

The Dangers of Day Trading Apps - Transcript

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Tom Mullooly: Welcome back to the podcast. This is episode number 336. I am Tom Mullooly and joining me today is Tim Mullooly and Brendan.

Tim Mullooly: So there's an article in the Wall Street Journal, and there's a couple articles over the last few weeks about it. I'm talking about Robinhood and there was a complaint filed in Massachusetts against Robinhood.

Tom Mullooly: I understand that this is not just any complaint. This is the securities regulators for the state, or the Commonwealth of Massachusetts have filed this complaint against Robinhood.

Tim Mullooly: It said that... So Robinhood has aggressively marketing towards inexperienced investors and failed to implement controls to protect them. There's a lot of cases of just crazy amounts of trades happening in people's accounts and over a short amount of time. And they have little to no investing experience. And we know here how dangerous that can be for some people, if they don't know what they're doing and they're trading in and out of stocks, things that they don't understand can be pretty dangerous for people out there.

Tom Mullooly: I think what really opened my eyes where, if you want to speculate 500 or 1,000 bucks in some crazy stock, that's fine. I think if it's suitable for the right size of your net worth, for what you want to speculate with. But in reading through the article in the Wall Street Journal and reading through the complaint, it seems like Robinhood markets option trading in a similar vein with trading and stocks. And I just don't think that folks really understand what's involved when you're buying and selling options, whether it's puts or calls.

Brendan: I think all of this has only been exacerbated by how crazy the market has been this year in terms of to the downside and upside tons of volatility, plenty of ground covered in between. And so Robin has been around for a few years now, but we're just starting to see, I guess, people fully understand what goes on, on their platform more so this year as maybe more people decided to dive into day trading for sport. Bored at home during the pandemic, I guess.

Tim Mullooly: Yeah. Yeah. That definitely has factored into it. We talked about earlier in the year, two people didn't have sports to bet on, so they turn to the stock market to try and quote unquote "bet on," some of these individual stocks.

Brendan: I think that's the biggest problem in some of this is. And is it Robinhood's fault? They're basically playing into people's worst instincts. And so they're trying to adopt a platform

that looks like a visit to the casino or some kind of online betting app, like a draft Kings or something like that. And so it seems a lot of the prompts and the interface that they have, it's designed to get people to interact with it. I guess maybe they're running into a problem because securities laws is more strict than what somebody-

Tim Mullooly: Like casino, gambling was.

Brendan: Casino is allowed to do this sort of thing. But if it involves stocks or marketable securities, then there's a little more regulation on that than you might run into otherwise.

Tim Mullooly: It seems like Robinhood operates more just like a technology app that is more interested in getting as many interactions and downloads and users as they can. Just growing their user base and not necessarily making sure that they're taking care of the people that are actually putting money into the account.

Brendan: It's a free service. So when something is free, I think you've got to realize that you are the product. If they're giving it to you, it's like social media platforms too. We are the product because they're selling advertisements. That we allow them to profit from, by participating on their platform. And so, yeah.

Tom Mullooly: So here's a platform and app that's done little to no marketing and they've got 13 million accounts now. I don't know what the average size is, but we've gotten calls from folks who want to speculate 1,000 bucks or 2,000 bucks in something. And we've even told them, if you want to do that, think about Robinhood. You can do it right on your phone.

Tim Mullooly: And it's because, we here have a fiduciary responsibility to our clients. So if they want to buy these things that we wouldn't own or don't own for our clients, we don't want that here under our watch. So you point them towards a Robinhood where they can get exposure to those things. But now, obviously, as we're finding Robinhood doesn't have any sort of real fiduciary responsibility to their clients or the users, I would say. I guess they kind of do in Massachusetts, but not on a national level.

Tom Mullooly: You had raised this right before we turned on the microphone. You want to talk about that a bit?

Tim Mullooly: Yeah. I mean, there was the Department of Labor's fiduciary rule last year or the year before trying to go in across the country that didn't end up happening. But as soon as that got shot down, Massachusetts as a state adopted its own fiduciary rule for brokers and advisors earlier this year. So the complaint that was in the Wall Street Journal article was saying that it didn't adhere to the fiduciary rule that they now have in place in Massachusetts. So that's just for the state of Massachusetts. It's not here in New Jersey or anywhere else in the country.

Tom Mullooly: So the regulation in Massachusetts, I'm just going to read this part, stipulates that a broker dealer and that's Robinhood, has a duty of loyalty to its customers in part, by making recommendations that give priority to the customer's interest, without regard to the interests of any other party. Regulators say the lists of popular trades to which users have access,

have the potential to influence the securities that traders buy without the company conducting any kind of suitability analysis. So Galvin's complaint goes on to explain that this is no different from a broker handing a list of securities to a customer, and then pretending to be surprised when the customer purchases securities from that list. And then proclaiming he made no recommendation to the customer.

