





“In the same way that Facebook hijacked the word friend, Robinhood has hijacked the word investing.”



Stealing From The Poor and Giving To The Rich

The New York Stock Exchange building in lower Manhattan is an impressive piece of neoclassical architecture, a stone offering to the gods of money where stocks are traded with unimaginable speed each weekday. Those who haven't witnessed the commotion firsthand have probably seen footage showcasing a raucous concert with an instantly recognizable cadence and rhythm. Floor traders in their exchange-issued jackets shouting with phones in hand, a disheveled collection of off-key soloists that somehow come together to form an open outcry orchestra perfectly in tune. The maestro overseeing this activity is the market, invisible but ever-present, waving its conductor's baton like a metronome from the start of the trading day until its conclusion. This is the symphony of global finance, played flawlessly in an iconic echo chamber with pitch-perfect acoustics, its music broadcast across the world.

Well, not exactly.

The reality is that while the building is still open, the concert has been closed for well over a decade. The musicians have largely been replaced by machines, whose instrumentation is 0s and 1s, bits and bytes. The tune these days is white noise, a quiet hum of computers executing trades at speeds the erstwhile system of human involvement could never hope to match. With this innovation has come an evolution for the financial industry, and into this environment an online investment brokerage called Robinhood was born, with a mission of democratizing investing by making it easy – really, really easy – to buy and sell from a mobile phone, with no commission charged. But in the same way that Facebook hijacked the word friend, Robinhood has hijacked the word investing, with an interface designed for the action of trading, not the inaction of buy-and-hold. This is not only intentional but essential. The Robinhood model really doesn't work without a high level of taps and swipes.

Numerous studies have shown that trading strategies are inferior to buy-and-hold strategies, but a generation of potential new investors are being bred into traders, with the wealth accumulating not to the users but to their enablers, including the high-frequency trading firms handling all that volume. This perverse incentive system is tailor-made for an impressionable group that's grown up with social-media dynamics like "followers" and "influencers," and it's allowed Robinhood to quickly grow its user base and potentially generate the kind of activity that impacts price action, particularly with growth

Robinhood is another log being thrown on the volatility inferno, joining the COVID-19 pandemic, the election season, the proliferation of misinformation, social unrest, the impact of climate change, and just a general sense that the world has lost its way. Like those other factors, Robinhood should not be ignored. For those with a longer-term investment mindset, it's important to understand not only its role in the financial market ecosystem today, but the role it may play going forward. That requires delving into the mindset of its user base, many of whom have had little exposure to the financial markets before but may be intimately familiar with other ways of putting hard-earned money to short-term work.



From Gambling to Trading

Barstool Sports is a sports and pop culture website started by Dave Portnoy back in 2003. One magazine profile of Portnoy – who refers to himself as El Presidente – described Barstool Sports as “the bible of bro culture. Rude, crude, sexist and often mean-spirited ... the site has become a go-to for young men who say they are disenfranchised by the mainstream media.”¹ Barstool has expanded its media reach since its early print publication days, and despite a slew of controversies (or perhaps because of them), its popularity has grown dramatically, attracting more than 60 million monthly active users to its sites.

Barstool has always had a strong connection to fantasy sports and gambling through both its articles and advertisements, and so it's hardly a surprise that more than 60% of its users gamble on sports, with nearly half of them doing so weekly.² Its popularity with this demographic attracted the interest of Penn National Gaming, an operator of casinos and racetracks, which took a 36% stake in Barstool in January 2020. Shortly after that, the world was turned upside down by the spread of COVID-19, and the lifeblood of Barstool – professional sports – was brought to a halt. But Portnoy was able to pivot quickly, finding a new outlet for his brand of provocative boorishness: online trading.

On March 23, the first Davey Day Trader live stream was released, and Barstool's audience was introduced to Portnoy as the title character. As it turned out, the timing couldn't have been more perfect: its launch date marked the bottom of the truncated bear market, and given how dramatically stocks traded to the upside, it was easy to make amateurs look like professionals. Or, as Portnoy would tell his legion of viewers as the market continued its surge in the early part of June, supplant them:

“You know what I find funny though? The people on the internet debating who the better investor is right now, myself or Warren Buffett. It's no debate... I'm not saying I had a better career. I'm not saying I have more money than he does. He's a Hall of Famer. He's one of the best to ever do it. No doubt. (But) he's old and he's washed up. I'm the new breed, I'm the new generation. There's nobody that can argue that Warren Buffet is better at the stock market than I am right now. I'm better than he is. It's a fact. You're just going to have to deal with it ... Listen, he's an old man, his time has passed him by. I'm sure he's nice. But how can you debate facts?”³

Did Portnoy actually believe this? Probably not. Regardless, words matter, and he has a base of almost two million Twitter followers who listen. “Scott Nazareth, a 29-year-old day trader from Toronto, said he's a fan of Portnoy's videos and believes older investors such as Buffett are missing opportunities in technology and airline stocks. ‘I kind of make fun of some of these investors,’ Nazareth said of Buffett. ‘They just have a hard time understanding the new normal, the new business models.’”⁴

Many of Portnoy's followers had never traded stocks before, and he was showing them on a regular basis how incredibly simple it was to make money as the market roared to the upside during the summer. For those who wanted to join the fun, they needed to look no further than their mobile phone,

1 “The Man Behind the Bible of Bro Culture” Entrepreneur, Dec 13, 2013

2 “What Are Robinhood Investors Talking About Penn National Gaming Stock?” Motley Fool, Aug 11, 2020

3 Dave Portnoy Twitter feed, Jun 9, 2020

4 “Barstool Sports' Portnoy is Leading an Army of Day Traders” Bloomberg, Jun 12, 2020



where an upstart brokerage firm was encouraging them to take control of their financial future by investing in the stock market.

