 |
| 2 | $ 3,900 | $ 16,900 |
| 3 | $ 5,070 | $ 21,970 |
| 4 | $ 6,591 | $ 28,561 |
| 5 | - $ 8,568 | $ 19,993 |
| 6 | $ 5,998 | $ 25,991 |
| 7 | $ 7,797 | $ 33,788 |
| 8 | $ 10,136 | $ 43,924 |
| 9 | - $ 13,117 | $ 30,747 |
| 10 | - $ 9,224 | $ 21,523 |

*Table 2: Reinvesting 30% of one's capital - simulation*

Please take a look at the following graph – it shows the relation between the amount of money (percentage-wise) you decided to invest in this simple scenario and the amount of money you would have gained after ten transaction (of which 7 would be winning ones).

Actually, the optimal size of your position is **40%** (as seen on Chart 1). That would give you total gain of $12,769.32 which is the same you would have if you gained about 8.6% per each transaction (there would be no losing ones).

This is just a hypothetical scenario, but in reality you could put almost all cash from the part that you don't use for speculation and put it into sound, long-term investment - for instance physical gold.

On the other hand, if you are a long-term

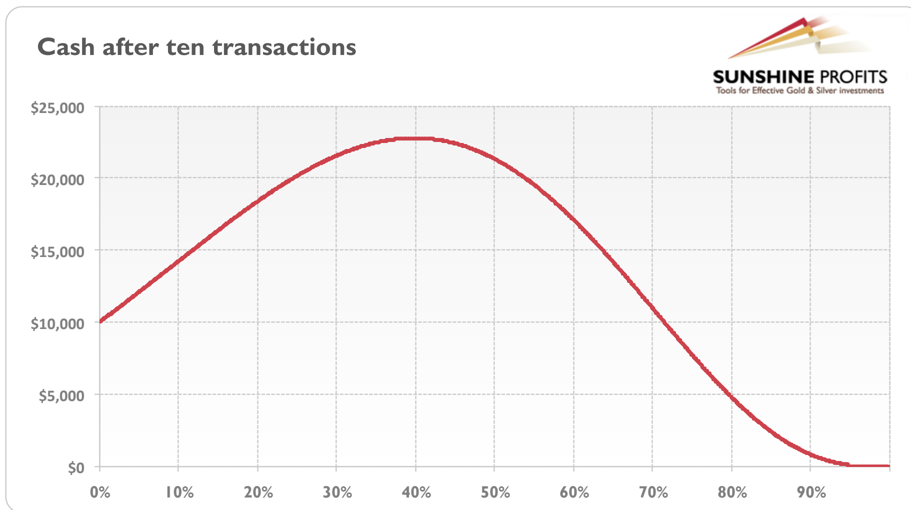


*Chart 1: Reinvesting X% of capital - outcome after 10 trades*

investor, you could boost your overall rate of return by putting only a small part of your holdings into more risky strategies. Naturally, we assume that these strategies are more profitable than the long-term investment. Here's an example:

The risky strategy is buying short (1 month to expiry date) term call options on gold or senior gold companies and you assume that they have 33% chance of gaining 500% (and 67% probability of losing all speculative capital used for this transaction). We took a rather extreme example to better show you that even such transactions can be used, if the size of your position is appropriate. You decide that your maximum share of capital you will ever decide to use for short term trades is 30% (thus leaving 70% for long-term investments). In case of the above-mentioned transaction, the optimal position size is about 16%. 16% of the 30% of your capital used for short-term trades is merely 4.8% of your total capital. The average rate of return from this transaction would most likely amount to 2.5% - in terms of your total capital per month since we are writing about short term options. This means almost 35% of annualized gain.

The 4.8% is the critical amount, so it still makes sense to use less (even 2% or so) of your capital for this transaction, if the risk (putting 4.8% of your capital for a very risky and profitable transaction) still seems to be too big for you. This approach would still give you about 15% annually. The point is that your long-term investment would not be greatly influenced but this strategy – after all 98% of your capital would not be used for it. That doesn't look that risky after all, does it?

