Why IPO's are Just Another Form of Gambling - Transcript

Tom Mullooly: Welcome to the Mullooly Asset Management Podcast. This is episode number 254, your trusty and reliable hosts are here. Brendan Mullooly and myself, Tom Mullooly. So welcome, and we appreciate you coming back for another episode. Brendan, what's on today?

Brendan M.: Did you hear about the Zoom IPO last week?

Tom Mullooly: Oh, I didn't even have to wait for the Zoom IPO because I bought it at a penny.

Brendan M.: Right, so a story that has come out. This happens pretty often with stocks, especially new ones coming to the market. People think that they've found a deal or-

Tom Mullooly: I found the back door.

Brendan M.: Yes. What happened is this company Zoom, it's a video conferencing company, the ticker now, they IPO'd last week on last Wednesday, the 17th. Their ticker is ZM, a totally different company-

Tom Mullooly: With a ticker symbol-

Brendan M.: ZOOM-

Tom Mullooly: Zoom.

Brendan M.: Was literally about to delist and was listed for under a dollar share, a penny stock on all-

Tom Mullooly: a penny, trading for about a penny.

Brendan M.: Yeah, twice now in the last week it has spiked to over $4 a share. So more up, you know, more than 100% in these 24 hour spans, and perfectly coinciding with the IPO. Again, totally different companies. ZM video conferencing company-

Tom Mullooly: Don't guess on these stock symbols.

Brendan M.: No, but like also if you thought that, like you said, you were getting in the back door, or that you had found some kind of loophole and you were getting into like pre market shares of this actual company Zoom that people want to invest in, I don't know. I just think that to believe that you have some kind of an informational edge in today's world is ludicrous.

Tom Mullooly: Yeah, it really is. I mean if you go back now a hundred years, the guys on Wall Street really did have an edge, an information edge. Even if you watch a movie like The Sting, it shows about the power of information. All you had to do was be five minutes ahead of the guy who's placing the bet, and know who won the horse race, to set someone up. For all practical matters up through the mid 1980s, information on Wall Street worked the same way. You know, we used to have one of those rebuttals that would say, you know, if I owned a print shop, I'd be a millionaire because I would get everybody's research reports and read them before you had them mailed out, things like that. It was just dumb stuff.

Brendan M.: So the belief that maybe you had illegal insider information 40 years ago might have had some kind of merit.

Tom Mullooly: Might. But yet, 40 years later, almost 50 years later, we still get people who ask us about, "Well, how do we get the seat right on the inside?"
Yeah. How do we get that? What's the hurricane angle?

Brendan M.: As if that exists at all. There's no, there's no free money to be made. If that's the kind of stuff that you're looking to do in the stock market, I don't think that you should be investing in stocks.

Tom Mullooly: No.

Brendan M.: If your understanding of the market lead you to things like this, buying the wrong stock because you think that you got special access in your e-trade account to an IPO, or that you have some kind of secret information or something like that, you literally should not have any money in stocks if that's what you believe.

Tom Mullooly: Let's take this a step further and we can loop it in. Maybe we can link to the Josh Brown video from a week or two back when he was talking about Lyft. When you're buying shares of an initial public offering, who's the seller and who's the buyer? I mean, we know who the buyer is. It's the person that wants to buy the stock, but what's happening here? The insiders are actually selling their shares. The insiders are selling.

Brendan M.: They come to the market with an IPO and they price it so that when it opens on the first day, it's going to go up. But you need to have the shares before that. You need to be one of the private shareholders or somehow be roped into this deal before. Before they begin trading, which exists.

Tom Mullooly: It does.

Brendan M.: But not for the average investor. So to go into your brokerage account on the day a company IPOs, and to pay money for the shares after it has IPO'd into the public, you might as well just light your money on fire.

Tom Mullooly: In many cases you're right. There are exceptions. If it's a company that you honestly believe is going to be sliced bread, and you really want to own this company, and this is the first time that you want to own it, my brother wanted to own Netscape. He said, "I'll never get shares on the IPO, but I just really think this thing is going to work." This is, you know, 20 something years ago. "Just buy it for me because I'm never going to sell it. Just buy it for me when it starts to trade." We had plenty of people who called up and said, "I know we'll never get shares of Facebook, but I really want to own Facebook. So when it opens for trading buy it," and that totally did a swan dive when it first came out. First day, I think it traded at 65 or 70, and a week or two later it was at $29. If you're going to buy the stock in the open market, better be prepared to live with it.

