Casey: Welcome to the Mullooly Asset Podcast. This is your host, Casey Mullooly. This week we're going to talk about another hot topic that has been circulating in the financial media, and we wanted to share our thoughts as usual with you, our listeners. So thanks for listening, and here we go.

Casey: All right. Another newsworthy headline recently is Robinhood. They filed for their S1 last week, which is the report that's necessary to file an IPO.

Tom: Initial public offering.

Casey: Beat me to it.

Tom: Sorry.

Casey: It's all good.

Tom: Is it true that their symbol is going to be hood?

Casey: Yes.

Tom: Oh my goodness. That's terrible.

Casey: So in the report, Robinhood disclosed that they have 18 million active users with around $80 billion in assets, which puts their average account size at just under $4,500.

Tom: Is that the math? $4,500?

Casey: Yeah.

Tom: Oh my goodness.

Casey: More than half of these 18 million users said that this was their first brokerage account.

Tom: Mm-hmm (affirmative).

Casey: 47% of Robinhood users use it on a daily basis, and 98% of users use it on a monthly basis.

Tom: So the 47% using it on a daily basis, I think is particularly bad. Just my opinion. Because it's getting people to look at their accounts on a daily basis. Brandon had the podcast line of the century when he said, "Your assets are like a bar of soap, the more you touch them, the smaller it's going to get." And I can't say that line enough. The more people look at their accounts, the more apt they're about to be to make a mistake and do something that they're later probably going to regret.

Brendan: It's interesting because we're all scrutinizing Robinhood now because we have this data and it's fresh and this is what you get when you go public, because you have to disclose all these sorts of things. But this is the same math that is behind all the other big brokerage firms, and it's kind of gross. It's like cigarettes for finance. Like they have these addicts on their platform, like using... Like Robinhood, the idea of this app is engagement. They need people on the platform. They need you trading, they need you doing stuff so that they make money and they're doing a good job of it, but it's like financial addiction. It's not good. It's the same kind of grossness you feel when you find out stuff about Facebook.

Tom: Yeah. Well they...

Brendan: What they're tracking and what they're doing to make their money. It's like, "Oh, that's nasty. I don't want an account there anymore, gross."

Casey: Well, speaking about their money, in 2019, Robinhood brought in $278 million worth of revenue, and in 2020, they brought in $959 million of revenue. So that is just an insane increase.

Tom: Their revenue is tripled.

Brendan: They're not doing you any favors when they spray the little confetti things on the app after you trade options. They just fleeced you that's why they're spraying the confetti.

Tom: The confetti is for them. It's not for you.

Brendan And to be fair, I'm not saying... I think that when you have these kinds of addictive qualities to your product, or you're making money off of things that people are habitually doing, that's probably good business on their part. So... And that is their business, is they're there to turn a profit. They're not there as their name would purport to help you as a person...

Casey: They're trying to democratize finance.

Brendan: Yeah. I don't know, to some degree, it's sucks for the people. It's cool that people have accounts on there and that they're getting their feet wet with investing. But to think that this is some kind of a altruistic enterprises, just so far from the point, I think.

Tom: I'm going to sound like an old fart when I say this, but one of the best things about birthday parties is you play musical chairs. At least we did when I was growing up. What's the worst... The only bad thing about musical chairs. Sooner or later, the music's going to stop and you don't have a chair, and I just feel like if people are using this on a serious basis, look, if you've got $500 or a thousand dollars or something, and it's a play account, that's great, good way to learn.

Casey: Sure.

Tom: And it doesn't cost that much money when you lose it all. But there's some people who have made a lot of money on paper at Robinhood. And we actually did a video or a podcast about some guy who had thousands and thousands and thousands of capital gains.

Casey: I think it was 850,000.

Tom: Yeah, and he... I mean his 1099 was like a mile and a half long. I just think that this is going to end in tears for so many people.

Brendan: That's true of... I mean, whether you're doing this on Robinhood or Schwab or Fidelity or TD Ameritrade, the math behind all this stuff and the Robinhood filing holds true to some degree for all these other companies too. So if we're saying that Robinhood is gross then everybody else Is too, you know what I mean? It's like, that's not a unique issue to Robinhood, the speculation and profiting off of speculators by wider spreads or higher costings like trading options. All of these financial companies profit off of that, and now Robinhood wants to be public and that's...

Tom: Yeah, you pull back the curtain and you realize they're just like all the other guys that they purport to not be like. It's very similar.

Casey: Yeah.

Tom: Just at a fairly large fine.

Casey: Yes, speaking to that, they received the largest fine from FINRA at $70 million. I think about 56, 57 of it was in fines and the other 13 million was in restitution to clients.

Tom: Yeah.

Brendan: Again, like just to comp it to something like a Facebook. You chalk that up to a marketing expense for them. What do they care?

Tom: Yeah.

Casey: That's like a slap on the wrist. They don't care about that.

Casey: We're referencing Ben Carlson's breakdown of the Robinhood as one and I think somewhere in reading about Robinhood, I think that Robinhood holds a $23 million account just for this exact thing.