Another important lesson that you can learn from this simple scenario is that **at some point risking more capital does not give you more profit**. That means that no matter how risk-tolerant and brave you are, there is a point when it makes no sense to increase your risk exposure, as it would decrease your overall rate of return. **This is a major point that most beginning Investors overlook (and lose money)**, so we believe that additional examples will be useful.

As explained earlier, you can assess the long-term effectiveness of your approach toward particular transaction by multiplying it many times (reinvesting in the same transaction over and over again with the same strategy in mind) and checking the results. We have prepared a few simulations for this report.

The first one is checking how much capital you would have on your account after you used different amounts of capital for relatively low-risk transaction with a moderate expected gain. The results can be seen on the chart below.

The assumptions made here are:

- $10,000 initial capital,
- 10 transactions,
- Probability of gain 70%,
- Probability of loss 30%,
- Realizing gain means profit of 50% and if you are wrong you lose 50% of your capital (means that the market plunges, you panic and sell near the real bottom).

This can be viewed as an investment transaction.

As you can see (Chart 2), it more or less pays to use a large portion of one's capital for such a transaction. Investing about 80% of your capital would give you the best results (on average 8.6% per transaction that is reinvested each time), but you would still double you capital after ten transactions even if you used only about 50% of it. This would imply average gain of 7.2% per transaction. Using little capital (10% or so) would not hurt you either, but your profits would be very limited.

Now, let's take a look on a situation when you have a small chance of achieving a sensational gain and a big chance of losing the invested capital – for example by buying short term options.

Assumptions here are:

- Initial capital: $10,000,
- 20% chance of gaining 1000%,
- 80% of chance losing the invested capital (-100%).

This can be viewed as speculative transaction (Chart 3).

Under the abovementioned conditions it only makes sense to use relatively small amount of capital – 12% would be optimal here. If one chooses to use more than about 30%, he/she will be losing money in the long term.

It's just like Evel Knievel (Motorcyclist) once said – 'risk is good, not properly managing your risk is a dangerous leap'.

The 30 percent level is the breakeven point here. As you can see, the charts are completely different for both of these situations, just as your approach should be.

