You Know Robin Hood Folklore. Do You Know Robinhood Financial?

By James P. Freeman

"*Those who disrupt their industries change consumer behavior, alter economics, and transform lives.*" --Heather Simmons, *Reinventing Dell* (2015)

Uber disrupted the taxi industry. Then, Airbnb disrupted the lodging industry. Now, Robinhood is disrupting the financial industry.

Yes, gentle reader, you read that correctly. Robinhood in this example is the fintech company, not the folklore composition. The earliest iterations of the legend of Robin Hood were of course steeped in British folklore -- not finance -- as early as the late-twelfth century, during the reign of King John of England. Over the centuries, though, those generational tales morphed into the story we commonly associate with today: Robin Hood was a heroic outlaw who became popular because of his generosity to the poor and downtrodden.

That theme of serving the less fortunate is the principle inspiration behind Robinhood Financial -- in name and purpose. Not content to simply offer a better product or service, the company believes it too has a higher calling. Its website boldly proclaims: "We're on a mission to democratize finance for all." Well.

So, what exactly is *this* Robinhood?

Idealistically, it is another entrant into the increasingly crowded corporate space known as "market disruptor." (Seemingly, today, entrepreneurs simply want to disrupt things for the sake of disruption, more so than produce a better product or deliver a better service that, by definition, if it is truly better, would disrupt things.) Practically, though, notwithstanding lofty ideals, Robinhood is a free mobile finance tool.

The Silicon Valley start-up was founded in 2013 by two Stanford University roommates. Founders Vladimir Tenev and Baiju Bhatt were galvanized by the 2011 Occupy Wall Street movement, which initially sought social justice for greater financial equality ("We are the 99%"). They left a previous company they had started, which ran servers for high-frequency traders, to form a company that would aim to make finance more accessible to the masses. Thus, Robinhood Financial, the idea and company, was hatched.

Based in Menlo Park, California, with approximately 1,300 employees, the privately held concern is, technically, an institutional brokerage that is registered with the Securities and Exchange Commission and a member of FINRA (the Financial Industry Regulatory Authority). Robinhood's service offering is fairly limited. You may trade in stocks, ETFs, crypto-currencies, options, gold and use cash-management. Even so, Robinhood resembles less a brokerage firm and more of an investment app. There is virtually no human-to-human interaction. Essentially, it is a virtual trading app. And that alone has made it appealing to self-directed young people and novice investors. They are overwhelmingly its principal customers.

Robinhood has in fact obliterated the traditional model used by brokerage firms for decades to great success. Robinhood sought to disrupt the following. One, there was no need to save $1,000 to open an account (no minimums). Two, there was no need to pay commissions on trades (free trading). And three, customers could buy fractional shares of their favorite stocks (think Tesla). Combined, these three wrecking balls could and would be exploited for purpose.

Indeed, Robinhood would quickly become a darling of the social, cultural and financial disruptors.

Last July, a *New York Times* expose highlighted a number of eye-opening revelations about the company. Its customer base is young and lacks investing know-how. The average age of a customer is 31. Half of its customers, the *Times* found, had never invested before using the app. And, perhaps most concerning, 12 percent of its customers engaged in risky options trading.

Today, Robinhood is the fastest growing brokerage services company in America. In late 2019 it reportedly had 10 million active accounts. By the end of second quarter of 2020 -- in the aftermath of a wildly volatile market -- that number grew to 13 million accounts, a metric likely to grow by year end, given the still-extraordinary year in the marketplace. By comparison, surprisingly so, it has grown faster than more established brokerages (Charles Schwab has 12.7 million accounts and E-Trade has 5.5 million accounts).

To describe Robinhood customers as investors in a conventional sense may be an over-exaggeration. A better description is "user" (of a mobile app) instead of "investor" (of financial products). Actually, evidence abounds that Robinhood may have unwittingly also created a whole new generation of millennial day traders. What the world needs now is love not day traders (cue Burt Bacharach).

In the first three months of 2020, Robinhood customers showed their love by trading 88 times as many options contracts and trading 40 times as many shares as their Schwab counterparts.

Furthermore, during the second quarter of this year its customers executed 4.31 million Daily Average Revenue Trades ("DARTS"), a key brokerage industry standard for measuring customer trades. Notably, this is much higher than major incumbent brokerage firms.

Robinhood's founders must be pleased that they have indeed created a new cultural phenomenon, let alone an industry disruptor. In many ways Tenev and Bhatt have succeeded with their goals; millions of Americans now have access to a marketplace they did not before Robinhood. But the company may not be the benevolent, pure-bred democratic do-gooder either, despite its well-marketed altruistic intentions.

Make no mistake about it, these are capitalists who clearly embrace a profit motive, too. It was widely reported that the company made $180 million in the second quarter of 2020 (the majority from options trading). And perhaps more staggering, some estimates value the company at nearly $11 billion. Conceivably, then, the founders are billionaires. That surely is a new twist on the Robin Hood of yore.

Still, we are a long way from Robinhood becoming a sustainable kinder, gentler JPMorganChase.