Brendan M.: I don't think that people are, just to throw a blanket over everybody. I know that you shouldn't make blanket assumptions, but who is buying ... I mean pre-market is one thing because who knows what you actually paid to get into that. Those are people who own the company and

Tom Mullooly: And understand that the underwriters will get a small allocation, but it's a small allocation. It's a very small stub. I mean it's like 1%, and that could spread over a bazillion clients.

Brendan M.: I just don't think that it's helpful for the average investor to even go through the IPOs that have worked, because that's basically going back to like the whole meme of like if you put $10,000 into Facebook at the IPO, sure. By what you just said also holds true that you had to eat a 70% draw-down and probably multiple 50 percenters along the way there.

Tom Mullooly: Immediately.

Brendan M.: So who did that and still owns those shares today? Very few, if any. So if you want to do that, just acknowledge what you're doing. It is gambling in the pure sense of the word, more so than anything else you could do with your money in the market. So if you want to do that and you want to say that you're not going to sell no matter how far it goes down, then sure, knock yourself out. But don't delude yourself into thinking that you have insider info or

Tom Mullooly: But for goodness sake-

Brendan M.: Get the right ticker symbol.

Tom Mullooly: Yeah, get the symbol right.

Brendan M.: Yeah.

Tom Mullooly: Holy cow.

Brendan M.: Just to put a bow on that, get the ticker symbol right if you're going in to buy after market shares of an IPO. I would never recommend it to somebody doing any kind of serious investing, but at least buy the right company.

Tom Mullooly: First time I ever saw a real life, like in real time trade ever, didn't happen to me. It happened to the guy sitting next to me in the bullpen. His client wanted to buy Gap, and so he bought him a hundred shares of Gap, G-A-P, but he wanted Gap Stores. You know the company, they sell jeans, the ticker symbol is GPS. GAP is Great American and Pacific Tea Company. The A and P down the corner.

Brendan M.: I would love to see in instances where people buy the wrong shares, just to reiterate how much this is gambling, I wonder if they would do better with the ones that they bought by mistake than if they bought the company they actually wanted. I bet they would.

DISCLAIMER: Tom Mullooly is an investment advisor representative with Mullooly Asset Management. All opinions expressed by Tom and his podcast guests are solely their own opinions and do not necessarily reflect the opinions of Mullooly Asset Management. This podcast is for informational purposes only and should not be relied upon as a basis for investment decisions. Clients of Mullooly Asset Management may maintain positions in securities discussed in this podcast.

Brendan M.: All right, what else have we got?

Tom Mullooly: Can we talk about SoFi? I don't know if this was on your list or not-

Brendan M.: No, it is. I saw you tweeting about it over the weekend, so I'm sure you've got some takes to share with us.

Tom Mullooly: It's just totally wrong.

Brendan M.: Let's recap first what we're even talking about.

Tom Mullooly: Okay.

Brendan M.: SoFi I launched these no fee ETFs in the last week, and it was big news when they dropped this announcement about a month ago that they were coming out with the first free ETFs. It's, you know, two US based funds. I think it's covering basically like the S&P 500, and then like the small and mid cap space too.

Tom Mullooly: Correct.

Brendan M.: They're free. There's a waiver, eventually the funds are going to have an expense ratio, but maybe not. Their plan I guess is to throw them out there for free, use their built in network of customers and see if they can get enough scale to, I don't know, somehow make this work. We all knew that this would happen eventually, but they're the first. So with the launch of these funds, they have their own robo platform, and they went in and reallocated customer accounts to use their own funds as many of these robo advisors are doing to try to monetize the platform. But they moved on from basically like the comparable funds they were selling within the robo were like vanguard, total stock market funds, index funds or ETFs that cost maybe-

Tom Mullooly: Three.