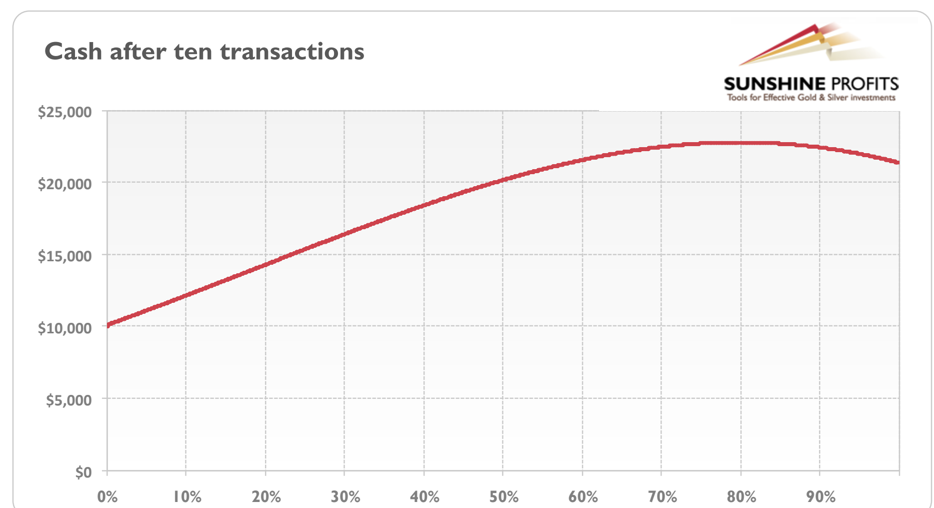


*Chart 2: Reinvesting X% of capital - outcome after 10 investments*

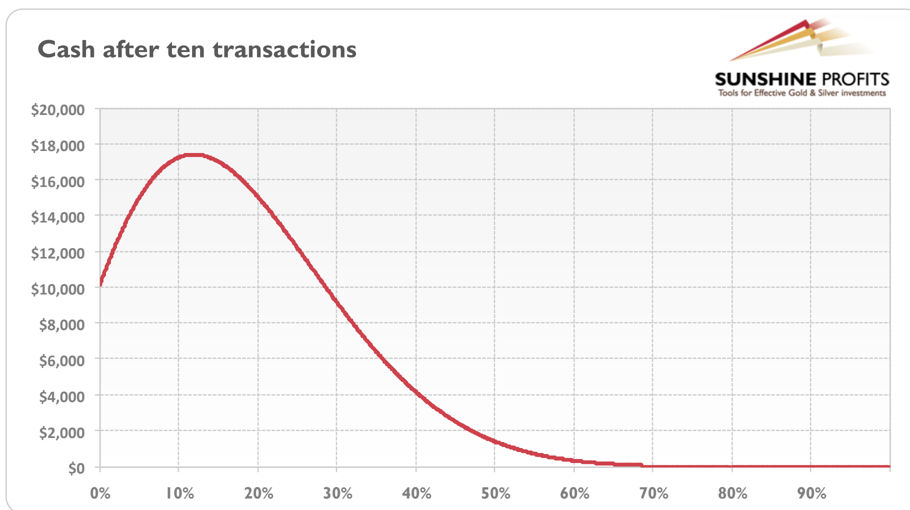


*Chart 3: Reinvesting X% of capital - outcome after 10 speculative trades*

When one confuses both of the situations the results are either bad or worse. The bad situation is when you view the investment as speculation and are too conservative. In this case you risk using too little of your capital for risky trades and therefore you are limiting your gains to some extent. In other words, you're missing out. On the above chart you can see this in its left part – when the invested capital is close to 0% and cash after 10 transactions is close to $10,000 (which means no profits as you started with that amount).

The good news here is that this will not make you lose money in the long run, only to gain less of it. That is not the case if you view speculation as an investment – that is the worse situation.

If you deal with speculative transactions as you would have dealt with investments (using a large part of your capital) you will ultimately lose money in the long run. If you invest large (relatively speaking) amounts of money in short term options, then you might get lucky a couple of times and earn a lot temporarily but you'll end up with very little if not with nothing. On the above chart you can see this in its right part – when the invested capital amounts to 80% and more and cash after 10 transactions is close to 0.

By contrasting the two above charts you can see exactly how and why long-term investors and short-term traders can be successful at the same time despite dramatic differences in their approach toward investments. If you had these charts for each transaction you could easily decide how much capital you should use – naturally the amount that gives you the biggest final outcome. If you had a tool that calculates that for your, the situation would be even simpler.

For rather safe (95% chance of winning), long term transactions, which let you gain about 50% of your capital, this tool would suggest using over 90% of your capital dedicated to the precious metals sector. This is exactly what most of long term investors do – keeping some powder dry, but investing a large part of their capital. Short-term investors (a.k.a. Speculators) would most likely stick to risky strategies, as the one seen on the most recent chart. This time it is prudent to invest only a small part of your holdings in each transaction.

Another thing is that you should think long-term even from a one-trade perspective. Combining single long-term-oriented transactions will give you a long-term-effective strategy. When entering a single trade you need to be comfortable with the amount of capital left after the money put into this particular trade is lost. This principle has already been found and successfully used throughout history. The legendary French ruler, Napoleon Bonaparte perfectly understood that you need to know your risks and take them into consideration before you get involved in particular action. "I accept I might be defeated, but caught in surprise, never" is one of his famous quotes.

When we apply this phrase to investing, we must realize that we may lose a particular trade, but we have to be prepared for it. This is exactly what the above-mentioned analysis does – we accept the ultimate truth that that at times a trade will be a losing one, but we are well prepared as we know which part of our capital we are using and how big position gives us best returns in the end.

With the above in mind let's jump right into one of the most important implications of the above analysis – timing the bottom of a short-term decline and timing a top of a short-term rally.