Brendan: I wonder how much of this is just Robinhood testing the boundaries though, because nobody has really done this style of investing platform app before. And so there really aren't clear cut rules, because I'm not... I get the point of that statement, but I don't think it is exactly the same. Because Robinhood is just using an algorithm to say, "Hey, here's what other people are doing." It's like Twitter, "What's trending." Sort of thing. So I don't think it is implied that like...

Tim Mullooly: It's not a specific recommendation.

Brendan: It's not like, "Hey, other people are doing this because it's a good idea." It's just that other people are doing it. I don't know if that's necessarily a recommendation. So maybe this sort of legal action... I mean, is it necessarily bad for Robinhood? They might be fine to do this. And then other people are going to start doing it too. So it can just define what the laws are going to be as more and more of these platforms start to exist. I'm not sure it's going to be a death knell for Robinhood.

Tim Mullooly: I think there was something in the Wall Street Journal article that said that they made a settlement of one point something million last year for something similar like this. But they have 13 million users and ads and things going on, how much money do they have coming in? A settlement for \$1 million dollars might not be very much to them. So like you're saying they could just be testing the boundaries, end up settling out of court for a small amount of money. And now they know what they can do.

Brendan: And the worst case for them is that they're told they have to stop this and they have a fine, and then they cut it out. But the people are still on their app. The people are there already. So in terms of generating popularity, I mean, they've done what they wanted to do, whether or not this is legally allowed on a go-forward basis, right?

Tom Mullooly: The complaint continues on and it talks about the... I think it's pronounced gamification, but it's gamification of the trading process by using alerts on people's phones. It's an app. So you're using it on a phone or an iPad. And you get these prompts apparently telling you, "Hey, check your account. This thing is up. Take a look. You may want to think about this." And it's leading to people who are doing... We're not even going to call it overtrading, but they're doing... People with no investment experience are doing massive amounts of trading. The article in the Wall Street Journal and there are screenshots floating around the web on Twitter of other examples from the complaint. But in Massachusetts, they talked about one customer with no investment experience made more than 12,700 trades in over six months.

Brendan: I think we might've mentioned this before, but I just wonder what the 1099s are going to look like for some of these Robinhood people. And if they even understand what that is from an investment standpoint, I'm sure they're-

Tom Mullooly: You are going to get a phone book dropped on there. And it has to be mail.

Brendan: It's going to be all short term gains and losses, depending on what they've done. I just wonder how many people are actually accounting for that because the tax surprise. I mean, even if you did well, that's an unpleasant surprise to have a bunch of short-term capital gains on the books. That's not great.

Tom Mullooly: But this kind of spills over into other topics. The whole idea of... I don't know if it's a disclosure issue or making sure that people understand the risks involved with buying and selling options. The risks involved with buying and selling leveraged and inverse ETFs. We've actually done a few podcasts on these things. It's been a while because we tend not to get involved in them.

Brendan: Literally nobody needs to invest in these.

Tim Mullooly: Especially people that have no investing experience at all. And just going back to what you were saying about gamifying investing. I mean, we were just saying, they want to make it seem like it's a casino that it's fun, but we say here investing shouldn't be fun. it should be boring.

Brendan: If somebody has convinced you that investing is fun, they're profiting off of you somehow, I promise. It's not a game.

Tom Mullooly: It's fun for them, because they're making money on you. So there was also this item that they brought up about... They started a money market fund. They started the fund with a waiting list. And the way you could move up on the waiting list was to tap the app as many times, as you could, during the day. Once you hit a thousand taps, they said you're tapped out for the day, come back and-

Brendan: Come back tomorrow.

Tom Mullooly: Come back tomorrow and start tapping. So you can move up the wait list. I don't understand that one at all.

Brendan: I mean, it's got to be some kind of engagement thing. So not only does it keep people just generally addicted to their app, but also engagement stats have to be through the roof. So if they're showing that to people who they want to add money to Robinhood, to become investors, backers of their product. They can show them engagements at skyrocketing because they've got hundreds of thousands of people tapping on their phone a thousand times a day to get into some money market funds. They don't know how the stats are getting there I'm sure, but it looks good for them.

Tim Mullooly: That's what I was saying earlier where it seems they're, they're more of just an app. The people running the ship there just care more about-

Brendan: Engagement.