Brendan M.: Three or four basis points to move to the free funds, which have no ramifications if you own it in an IRA, let's say, or a retirement account. But many people own them in brokerage accounts.

Tom Mullooly: Yeah.

Brendan M.: It's a big problem in terms of people now paying taxes, short and longterm capital gains, to save three or four basis points, which is entirely negated by paying all these extra taxes. What do you have to say about this whole debacle?

Tom Mullooly: All right, so the first thing that I thought of was my understanding of some of these online trading apps like Robin Hood, or even going online and having like a an e-trade or a TD Ameritrade account where you're the owner of the account, this is not discretionary, or it's not something where you've signed over to an advisor or to the firm to do their trades. Although there's probably something in the small print that says this is going to be a discretionary account, because otherwise it wouldn't have been able to do it. But the first thing I would think of was I would love to be a class action lawyer on Monday morning. I would say you could argue that every one of those trades is an unauthorized trade. Every single one of them.

Brendan M.: Yeah. I don't know the nature of their agreement because this is unlike a Robin Hood, which is a trading platform. My understanding of this is that it's a Robo Advisory Service, and so I'm sure there is some kind of an agreement to rebalance the accounts.

Tom Mullooly: Okay. Well they're certainly not exercising any kind of fiduciary standard of care either, because they're going into their own proprietary accounts.

Brendan M.: Right. Seems like a conflict pretty much across the board. Whether we're talking about-

Tom Mullooly: What genius thought of this?

Brendan M.: I mean, well if there's a conflict there then I'm sure like Schwab has one too because their robo uses primarily their own ETFs. I'm not sure. If they're deemed to not have a conflict, then perhaps they're operating under the same set of circumstances at Sofi. But I agree in the sense that I don't think a fiduciary would recommend a transaction like this, because I know that when we're looking at accounts, new clients coming in with allocations, we are running a plan for them, and perhaps a lot of times there is some kind of reallocation to do to the account as a result of the planning exercise we put them through.
People have just accumulated stuff over the years. We want to be very sensitive to allocations in taxable accounts, especially because-

Tom Mullooly: Absolutely.

Brendan M.: It's one thing, and I've heard it expressed this way, the move from the average mutual fund, let's say, where fees are like 75 basis points to like 1% a year, we've seen ones that are very, very high, like higher than that.

Tom Mullooly: Sure.

Brendan M.: Okay, so somebody comes in with that kind of a portfolio and there's taxes baked in because they've held these funds forever, and they have made some money in them over the years despite being expensive. We want to be careful about how we unwind that, but I think you can make a much better case when you're moving from a mutual fund with an expense ratio of 1% to an ETF that costs 10 basis points, rather than somebody who might come in that has a portfolio of ETFs and it's not necessarily the exact fund that we would choose for our client allocations, but it's similar in costs to what we would use, and it serves the same purpose, and there's a baked in tax gain in it.

Tom Mullooly: Yeah. Are you going to trigger a taxable event just because they know-

Brendan M.: From Vanguard shares ETF or like whatever the case may be? Probably not.

Tom Mullooly: Probably not.

Brendan M.: But it's something that you need to determine on a case by case basis, and so without saying specifically for every person across the platform if this is a good idea or not, I think it's really tough to at the 10,000 foot level to make an allocation decision like that and to say that it's going to be better for everybody. Like I said before, if you're reallocated in an IRA then sure. I mean, yeah, three basis points. I probably wouldn't make an allocation change based on a three basis point fee difference-

Tom Mullooly: It's a rounding error.

Brendan M.: For the comparable funds, but if there's no tax ramification, sure. Like what's the harm I guess is what I'm saying. But if it's in a taxable account and now they're going to have to pay short and longterm capital gains on it, then there is a problem.

Tom Mullooly: I know that we have a couple of things that we want to talk about, but there's something that I've got to say about all of this stuff. You know, we spend a lot of time talking about fiduciary obligation, and I think it needs to be said that the fiduciary obligation in the investment world is not an on/off switch.

It's not like I'm black and you're white, there's a lot of gray, and it's not something that anybody has a clear answer on. Even though investment advisory firms, you have the full 100% fiduciary obligation, I have to believe that these brokers, whether it's discretionary, nondiscretionary, whatever, if they see clients doing things that are reckless, they have some modicum of fiduciary obligation to act.