Robinhood is a trading app and should not be considered a wealth management or financial planning tool. It is neither of those things. Strange, then, that the company's website implies those very things. For instance, it tells users: "Build A Balanced Portfolio." But Robinhood does not offer the common criteria to do just that, like a diversified product set; nor does it emphasize other important factors such as risk tolerance, time horizon, income analysis, etc. For those in their twenties, Robinhood's advice -- BOMB (budget, organize, maximize, balance) -- borders on parody. It comes across as overly simplistic.

The same may be said about its overall presentation. You almost wonder if Robinhood consulted with video game creators in the design and utility of the app. The user experience (U/X) is happily geared to young people. It's awfully gimmicky, too.

The "Learn" tab is filled with snappy, cartoon-like graphics accompanied by definitions to financial terms and concepts (tellingly not in alphabetical order). "Learn how to talk the talk here," viewers are told. But in case the foreboding financial world is a trigger warning for sensitive souls, it also offers this comforting alert: "Don't worry, this is a safe space." Who will tell them investing is fraught with risk and loss? No need to dwell on the negative. After users execute a trade, virtual confetti drops down over the screen in celebration. And to reinforce the idea that the U/X is like viewing financial cotton candy, its three-minute daily newsletter is called (seriously) "Snacks."

So how does Robinhood make any money if it offers no-commission trading? It employs a process -- little understood by the investing public -- called "payment for order flow." This means that the company sells its customers orders (trades) to high-frequency trading firms, like Citadel Securities and Two Sigma Securities. They in turn effect the actual trades. Robinhood has certain transactional arrangements with these kinds of firms. And they further trade on these trades, taking into account small differences in market prices (called arbitrage) to eke out their own profits. Robinhood tells its users their trades will be executed in real time, but one must question whether they receive the best price. This entire cycle presupposes robust trading volume. And Robinhood users are very active traders. (It is believed that Robinhood makes half its revenue from such gambits.)

It is arguable, then, given the evidence, that Robinhood emphasizes more robust trading than reasonable investing. And some believe that so-called push notifications -- behavior nudges -- that pop up on users' screens on the app may encourage trading. And more and more short-term trading. In many respects the app does feel like a smart-phone game. A hand-held casino.

Understandably, Wall Street sharks derisively refer to Robinhood-type customers as "dumb money," precisely because they are unsophisticated, unserious short-term amateurs who are little concerned about company earnings, securities prices, let alone market dynamics. Ironically, these customers are easy prey, not emboldened investors.

And this fact can not be overstated: the more often small investors trade stocks, the worse their returns are likely to be, studies have shown. Moreover, their returns are even worse when options are involved.

As most financial professionals understand, emotion costs you money and discipline make you money.

Like all financial technology, Robinhood's is not immune from the vagaries of technological bugs. The app was down for two days for many users this past March, just as COVID-19 was roiling capital markets. More recently, Bloomberg News reported, that a number of Robinhood customers had their accounts hacked in recent weeks, and they were unable to reach anyone at the company as the intruders liquidated positions and stole the proceeds.

Robinhood users also may face unexpectedly higher taxes. Many brokerage firms offer tax-advantaged accounts, enabling investors to make pre-tax contributions or tax-free withdrawals and defer taxes on gains; Robinhood doesn't offer these types of accounts and its users don't have these advantages. As Robinhood users tend to be very active traders it is conceivable that they are holding on to stocks for less than a year. If users bought into the market this year during its low points and sold later on this year at a profit they may be subject to short-term capital gains -- gains on assets owned for a year or less. But gains on investments owned for a year or more are taxed at a lower long-term capital gains rate. Robinhood does not offer any tax advice. So to the young self-directed user, such tax implications may come as a surprise.

In certain ways, Robinhood is a uniquely American company. Its do-it-yourself (DIY), self-directed, Manifest Destiny ethos is reminiscent of early American character: rugged individualism at the dawn of a new frontier. But this is more touch-screen bravado than Lewis and Clark brawn.

As Robinhood users eventually grow older and are faced with inevitable and serious life-decisions -- getting married, buying homes, raising children, saving for retirement, overcoming health issues -- will their DIY financial behavior prove valuable later in life? Put another way, will they be amenable to, and hence be coachable by, professional financial advisors whose outlook is decidedly more long-term, not short term; whose focus is more planning, less trading? Furthermore, can financial bad habits and speculative ideas learned in youth be corrected early enough to prevent a financial catastrophe later in life?

Tara Falcone, a certified financial planner and the founder of ReisUP, a financial education company, gave NBC this assessment: "I liken [Robinhood] to giving the keys of a sports car to a 12-year-old."

It remains to be seen if Robinhood Financial and its band of rebels-with-a-cause will see its grand ambitions of financial engineering fully play out over the long-term. Social justice threads weaved through a loom of capitalist disruption may never yield a glorious tapestry of equity and fairness. As Facebook well knows. The social media giant this year dramatically diminished its own plans at attempting financial engineering for the good of the globe. "Libra," its crypto-currency, may never see the light of day. Recall its bold mission: "Reinvent Money. Transform the global economy. So people everywhere can live better lives."

Robinhood may likewise prove to be a great pretender instead of a great disruptor. As is said: *caveat emptor*.

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