The main point here is that the approach should be different depending on whether we are talking about long-term investments or speculation.

**Based on the earlier analysis, we believe that it does not make much sense to wait for the exact bottom as long as we are talking about your long-term holdings**.

First of all, the chances that a particular investor will buy exactly at the bottom are really low. Of course it depends on what you define as the exact bottom (particular minute, day, week, or month?). The longer time frame you choose, the higher probability of being right you have. Still, the probability does not get past 90% or so, meaning that you can never be sure that this is it. Being sure or as we prefer to view it – having more than 90% certainty – is the characteristic of a long-term investment.

As far as these decisions are concerned, you usually have all (most) the fundamental information that you need to make you sure that the market will ultimately go up or down. In our case, for example, one of the reasons that we think this bull market in precious metals is well founded is that the quickly developing countries from the BRIC group (especially China) will put enormous pressure on prices of all commodities. This is true despite local downswings on the Chinese and on the global markets. After all – the economic forces are much less volatile than the leading world stock market indices.

Timing the market is not the matter of fundamental factors. It is usually done by conducting technical and/or cyclical analysis and perhaps combining it with other techniques which are not of fundamental nature. These are often subjective and a considerable amount of doubt is needed before making the final decisions. By this we mean that you should not invest all of your capital based just on the abovementioned analyses. The results can – and sometimes will be – astonishing, but occasionally you will end up with losing your invested capital. It is prudent to make sure it's not all of it.

The point here is that the chance of realizing an outstanding gain is usually not more than 90%; in fact it is often less than 50%. Think about it – if a decision that is not based on fundamentals has relatively low probability of proving profitable, then this is not investment, this is speculation. Speculation (high expected rate of return, relatively low probability) does not become investing if you choose to use most of your investment capital to it.

Let's move back to the situations, when most investors realize that the bottom is near. You are pretty sure that the bottom is near but you don't know if it will take place right now or in a few weeks. In other words – the probability of picking the bottom is low, but probability of picking the **range** within which the prices will reverse

is much higher. Therefore if you decide to sell/buy a part or all of your long-term holdings (rather (dis)investing than speculation) then we do not advise timing the exact bottom, but instead to try to buy around the bottom. This way you are not likely to get the best price, but **you are still likely to get a good price**.

The important thing here is that you will boost your chance of NOT buying too late or not buying at all. Getting into day-to-day price swings is only for those who have time, nerves and stomach for it. Controlling your emotions is crucial and failing to do so, may result in not buying at all, as you get scared and want to be sure that this is the uptrend. The problem is that it is after the buying opportunity that you get so sure.

A long-term view on any strategy or approach should be kept in mind at all times. In the long run you will have many opportunities to buy or sell your precious metals or related equities and profit on it.

## So, what's the best way to approach the market? Investment of Speculation?

In our view, it's the combination of both. In our view **the optimal solution is to make long-term purchases when you know that prices are relatively low**, but do not wait for the exact bottom **and dedicating some cash to speculation – which means using only a part of your money to time the exact bottom**.

Why do we combine both of these strategies? Because diversification between strategies **reduces risk and increases profits**. A picture can tell a thousand words (though we doubt that our essays would be get published if they consisted of charts only...), so we prepared another chart to back up the previous statement. Dividing capital into 3 categories: investment, speculation, cash gives us two variables (the share dedicated to investment and the share dedicated to speculation), it can't be presented on a linear chart, like the previous situations. We have therefore created a specific area-chart. In this case the horizontal and vertical axis are variables (particular shares), and the profit is marked with color. White color means that a particular combination gives you exactly no profit and no loss in the long run. The more golden the color gets, the highest profits you achieve at given combination and the more black it gets, the more losses you suffer. Let's take a look at a realistic example. The assumptions here are:

- Starting capital: $10,000;
- Investment: 70% of achieving 50% gain and 30% of suffering 50% loss;
- Speculation: 20% of achieving 1000% profit and 80% of suffering 100% loss.