I never hear this discussed ever, and I know that we didn't plan on talking about this. Brokers have some degree of fiduciary obligation. It's not full on 100% obligation like we do, but if they see people doing things that are just plain wrong, they shouldn't be happening.

Brendan M.: I agree that it was a little shady to do it this way. They basically announced they were going to shift the funds from the Vanguard ETFs or index funds to their own, the Sofi products. It was like a same day announcement, like there was no chance to opt out. But it's a

Robo Advisory Service, and the funds don't have a track record, but like you pretty much know what you're getting.

Tom Mullooly: You're tracking an index.

Brendan M.: They're index products, it's not the S&P 500 explicitly, or like the 600 or the 400, but-

Tom Mullooly: They would have to license it as an S&P tracker.

Brendan M.: that wouldn't be free. That's why they're doing it this way. So it covers the large mid and small cap. It covers like the US total market space, and they're free. So I don't think they're like trying to jam crummy products like junk bonds or something into somebody's account. I just think that the way that they went about it, I would hope that they and other people who have plans to do stuff like this learn that this left a bad taste in people's mouths, and it was bad PR, despite in the big picture I think that a lot of worse things have occurred.

There are some capital gains taxes for people to pay, a lot of worse stuff than this goes down in our industry on a day to day basis.

Tom Mullooly: I'll agree with that.

Brendan M.: Yeah. I don't know the extent to the permission they get, I would imagine with a robo advisor service they have permission to rebalance the accounts, but I would think that it should be more tax sensitive than that. Like I know that platforms like Betterment take into account tax. Literally these platforms like advertise tax loss harvesting, and so to not be tax sensitive when you're doing a move-

Tom Mullooly: Wasn't there a Robo advisor that got in trouble for advertising that they would do tax loss harvesting and then they didn't?

Brendan M.: I don't know. There's been some discrepancy or dispute over advertising the performance addition that something like tax loss harvest and can have over the years, and I agree with that because that's very situationally dependent. The same move in the exact same account, like let's assume you and I have the same accounts, but you're in a different tax bracket than me. We have the same hundred thousand dollar accounts at whatever, Robo X, Y, Z, and they do the same tax loss harvesting move for you and I, we can reap very different results based upon what brackets were in.

Tom Mullooly: Sure.

Brendan M.: It could matter far less for me than it does for you, or vice versa. So to say blanket statement that you can add half a percent a year by tax loss harvesting, I don't know, maybe over the long term, but to say that that average result is applicable to like everybody's situation-

Tom Mullooly: Across the board. No.

Brendan M.: That's really tough, and I don't think you should be able to advertise that.

Tom Mullooly: You should just put like, look, your mileage may vary. You know?

Brendan M.: But that's not catchy. The whole phrase of like harvesting is fun. It's like we're going out to the fields to bring in the crops or something.

Tom Mullooly: We're going to have an ice cold Bud Light at the end of our work day.

Brendan M.: Kick back on the porch and reap the rewards.

Tom Mullooly: Reap the rewards of our harvesting.

Brendan M.: Yeah. I don't know. I think Sofi could have handled this better.

Tom Mullooly: Lesson learned I guess.

Brendan M.: So my last nitpick, I don't know this guy, so maybe I'm being unfair to him, but there was a guy who they quoted in this article at the journal who runs a website where he like puts, I don't know how much money, but he basically invests in all of the robos and then measures their performance.

Tom Mullooly: Little test accounts, yeah.

Brendan M.: Yeah, oh my god.

Tom Mullooly: Yeah.

Brendan M.: No. Like you're enabling people to do the literal worst thing they could possibly do, which is chase performance with a robo advisor. Like I'm going to put my money with Vanguard this year because they outperformed Schwab and Betterment by 52 basis points last year.

Tom Mullooly: Like two dollars. Give me a break.

Brendan M.: Yeah, don't do that. Just to put a bow on that.

Tom Mullooly: Every industry has their peanut gallery. You know? There's folks out there that will critique Car & Driver, which is a magazine that critiques cars. There's people out there who critique different coupon websites. So we have to have someone who critiques the Robo Advisors.