Tom:
[crosstalk 00:06:41]

Brendan: To pay for the nonsense.

Tom: Right. Exactly. So they've built...

Mortimer: It's the cost of doing business. Yeah.

Tom: And there's something... Like how many class action lawsuits are going on now? I mean, just...

Casey: Too many to count. I mean, the 56 million comes from failures of Robinhood back in March for the outages that were caused and for lack of due diligence and approving customers to place options trades. I think there was several thousand unfilled customer complaints that Robinhood was supposed to report to FINRA and just didn't.

Tom: Yeah. Can we just talk about that for a moment? Like when you get a written complaint... If you're a firm and you get a written complaint as a member of FINRA, you are required to disclose that to FINRA. And if it's more than $5,000, this actually creates a complaint file. Each one of them.

Casey: It sounds like they were kind of expecting it. And they were like, "Yeah, we're going to get complaints, but we have the cash to just pay it out so..."

Casey:
[crosstalk 00:07:42]

Brendan: With how much money they're going to get from the IPO? It doesn't matter.

Tom: This is going to get buried in the bottom drawer.

Casey: Yeah. Like it doesn't matter.

Brendan: Every place of business has these sort of costs to bear and they just do it because it's obviously more profitable to run a firm and have these negative things occurred than it is to lock it down and be less profitable as a result of it.

Casey: Yeah.

Tom: When you talk to people who are on the platform, who are trading on a platform, they're like, "It's free. There's no commissions. This is a gift." But is it really?

Casey: Well I think the whole game stopped saga when with the outages and everything kind of shined a light on how Robinhood makes their money and how they get paid to direct what the people are doing on their platforms to other financial services firms and headphones alike. And it's a whole kind of convoluted mess because yes, it is free to place the trades on their platform and I would make the argument that these accounts on Robinhood, what harm is it actually doing?

Tom: So I look at this and say, what we expect to hear is, "Hey, what do I care? I bought XYZ stock at this price and now it's that price. I didn't pay any commissions, so who cares?" But the fact is the way Robinhood makes their money, they don't sell ads on their app, it's payment for order flow. So they are directing all of their trades, Robinhood doesn't do the trades. They're getting firms to pay them to say, "I want all of your trades from this morning sent to us and we get paid." And sometimes it's a penny per share, sometimes it's more. Sometimes it's a fraction, but this is where their revenue comes from.

Brendan: It's where every brokerage firms revenue comes from. It's not unique to Robinhood. So that's the issue that I would take with painting them in a negative light over this, is that this isn't them. It may have opened the curtain. You discover, "Hey, Robinhood is doing this." And then you discover, "Hey, literally, everybody's doing this and it's just the cost of owning financial assets" and hopefully you're not an idiot and you're not day trading and losing your money and if you own assets over the long run, it's a nominal cost to bear as in comparison to the money that you make by participating in financial markets.

Tom: Now we talked on a podcast many episodes ago about payment for order flow, and there's a good side to it and there's a not so good side to it. I think it's something that if you're going to have low commissions or no commissions, that this is something that we just have to live with, that there's a cost in the middle of that transaction.

Brendan: Trading stocks isn't a public utility. Like people need to be compensated for doing this. These are corporations that are letting you trade. [crosstalk 00:10:28] These exchanges are publicly traded companies. They need to make profits too and I don't think anybody should have a problem with that. It is what it is.

Casey: I think it just rubs... It rubs me the wrong way when Robinhood, like their whole shtick is just kind of like, 'Finance for the people, we're doing you this huge service.' It's like, "No, you're not dude." [crosstalk 00:10:47] You're just here to make profits and like run a business.

Brendan: It's really good marketing. I feel like there are companies in every industry that say something along those lines about how they're different and they're not like one of the other guys, but if you really dug into the details, you'd probably find that they are, and it's just good marketing and there's nothing wrong with good marketing. Good for them. I wish... I bet you that all the other broker terms wished that they invented the messaging of Robinhood, because it seems the messaging is all that matters. Like most people are not digging into these details.

Tom: I got to learn a new phrase, instead of saying all the time, when I was a broker. But when I was a broker, a lot of people didn't do options.

Casey: Back in my day.

Tom: Yeah, I know. At my old school, a lot of people didn't do options because of the commissions on options were obscene. I mean...

Brendan: That's why they didn't tell them?

Tom: Four or five... Well, yeah. So the...

Brendan: Aside the fact that they're not going to make money doing?

Tom: Well, two out of three options expire worthless. I mean, that's the first thing you have to explain to people before they get involved with options. Two of three times your options expire worthless. Now you can be on one side or the other side of that trade, but the commissions involved with trading options were obscene. Now, when you talk about payment for order flow, we're not just talking about buying a hundred shares of GameStop.

Tom: We're talking about a hundred calls on Facebook. That can get super expensive and the spreads are just as wide on some of these options. There were a lot less liquid than buying Ford Motor Company. So there's a lot of play in that too and I think they've done, Robinhood has done a good job of minimizing the risk and the exposure that clients have when they are... Or Customers have when they get involved with options. I don't think they've done as thorough a job as someone whose livelihood would be on the line.

