Investing Vs. Trading – What's The Difference?

What's the difference between investing and trading? Many people use these terms interchangeably but they do mean completely different things. If you are a serious about managing your own money and the risks associated with it, you need to understand the difference between these two terms.

It is easy to see why even the most experienced investors may find it difficult to differentiate between trading and investing. At their simplest level, both can be defined as the application of capital in the pursuit of profits. The mechanics of buying and selling are basically the same and sometimes the analysis one does to make those decisions is identical as well.

The fundamental difference which separates trading and investing is the time frame. Investing is putting money into some specific approach for an extended period of time to achieve an above-average, long-term rate of growth. Trading, on the other hand, is speculating on short-term changes in price.

A trader is not trying to predict what is going to happen in the next 10 years. He or she is concerned with price fluctuations immediately after initiating a position. Their objective is to secure quick profits from knowing better than the market what the future will bring. But many investors argue that over time you can't successfully predict market movements.

According to the Efficient Market Hypothesis, a security's price fully reflects all available information at any given time. If we assume that markets are efficient, then buying and selling securities in an attempt to outperform the market will effectively be a game of chance rather than skill.

In reality, markets are neither perfectly efficient nor completely inefficient. All markets are efficient to a certain extent, some more so than others. Traders aim to take advantage of less efficient markets where more knowledgeable investors can outperform less knowledgeable ones.

Relatively illiquid markets such as Real Estate and our own T&T Stock Exchange are not fluid or continuous enough to be considered efficient. Different participants may have varying amounts and quality of information providing the opportunity for skilful speculators to exploit pricing anomalies by judging which securities are misvalued.

Successful traders closely watch prices and trends and have a lot of courage to make quick decisions. They have the potential to earn superior risk-adjusted returns in a short time frame but studies show that such speculation rarely delivers.

In fact, researchers have concluded that frequent trading is hazardous to your wealth and can reduce your returns for several reasons. Not only can transaction costs become expensive, but it is impossible to consistently time the market and you can potentially forgo gains that long-term investors enjoy with much less effort.

Despite these costs, it is easy to see why investors find themselves addicted to the speed and excitement of the trading game. But it is precisely this uncertainty which makes active trading a difficult means by which to plan for your future.

It is perfectly acceptable to maintain a trading account but you should never rely on speculation to achieve your financial goals. Whether you are saving for retirement, financing a child's education or building wealth, it is investing – not trading – that can help you meet these life goals through the proper management of your finances.

Unlike trading, when you invest, you are looking at holding an asset for the medium to long-term, typically a minimum of three years. Generally, your goals will dictate how much time you have to invest.

If you are 35 years old and investing for retirement at age 65, then you have a time horizon of 30 years before you begin withdrawing money. Your time horizon is important because it influences how you invest your assets. Typically, a longer period allows you to take on more risk because the market's short-term ups and downs have tended to smooth out over time.

You do not have to be wealthy to be an investor. Investing even a small amount can produce considerable rewards over the long-term, especially if you do it regularly. As you earn investment returns, your returns begin to gain returns as well through the power of compounding. So, even at relatively low rates of return, you can double or triple your money over long periods of time.

Of course, the more money you save and invest today, the more you will have in the future. Financial planners recommend that you put away as much as possible, with the goal being to save 10% of your annual income. There is no guarantee that the market will go up the first day, month, or even year that you invest in it. But there is one guarantee: doing nothing at all will not provide for a financially secure future.

The first step towards successful investing is to determine your goals, then to develop a sound investment plan designed to meet them. You should have an individual plan for each goal that reflects your time horizon, financial situation, and personal feelings about risk.

Generally, if your goals are more than five years away, most of your investing dollars should be in stocks for long-term growth. Only invest money for the short term that you are actually going to need in the near future. If you will need the money next year, use one of the shorter term and safer havens for your cash (such as money market funds or certificates of deposit) to preserve your capital while protecting the purchasing power of your dollar against inflation.

In my opinion, using an investment professional to help you tailor an optimal portfolio for achieving a secure and comfortable future is much better value for money than getting a hot stock tip. There are substantial long-term benefits in buying and holding a diversified investment portfolio instead of trading stocks or mutual funds frequently.

No matter which stocks you choose, trading in and out of the market is unlikely to deliver predictable results in any one year. It is far more realistic to expect results that fluctuate in the short-term and average out to a reasonably predictable level over time. Granted, there is nothing exhilarating about predictability, but your money is too important to invest without strategy.

Remember, you invest to make money to achieve a specific goal, not to beat the market. Successful investing isn't a competitive 100-yard dash. Successful investing is more like a marathon, where commitment and endurance will see you to the finish line. Invest wisely. Your future depends on it.