Brendan M.: Yeah. I just wish it were based upon literally anything else. Like what funds they're using in their allocation, or maybe how ethical we believe them to be. What's the mix of their investments? Are they only using in-house funds or does their aggressive allocation put X into US versus international, or like whatever it may be. More broad level comparisons, as opposed to this one returns six versus six and a half last year. As if that's predictive at all. Like knowing who performed the best last year, it tells us who's going to perform the best next year.

Tom Mullooly: It just doesn't work that way.

Brendan M.: It doesn't work that way, and we all say it doesn't work that way. But-

Tom Mullooly: That's what a lot of people use.

Brendan M.: Right, exactly. The first thing that you're going to look at if you have to make an allocation decision is past performance. Even though our industry is plastered with a disclaimer saying, "Past performance is not indicative of future results," we all give lip service to it as if-

Tom Mullooly: Ah yeah, that's true.

Brendan M.: But then we do the exact opposite when we have to go look at it.

Tom Mullooly: That's right. We should just all get in the habit of saying your mileage may vary.

Brendan M.: Last one that I want to bring up today was from Christine Benz at Morningstar-

Tom Mullooly: Friend of the firm.

Brendan M.: She's on every show, so I figured this was a good one to bring in, and she talked about how to avoid IRA pain points-

Tom Mullooly: This was really pretty good.

Brendan M.: It was good in the sense that she was talking basically about eliminating frictions that exist in basically the process of getting money into your IRA, and making sure that it gets invested. Both of those things alarmingly are not happening for people from what the article shared. So Vanguard had some stats from 2016 that showed, in 2016 during January through April, that four month stretch accounted for two thirds of the IRA contributions they received that year, and they were all back dated for 2015. Meaning that most people make their IRA contributions at the last second, was Christine's point. There's obviously an opportunity cost to that, to waiting, because the money literally could've been in there-

Tom Mullooly: January 1st.

Brendan M.: 16 months earlier. But another problem is that of this last second money that comes in, Vanguard also said that it is far more likely to sit in the money market for an extended period of time-

Tom Mullooly: Doing nothing.

Brendan M.: People are in such a rush to make the contribution at the deadline that they don't have any kind of settings for, "Oh, this money should be invested." So it's in there. You get your tax deduction perhaps, if you're doing traditional and you fit the limitations, but you're putting the money in there and then it's just sitting there. So what good is it doing for you? It was a tax deduction, sure, but like let's calculate that five, $6,000 tax deduction in years past. Like how much money did you really save by rushing to do that? Then you didn't even invest it? A few hundred dollars?

Tom Mullooly: That's really the eye opener. I think sometimes people, I don't know how it works for everybody, but sometimes people get a phone call from their accountant. Now I'm going back into the eighties and nineties, and people would be told, "Hey, you need to make a contribution before Tuesday, get money into your IRA." I think it would be a lot more useful if the accountant said, "You know, if you put $5,500 into an IRA before April 15th, you can save blank on your taxes,"-

Brendan M.: And no one would do it.

Tom Mullooly: At least then you can make a decision about, first of all, I don't know if I have that money, and secondly, I don't know if I want to do it.

Brendan M.: Are you sure you feel that way? Because I might disagree. I might take that as incentive to make the contribution, because I think that if it were reported the way that you were, half the people wouldn't even bother.

Tom Mullooly: They wouldn't bother.

Brendan M.: Which I don't think that's the outcome that we want.

Tom Mullooly: By Tuesday? Gosh, I'm busy. I don't know.

Brendan M.: To save like-

Tom Mullooly: $400.

Brendan M.: Four or five hundred, a thousand dollars. Depending on what your bracket is, that's going to tell you how much the deduction actually means to you. Sure, you're deducting 5,500 or $6,000 now, but it doesn't necessarily mean that that is your actual tax savings.

Tom Mullooly: Right. The other part too is that you are kind of kissing that money goodbye for a little while, it's going into a retirement account. I mean, don't do what we see some folks do. They put it in and they take it out a year later. Which is just ridiculous.

