Is Robinhood a Smart Way to Invest?

By Tanner Bouck

IS ROBINHOOD A SMART WAY TO INVEST?

At the beginning of 2021, GameStop's stock price rose approximately 2,500%, going from $20 to $483 in just over two weeks. Although that is an incredible return if you bought at the $20 price and sold at the $483 price, the risk of losing hundreds of dollars per stock if you bought and sold at the wrong time is more likely. The high of the day for GameStop's stock price just a week after it reached its peak was just above $70, a decrease of 85% from its high of $483. After hearing about this exhilarating return on investment in such a short period of time, everyone wonders, how can I participate in these earnings? Investing is enticing as it may appear possible to make a significant amount of money by simply buying a stock. Figure 1 shows the daily highs of GameStop's stock price over the course of three weeks, which indicates the extreme fluctuation that occurred. This can be exhilarating, but also dangerous due to how quickly a drop-off can occur. As you analyze the figure, consider whether GameStop's stock price should be $483. Market capitalization is a common way to measure the value of a firm. When the stock price of GameStop was $483, the market capitalization was $270.1 billion. The market capitalization on January 4, just three weeks earlier, was $595.3 million. This shows that supposedly the value of this company increased by $269.5 billion in three weeks, without any major change in the company's assets. This is strong evidence of a highly over-valued company.

Figure 1: Data provided by Yahoo Finance

Robinhood is a retail investing app which democratizes investing for all, creating a new and trendy way to participate in the stock market. Some of the draw of using Robinhood is that it is quick and simple to use: download the app, connect your bank account, and start buying stocks with a 0% commission rate. Younger, less experienced investors are joining Robinhood to get a piece of the action, attempting to turn their $20 into $483. However, Robinhood does have potential drawbacks.

The following should be considered before investing with Robinhood:
1.The risks associated with using Robinhood
2.What Robinhood does not tell you
3.The differences between investing with Robinhood compared to other investment firms

RISKS ASSOCIATED WITH ROBINHOOD

Investment strategies in the stock market include speculation and buy-and-hold. Both strategies have proven to be successful; however, both do not have equal risk.

Speculative Risks

Christian Hecker, a Chief Data and Analytics Officer for SAP writes that speculators' "behavior was formed by short-term expectations, mainly based on financial market data. . . . For speculators, market psychology usually was more important than prospects of the real economy." Speculating has exponentially higher risk when it comes to investment strategies. When Robinhood clients use the speculative strategy, the reality is that they can lose a huge portion of their investment. When a new investor signs up for Robinhood and invests in stocks without doing research, this is not mere speculation—this is gambling.

For example, if someone downloaded Robinhood last January and bought four shares of GameStop's stock at $483 a share because their friends told them to, by the end of the day they would have realized that each share was only worth $193. If this person decided to cut their losses and sell the shares before the value decreased any more, they would have lost $1,160 in less than 24 hours. That is a dramatic and extremely unlucky scenario, but it shows the enormity of risk that a Robinhood investor takes on when they invest based on the word of their friends and acquaintances. When a new investor signs up for Robinhood and invests in stocks without doing research, this is not mere speculation—this is gambling.

Buy-and-Hold Risks

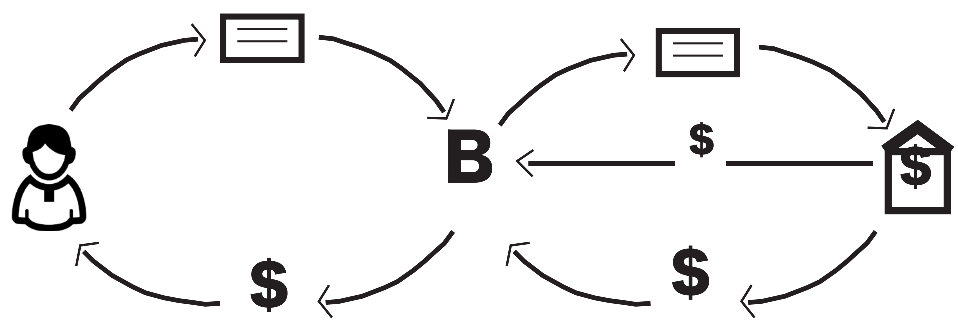
A safer approach to investing in the stock market is the buy-and-hold strategy, which is when someone buys a stock with the intent to keep it for a long period of time. The stock market generally has an upward trend, which makes this a less risky investment if someone analyzes different companies and invests in the ones that aren't tanking. The key to this plan is sticking to it despite daily, weekly, or even monthly losses. If someone buys a share of their favorite drink (say, Coca-Cola) and the price falls over the next few days, it can be tempting to sell the share before they "lose" any more money. However, the proven strategy is to hold strong to the share since Coca-Cola is a long-established and successful company. Most likely over the course of a few years and decades, the money will exponentially grow.