The most golden part of the chart (Chart 4) (highest profit) corresponds to the 62% (investment) / 9% (speculation) combination of taken positions. After ten transactions one would most likely have gained about $18,500, which is 11% on average per transaction. Please note that this is done while still having over 20% in cash at each transaction.

If you invested 100% (no cash left) in the long-term only, you would have likely gained only about $11,350, which is less than 8% on average per transaction. Consequently, **you're not only making bigger gains, but you're also limiting your risk** by limiting your total exposure (you can keep more money not invested at all)!

- tal to the former,
- In 95%+ of cases, timing tops or bottoms should be done with only the speculative part of one's capital,
- Long-term investments should be sold only under most bearish circumstances when the probability of a decline and its projected size are really significant,

In case you'd like to calculate exactly how much money should you use at most for a given transaction, you'll need to use some tools to help you with that. You can easily make similar calculations, for example, using your worksheet program. Calculations for different time-frames are more sophisticated than those presented above. Whatever method of calculating

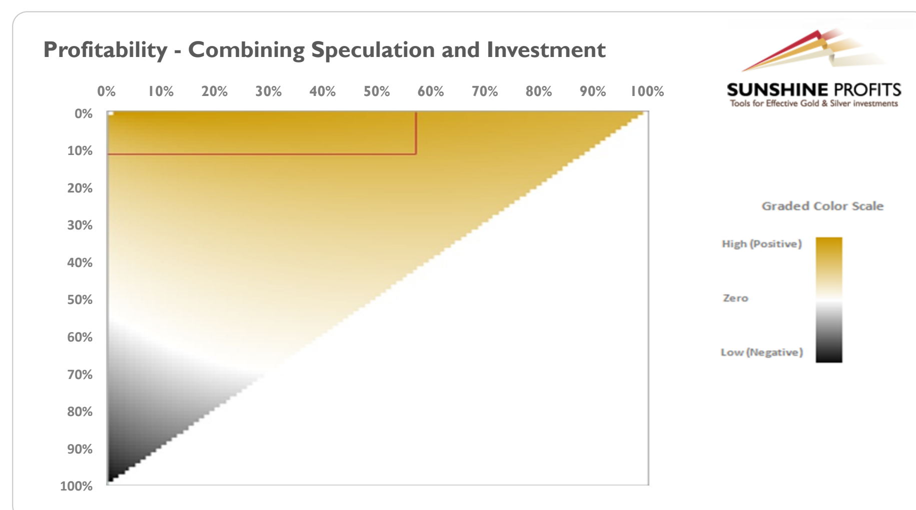


*Chart 4: Profitability - Combining Speculation and Investment*

Additional interesting fact here is that taking a closer look at the chart lets you see that this chart in fact includes two previous charts, as they are the particular cases where either investment share is set to 0% (only speculation) or speculative share is set to 0% (only investment). These can be observed by focusing on how the colors change on the left border and on the top border of the chart. For example the white color is visible at about 30% speculation share and 0% investment share – this is exactly the same 30% that corresponds to the point on the second chart in this essay, where one is at the breakeven point.

Summing up:

- Die-hard Long-term Investors who don't view speculation as sound and Speculators that don't care about long-term fundamentals can both make money over time because the sizes of positions that they take are dramatically different,
- Sticking to long-term investments is a good idea, but not the best idea. The best idea is to combine both: long-term investments with short-term speculation and dedicate more capi-

the positions you use, you need to keep in mind the long-term effects of this particular strategy. As shown in the above example, you can have a profitable strategy from a 'one-trade' perspective, but if you repeat it and you invest too much money into risky bets you are likely to end up losing money.

One of the tools that we developed (the Position Size Calculator) gives special attention to the success of your portfolio from a long-term perspective. It is designed to optimize a strategy between short, medium and long term options, however you can also use it to calculate positions in the short-term only – for example such as presented above.

Thank you for reading. We hope that this essay will contribute to your investment successes in the coming years. Please feel free to rate and comment on this report on our website. If you're interested in reading our other reports, we invite you to visit our Reports section

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