Brendan M.: Yes.

Tom Mullooly: You've negated whatever right off you got, whatever deduction you got, because now you're going to have more taxes and penalties.

Brendan M.: I agree. It's something that should be considered not in like a one week period of time. Like, "Oh crap, I have to do this now because my accountant said it." It should be considered. The tough thing here is if you're on the threshold, whether we're talking like a roth or a traditional IRA of deductibility or eligibility to contribute at all to a roth, if you're on the threshold or your AGI from last year or this year projects to be very close to being boxed out of this, you might have to wait to see if you come under these thresholds. Or, a point that Christine brought up, if you are going to do something like a Roth conversion, it may make sense to leave it in a money market because you don't want extra taxable income to show when you do the conversion.
There are reasons to not listen to what we're saying here, but for the average person, I would say-

Tom Mullooly: I have to say that over the years I've seen too many IRA statements get slid across the table, and people hand it over and they're like, "This account isn't doing anything." You look at it, you start reading through like all the pages of the statements, yeah. It's sitting in cash, sitting in a money market. I don't know, I put the money in every year. It doesn't grow.

Brendan M.: That may be a product of getting tax advice, but not necessarily financial planning or investment advice. So an accountant isn't going to say in most cases, unless they do both of these things, they're not going to say make this IRA contribution, and by the way put it into a target date fund or a balanced fund, which is something Christine recommended. Which simplifies it. Have a default.

Tom Mullooly: Yeah.

Brendan M.: Use a balance fund so you don't have to make a call in April to say, or stocks or bonds over, undervalued. Like you don't need to have an opinion, just put it into some kind of a one off product where it's going to invest in an array of asset classes for you.

Tom Mullooly: Agreed.

Brendan M.: So that you can just autopilot it, kind of, to at least get it invested in something.

Tom Mullooly: So you raised an interesting point almost accidentally a moment ago when you said when you bring this up with your tax preparer, he's focusing on getting your taxes done and on time, and getting you in a position where you're paying the least amount of taxes. The financial planner on the other hand, I think their response would be like, "What the heck? Like it's April. You could have started making this contribution like even weekly, 16 months ago. What's going on?"

Brendan M.: I would say that a two way street for sure with clients and the professionals that they work in or work with, but advice worth paying for should be proactive, not reactive. So when you show up at your tax preparers office in March or April, you're not giving them a lot of runway to work with. So you're going to get reactive advice, which means you're going to get the last second IRA contribution. Or if you're a business owner, all you can do at that point is fund a SEP, when in reality maybe it would've made more sense to do some other kind of employer sponsored plan throughout the year. But you need tax planning to get that kind of advice. Just like you need investment and financial planning to be proactive about this kind of stuff, so you don't show up at your financial planner's office and say, "it's April, I need to make out a check to my IRA."

Tom Mullooly: Yeah, who do I make the check out to?

Brendan M.: Right. Again, like I said, some firms are more predisposed to that kind of proactive planning based out of ICE. Some are more reactive and they'll just say, "Sure, make the check out to wherever, and what do we want to do with this?" can be avoided.

Tom Mullooly: I agree with you on that, and I believe that there's a lot of tax professionals out there that want to help their clients, but they're overwhelmed.

Brendan M.: March and April is not the time to ask additional questions about your situation.

Tom Mullooly: The year's over.

Brendan M.: Now's the time to get your taxes done. You should meet with your tax professional in July or August or September. Get on their schedule. If you want to do some planning and they offer that kind of service, and in many cases I think you're right. They would love to get together, I think more than once a year, not in the spring, when they're not super busy they can really take a look at your situation, and you're giving them enough of a runway to say, "Here's what I'd recommend and here's how we can make it happen before it's too late." You still have half of the year, half the calendar year if you're meeting with them in the summer months.

Tom Mullooly: Another great article from our friends over at Morning Star.

Brendan M.: Yeah.

Tom Mullooly: So we had Jeff Ptak on Tim's podcast.

Brendan M.: Yes. Coming soon. Very excited to hear that one.

Tom Mullooly: Looking forward to that. Thanks for listening to episode number 254, and we will catch you on the next time.