Tim Mullooly: ... app growth and user engagement and getting investors on the backend to throw money to support Robinhood as an app. They don't necessarily... They're not flaunting the huge success stories of people that make money on their app. It doesn't matter to them, as long as there's people there tapping-

Brendan: As long as they're on the app.

Tim Mullooly: Yeah, as long as there's people they're tapping 1,000 times a day, that's why they send you push notifications. It sounds like Snapchat or Instagram, they want users on the platform. They don't care what they're doing once they're on the platform.

Tom Mullooly: It just seems kind of kooky to me that there's a lot of people making hundreds and thousands of trades on a weekly basis. And they're tapping their phone, tapping the app hundreds, and maybe 1,000 times a day. This is a lot of people with a lot of free time on their hands.

Tim Mullooly: Well, like Brendan said earlier, I mean, this is why it got so popular during 2020, because there was nothing else to do for a long time for people. And for a lot of people there still isn't. If you're out of work or maybe it seems an enticing idea to try and make some extra money if you're not working. It's a dangerous proposal. We know to kind of bet the rent in a sense on day trading stocks. But I don't know. In a year like this, in 2020 people might not have felt there was any other option for them.

Tom Mullooly: I'm going to be the get off my lawn guy. But if I were not working and worried about money, I wouldn't be trying to make it by trading stocks. I just wouldn't. So I'd be more focused on preserving my pile of cash.

Brendan: I mean, I think that lottery mentality plays right into this, whether it's on Robinhood or any of the other on my brokerage firms. I mean, you see advertisements for them too touting how they can teach you to trade options and stuff. And I think that that's just as shady, as trying to get people to do it on an app. So I don't think it's good. The places where you're going to place the trade. Again, you are the product, whether the trades are free or not, they're letting you have an account and trade on their platform because they're profiting from that somehow. And so I think you've got to remember that they're encouraging you to trade, not because it's going to be better for you as an investor, but because it's better for them.

I don't think that they owe you anything really. So I think you've got to be the one to come around to the idea that I think less is more when it comes to investing, at least as it pertains to trading. I mean, the Nick Murray line is, investments are like a wet bar soap, the more you touch it, the less you have. And that kind of wisdom has been out there for a long time. But it seems every era has its own team of-

Tim Mullooly: Traders. Yeah.

Brendan ... day traders, who just don't want to believe it. So I don't know. This is the new age of that, I suppose.

Tom Mullooly: So they do... Robinhood, like all brokers makes money on payment for order flow. And so when Brendan refers to, on a free platform, you are the product, that's exactly what's happening. So in order to do the trades, they are selling your trade away to another broker. And so the firm Robinhood collects fees, not from you, but from other brokers who were placing the trades on exchanges. They're paying for order flow. It's a vicious cycle, what's going on with this. Now, this app has been pretty successful for the right reasons or wrong reasons. And just about every brokerage firm out there now offers an app on their phone. I personally would... I try and discourage people from checking their accounts on their phones, but it's inevitable. People are going to look and they look more when markets are volatile in both directions up and down. I just wish they wouldn't do that.

Brendan: I'm just thinking, anything that's an app, if you have it on your phone, you're going to open it from time to time. And so I mean, you would check in less frequently if the app just wasn't on. Because we all have the apps on our phones, you just mindlessly open them sometimes because you're bored. It's like, "Okay, I'm going to open this. I'm going to open Twitter again." Or, "I'm going to check Ring when I know that nothing's even happening." I do all this stuff on my own phone. So if I had one too, that had an investment account in it, especially if it were sending me push notifications, then yeah. I'd probably log in more. That's just human nature. That's all they're playing into by doing this sort of stuff, I think.

Tom Mullooly: I have an app on my phone from a conference that I attended three years ago and it's still on my phone. It's ridiculous. I actually opened it a couple of weeks ago. I was like, "What is this for?"

Tim Mullooly: Yeah, I mean, Robinhood is just what seems like the first trading app that's going to come along that's become really popular. But there's always going to be more ones that come along. And I think it just goes back to the point between trading and investing and what we always try and tell people the method of how you can do it has changed over the years and it's gotten easier. You can have it in the palm of your hand now as you're walking around outside. But the underlying principle is still the same that day trading your account is dangerous and it's different from investing. So however, the method of how you do it, I think for people listening, that's the ultimate point of articles like this is to kind of at least try and drill that point home.

Tom Mullooly: Did you have another item that you wanted to talk about?

Tim Mullooly: Yeah, real quick. There was an article last week in CNBC and the headline pretty much says it all. We don't really need to go into the details of the article. But the headline is that 45% of Americans don't know how much tax is withheld from their pay.