Democratizing (and Gamifying) Finance For All

Robinhood was started in April 2013 by Vladimir Tenev and Baiju Bhatt, two men in their 20s with an implicit understanding of the millennial mindset and its inclination toward making the less accessible more accessible and the less economic more economic. It was packaged in a mission that screamed equality – “democratizing finance for all” – and designed around removing any intimidating barriers to entry. It was free, easy to use, and addictive, with a brilliantly designed user interface that won the Design Award at Apple’s Worldwide Developer Conference in 2015.

If there’s any question about what users Robinhood is targeting, it’s answered immediately upon downloading the app. Before sign-up, users are greeted with a list of stocks, along with their price action for the day. On one recent day, the top ten stocks displayed were Snap, Apple, Twitter, Tesla, Netflix, Facebook, Microsoft, Disney, GoPro, and Starbucks. Users have to answer a few questions about investment experience and any potential insider-trading conflicts (for those who don’t understand these basic questions, Robinhood helpfully moves the sign-up process along by pointing out, “If you don’t know what this means, it likely doesn’t apply to you.”), and then, after a quick review of terms and a linkage to a bank account, it’s almost time to trade. But first, a free gift. New users receive one share of stock.

Robinhood awards the stock through a virtual scratch-off game, where the user chooses one of three boxes and then gets to scrub the screen until the big reveal. On a recent sign-up, the reward was a single share of VBI Vaccines, a small-cap biotech company trading under \$3, after which confetti rained down on the screen as if a game had just been won. A notification window followed (“Want more free stock? Invite friends to Robinhood to get more free stocks like Facebook, Microsoft, or Visa. Get up to \$500 in free stocks per year!”) and then the account was armed and ready. True to form, function, and design, trading stocks from here was frictionless.

Robinhood’s growth has been turbo-charged this year, with 3 million accounts added between January and August, and it expects revenue to increase 250% from 2019. Competitors have obviously taken notice, as all of them have copied the company’s zero-commission offering, showing that the adults are officially no longer in charge. Behind this growth is a surge in trading activity. “Robinhood’s merry traders are moving markets: Certain stocks—Elon Musk’s Tesla, marijuana conglomerate Cronos, casino operator Penn National Gaming (author’s note: Remember them?) and even bankrupt car-rental company Hertz—have become favorites, swinging wildly on a daily basis. For the first time ever, according to Goldman Sachs, options speculators like the ones Robinhood has cultivated have caused single-stock option-trading volumes to eclipse common-stock trading volumes, surging an unprecedented 129% this year.”⁵

The story of how Robinhood makes money with no minimum account sizes and zero-

⁵ “The Inside Story of Robinhood’s Founders, Option Kid Cowboys, and the Wall Street Sharks That Feed On Them” Forbes, Aug 19, 2020



commission trades is best exemplified by that options trading volume. The idea of free anywhere on the internet is almost always a misnomer. Nothing is truly free, it's just that the costs are not always so clearly identified.

The Real Cost of Zero-Commission Trading

On its website, Robinhood has a page titled “How We Make Money,” and until late 2018, Robinhood did not disclose the fact that it took money from high-speed trading firms for sending them customer orders, an omission that is currently the subject of an open SEC probe. This is called payment for order flow, and it occurs when brokerages bypass exchanges and send their orders directly to market makers (sometimes known as high-frequency trading firms). When the company did reveal that information in an October 2018 blog on its website, it explained how the system works: “When you buy or sell stocks on Robinhood, like many other brokerages, we send your order to market makers like Two Sigma, Citadel, and Virtu, instead of exchanges like NYSE. Market makers don't front-run your orders — they're actually required by Regulation NMS to execute your order at the best price among all of the exchanges, and unlike exchanges, they don't charge fees.

We don't play favorites. To compete with exchanges, market makers offer rebates to brokerages ... We send your orders to the market maker that's most likely to give you the best execution quality.”⁶

To be clear, payment for order flow to high-frequency traders is legal, and according to the SEC, may result in slightly better execution prices. But at a time when execution prices are sometimes measured to the hundredth of a penny, that better execution price is likely to be entirely immaterial to the account holder. However, it's not immaterial to the high-frequency traders, who pay for order flow because it's information that they can use in their own proprietary trading to generate substantial profits of their own. And of course, it's not immaterial to Robinhood, which earns payments for directing orders to high-frequency traders. Lower trading activity equates to lower payments for Robinhood, and so their incentive, unquestionably, is to get its users to trade, especially in the area where the payments are highest: options.