HOW PAYMENT FOR ORDER FLOW WORKS

Retail brokers typically don't execute their customers' orders. Instead they pass the trades to wholesalers like Citadel Securities or KCG that pay them a fee.

1 A customer instructs a broker to execute a stock trade

2 The broker sends the trade to a wholesaler, and collects a fee



3 The wholesaler is required to find the "best execution," which could mean the lowest price, the speediest trade or the one most likely to be completed. The wholeslaer returns the proceeds to the broker, who credits it to the customer.

FIGURE 2

WHAT ROBINHOOD DOESN'T TELL YOU

Investment Information

Most Robinhood users mistakenly think that Robinhood will help them know what companies to invest in. The app lists information that offers inauthentic transparency, such as the top 100 most popular stocks (the ones that move daily and have easy earnings). This information can give misplaced confidence to the uneducated investors. The app also has trends available from the past day, week, month, three months, year, and five years. All of these trends are helpful if someone knows what they are looking for, but for inexperienced investors, this information further encourages full, blind confidence in what the app suggests they should invest in.

James Pasztor, who has decades of experience in the financial planning industry, wrote, "Robinhood is just an easy-to-use caveat emptor mobile trading platform, a tool, and it is up to individuals using the app to be fully aware and informed as to what risks they are taking." Each investor must seek information to make smart, informed investment decisions. Robinhood users should gather data from different sources to decide which stock to invest in and what strategy is most effective for them. This is especially true when these sources are professionals in the industry.

How Robinhood Makes Money

Robinhood earns a large majority of its revenue through payment for order flow (PFOF). PFOF is the compensation that a brokerage firm receives for routing trade execution, meaning the best price at the time of transaction for the share of stock is not always guaranteed. Figure 2 illustrates how a PFOF operates from the customer to broker to the wholesaler or market maker.

PFOF is consistently the way that Robinhood makes most of its profits since its foundation. This practice is widely criticized because the broker is working in a self-interest capacity instead of prioritizing service to their user. This practice is not uncommon because many brokerage firms do the same thing, but the policies of a brokerage firm's PFOF is something to consider when choosing where to invest money.

PFOF can be connected to misleading communication and trading practices. Robinhood received the largest fine ever issued by the Financial Industry Regulatory Authority (FINRA), a government-authorized non-profit organization that oversees US broker-dealers. The fine totaled $70 million for Robinhood's systemwide outages as well as false and misleading communication that defied regulations established to protect investors and the market. Robinhood paid the fine, but it continues to profit from PFOF.

ROBINHOOD VS. OTHER INVESTMENT FIRMS

Robinhood's Simplicity and Accessibility

The ease and simplicity of starting an account with Robinhood has attracted many millennials, with the average age of users being 31. Furthermore, 55% of users are also first-time investors. This in large part is due to its easy-to-use phone app and policies of no account minimums and no commission fees. The only additional service that Robinhood offers for a $5 monthly fee is Robinhood Gold, which has additional investing resources such as professional research and access to margin investing.

Other Investment Firms

A major advantage that other investment firms have is the ability to retain new investors that become experienced investors. Companies such as Fidelity, Charles Schwab, and E*TRADE offer $0 commission on trading stock like Robinhood, but they have more options for working with a financial planner and provide other investment options outside of stock. These companies are more attractive to investors who are looking to diversify their portfolio and are willing and able to pay fees for more services.

CONCLUSION

Investing using Robinhood can be a great tool depending on your knowledge, situation, and investment goals. For some, Robinhood is the best option to avoid paying fees or to invest small amounts of money while they get their feet wet in the stock market. However, before you dive headfirst into investing, decide what your investment goals are, learn the risks associated with your plan of action, and take time to compare firms and stock choices. Although Robinhood may be a perfect fit for some, it is not a perfect fit for all.

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NOTES

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3.Hecker, Christian. 2021. "How should Responsible Investors Behave? Keynes's Distinction between Entrepreneurship and Speculation Revisited." Journal of Business Ethics 171, no. 3 (July): 459–473. DOI: 10.1007/s10551-020-04427-2.

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