Tom Mullooly: Too much. Of course, of course.

Tim Mullooly: Yeah. With it being December, you can look at this stuff anytime a year, but the end of the year is typically a good time for people to look back at how much came out in taxes. You're going to get tax forms for the end of the year to file your taxes for 2020.

Brendan: The way the withholding form works, I think leads to a lot of the confusion because it doesn't tell you a dollar amount based on your income, or even like a percentage figure. It asks you leading questions, like your status for filing your taxes, single or married, head of household, that sort of thing. It asks you how many dependents you have in your household, things like that. And then companies use that to back into the withholding percentages that get applied to your paycheck. And I think it might be a little more straightforward if they did that differently. Especially considering now that the form for the withholdings doesn't even really match up with how things work on the updated 1040, that most of us file for taxes each year. So I think that's a big disconnect there because you don't have to apply a percentage. You answer some questions and they... It's an inexact science, I guess, it's what I'm getting at.

Tim Mullooly: And do you do it one time. It's not like you need to do it every year.

Brendan: You could though.

Tim Mullooly: You could and-

Brendan: Worth reviewing.

Tim Mullooly: Yeah, they do say in the article that it is worth reviewing every year, especially if the amount that you're bringing in changes, you should at least review it. But I mean, you fill out this form when you start at a company and then you don't have to, you might not look at it again for another five years, six years.

Brendan: Work is probably not going to prompt you to do anything about your withholding.

Tim Mullooly: Exactly.

Brendan: And I think when most people find out there's a discrepancy is when they haven't changed it, something changed somewhat dramatically, like a life event filing status or a change in income. And then the following year, whenever it happens to be, when they go to do their taxes, there's a big surprise.

Tom Mullooly: I got whacked.

Brendan: And so around this time of year, not a bad time to review, just because you would, if you're applying payroll changes now, in terms of your withholdings, you're probably starting with a clean slate come January and so.

Tom Mullooly: It is a good thing to look at every year in December. I want to remain professional, but I do chuckle a little bit when I hear people say, oh, that accountant is no good. I paid way too much in taxes. When I brought my tax stuff into that person, I need a new

accountant because I wound up paying too much. The accountant had little or nothing to do with that.

Brendan: It has everything to do with your withholdings. And so, I mean, if you didn't get a return, meaning a refund from your taxes and you're upset about that or you owed money. I mean, if somebody is preparing your taxes for you, I think a good barometer of whether or not they're worth their money is if they can help you to adjust your withholdings to change that rather than just giving you the scoop after the fact. But whether it's your preparer or your financial advisor, I mean, somebody can help you to fine tune that. So there's fewer surprises moving forward.

Tim Mullooly: Yeah. Just a quick step from the article, they said the IRS issued \$125 million in refunds in 2019. And the average was about \$2,500 per refund.

Tom Mullooly: It's a lot of money.

Tim Mullooly: I mean, obviously there's... It is a lot of money and obviously there's going to be outliers there that drag the average up. But we've talked on different podcasts and videos about how you can mentally think of a tax refund. Some people think of it as a nice bonus, around tax time. But it's really just your money coming back to you. You could just adjust the withholding, like we were just talking about and get more in paycheck on a weekly or monthly basis however you get paid.

Tom Mullooly: Back when people were actually traveling for fun before the pandemic. I do know of some families that intentionally over withheld because they would get this money back in the spring. And that would be their annual vacation or their trip.

Brendan: I would just say that if you're doing that, that's fine. Just make sure it's actually going to happen. Conversely, if you wanted to do... I mean, you could set something up to just auto deposit into a savings account each month.

Tom Mullooly: You could save it. Yeah.

Brendan: So if you were going to get the average of \$2,500 back, you could just send 200 bucks to a savings account each month, and then you've got your vacation money come 12 months later.

Tom Mullooly: Right there.

Brendan: Like clockwork and you don't have to wait for the IRS to fork it over, be surprised when it isn't there, because something change in your tax situation.

Tim Mullooly: There was a change.

Brendan: We ran into that in 2018, the first year after the Tax Cuts and Jobs Act was implemented because some of that actually went on without people realizing it. And they changed the withholdings so that people got a little more in their paychecks.

Tim Mullooly: But not enough for people to realize it on a weekly basis. But then they realize it-

Brendan: But then the refund that they would anticipate the following April wasn't there and people were bent out of shape about it when they were really no better or worse off. It was just the money was delivered to them in a different fashion rather than a lump sum they got monthly.

Tom Mullooly: Not communicated very well. That's going to wrap up episode 336. Thanks again for tuning in and we will catch up with you on the next episode.