Maximizing Revenue With Complex Products

Options trading – the buying and selling of puts and calls – is the most lucrative product for Robinhood because the payments from high-frequency traders for this volume are dramatically higher than they are for stocks. Not surprisingly, Robinhood makes it very easy for its users to trade these more-complex products, despite the fact that most of them have no previous knowledge or experience. According to a report by Piper Sandler, Robinhood gets paid over 3 times as much for options than stocks, earning an average of 58 cents per 100 shares for options contracts versus only 17 per 100 for equities. The reason is that options are less liquid than stocks and tend to trade at higher spreads, a much more profitable offering for the high-frequency trading firms executing the orders. While Robinhood says that only 12% of its customers trade options, those trades accounted for 62% of Robinhood's order-flow revenues in the first half of 2020.⁷

⁶ “Under the Hood, The Official Robinhood Blog” Oct 12, 2018

⁷ “The Inside Story of Robinhood's Founders, Option Kid Cowboys, and the Wall Street Sharks That Feed On Them” Forbes, Aug 19, 2020



The financial casualties of options trading are known only to Robinhood, but there has been at least one human casualty, a young man who cited his inexperience with trading in a note he left his parents prior to ending his life earlier this year. Alex Kearns was a 20-year old who woke up one morning to find that his account had a negative cash balance of over \$700,000, which was a temporary balance that would be adjusted once the stocks underlying his assigned options settled, but which he may have misinterpreted as real cash losses incurred. Suicide is complicated and seldom reducible to a single identifiable factor, but as Forbes noted in an article about the incident, “The tragic demise of Alexander Kearns is a cautionary tale of the serious risks associated with the race to the bottom in the brokerage business. Robinhood, E-Trade, TD Ameritrade, Charles Schwab, Interactive Brokers, Fidelity and even Merrill Lynch have all embraced commission-free trading and zero-minimum balances in an effort to attract younger⁸ customers, many of whom have little understanding of the securities and markets they are dabbling in.”

And therein lies the problem. Labeling things as “free” is nothing more than a marketing convention, especially online. Free social media companies don’t itemize for their users the cost of the damage from the free flow of dangerous misinformation that occurs on their platforms and contributes to the fracturing of societies. And free brokerage platforms like Robinhood don’t explain to users the personal financial erosion that can be caused by utilizing a strategy inferior to the more staid, far less exciting approach of buy-and-hold, which would be a much harder model to gamify.

The Impact on Long-Term Investors

Patience is indeed a virtue of successful investing, and exercising patience gives investors a significant advantage. Trading generates noise, which long-term investors can not only capably withstand, but take advantage of as well. It’s particularly noisy when there’s lots of uncertainty, as there is today, providing a gift to investors able to stomach the volatility and focus on fundamentals. Smart investments purchased at a discount rise in price over time, and the line between investment and sale is never straight. The unexpected is the rule, the expected the exception.

Maintaining a long-term perspective does another magical thing for investors: it mitigates fear. Unless there is something that fundamentally alters the thesis for an investment, a bad day for a stock is nothing to be feared. Bad days happen. As do bad weeks. And bad months. For traders, this can be poison. For investors, who are given the opportunity to buy something they like at an even lower price, it’s manna. Prudently diversified portfolios allocated to strong, long-term-oriented managers tend to look back on difficult times as a key contributor to their long-term returns given the extraordinary bargains created by others – like traders – who are heavily focused on near-term events, where they have no unique insights or an ability to even remotely know what will happen to their investments.

The Rich Getting Richer

Robinhood’s model is built for trading, and it’s been executed very effectively. In its latest round of funding in August, the company was valued at \$11.2 billion, up from \$8.6 billion

⁸ “20-Year-Old Robinhood Customer Dies By Suicide After Seeing A \$730,000 Negative Balance” Forbes, Jun 17, 2020



in the previous round, which occurred one month earlier. In the process, the founders have become paper billionaires. The CEOs of high frequency trading firms Two Sigma, Citadel, and Virtu are billionaires already, and their work with Robinhood is only contributing to that wealth. The venture firms investing in Robinhood are run by men who are all fabulously wealthy already, and on the day that Robinhood goes public, which is in the plans, that wealth will increase substantially.

There's an old adage in the business world: If you're not paying for the product, then you are the product. With regard to internet companies, it means that even though some services appear free, they make money by selling their users. Social-media companies utilize user data to sell targeted advertising and work tirelessly to keep their users on their sites as long as possible, despite numerous studies that have found a negative relationship between time spent online and overall levels of satisfaction and happiness. Robinhood utilizes users' trades, providing them an addictive platform that encourages activities that are not in their best long-term interest.

If there are any doubts as to what Robinhood's intentions are, a recent phone notification 45 minutes before the market opened should put them to rest, "It's time to start trading!" This brings to mind another old adage, this one from the gambling world: If you don't know who the sucker sitting at the table is, then it's probably you.



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