Brendan: I don't think you can protect people who want to trade options entirely. They're taking on risks that they probably shouldn't be taking or don't understand and if they want to do it, they're an adult, and they've got to bear the ramifications of that. If it goes, go south on them, which I think it inevitably will the longer you do it and the more you do it.

Casey: Yeah. I think it's going to keep happening until it doesn't.

Tom: Right.

Casey: Like they're going to let them meaning, the SEC, the regulatory bodies, they're going to... FINRA, they're going to keep letting this happen as long as the firms are meeting the requirements, like the disclosure requirements, which it sounds like Robinhood may or may not be doing, they might just be eating the cost of that. Mm-hmm (affirmative) Who knows?

Brendan: It's interesting though because Robinhood, like all the other firms, you look under the hood at what makes them money and it's all the fun stuff that people think is cool, like trading options or doing like penny stocks or things where basically somebody can make a gigantic spread off of you as the customer.

Tom: Crypto.

Brendan: Right. Like the spreads... When the spreads are a mile wide, that's like... Brokered firms love you doing business in those spaces and they love it not because you're getting rich because, they are getting rich off of you.

Casey: Right. What do you mean by a spread?

Tom: Okay. So again, when I was a broker, I worked for a firm that made a market in securities. I could call up the trader for a particular stock and it was a... I'll give you a specific example without giving you the name or the symbol. But it was a stock that traded at $7 on the bid and $8 on the ask. So that's a $1 spread between the bid and the ask. I could call up the trader and say, "I want to take down a block of XYZ stock. It's bid seven, asking eight." And he would say, "I can sell it to you at $7.05 or $7.08 and then you would get it for your client at $8. You or the trader would keep seven eighths or 87 and a half cents per share. That's the spread. The difference between the buying price and the selling price.

Casey: Right. So when a spread is tight, which is not what we're talking about in this instance with Robinhood on the penny stocks and the Doge coins and cryptos alike that's options. That's when the spread is wide.

Brendan: Right.

Casey: So in your example, the difference between the bid and the ask in a perfect world would be nothing.

Tom: Right.

Brendan: But then their business, they need to be paid to... [crosstalk 00:15:30]

Casey: Right. They wouldn't be making any money on it. So then they're out of business and the market ceases to exist.

Tom: Correct.

Tom: And so for many, many listed stocks, the spread between the bid price and the ask price is a penny or 2 cents or 3 cents.

Brendan: Brokage firms are happy to take your business in any capacity, but they're definitely not thrilled when you're just buying and selling stocks, mutual funds, ETFs, that are widely traded with tight spreads like that. They're not really profiting much off of that.

Casey: So the more widely traded security is usually the tighter the spread?

Tom: That's right.

Casey: So that's why these things out of left field, the spread is...

Tom: Way more volatile and way more profitable.

Brendan: Right.

Tom: When you've got some of these crypto assets that are trading hands so quickly, some of these crypto assets will trade four times their size in a week. That means basically someone who bought it on Monday has sold it on Thursday. That's how fast these things are trading hands. Look at...

Brendan: Ben had stats in his post about the rate of turnover on some of the crypto stuff and it was insane.

Casey: Yeah.

Brendan: I forgot what it was. It was like, something billion in terms of like the assets that they had held and then it was like multiples of that in the billions of what trades on like a weekly basis or whatever it was, monthly basis.

Tom: So the numbers were that Robinhood noted clients held approximately 12 billion in crypto assets yet in the first quarter of 21, $88 billion of crypto was traded on the platform.

Brendan: They love that.

Tom: Oh, hell yeah.

Brendan: They just made so much money off of that.

Casey: Yeah. Yeah.

Brendan: That means that 12 billion got turned over. I mean...

Tom: Seven times.

Brendan: Yeah.

Casey: Six or seven times.

Tom: And a quarter.

Tom: Yeah. In three months. So people were holding this for on average 10 trading days and moving on to something else.

Brendan: And the best part for them is that they make money whether the price is going up, down, sideways, it doesn't matter. The fact that the trades are occurring is what is profitable to them. It doesn't matter whether you made money or lost money.

Tom: There's a scene from 'Trading Places' in 1983 that you just paraphrased. So tell them good part, Mortimer.

Brendan: It's always... We all sound like a bunch of bookies.

Casey: You know we're getting into dangerous territory when Tom starts quoting trading places.

Brendan: Yeah.

Tom: It's only 1983, it's almost 40 years old.

Casey: So it seems like it's been happening pretty regularly lately though, which may not be a good thing.

Tom: I don't know if that's so good.

Casey: So moral of the story is, you got to be careful about what you're getting yourself into if you're trading options and cryptocurrencies and speculative stocks on Robinhood and I think that's going to be it for episode 365. Even though we could talk about Robinhood all year long. Get it? 365, all year. Okay. Anyway, thanks again for listening and we will see you on episode 366.

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