Investment Insights
Reddit and Robinhood vs. Investing for the Long Run

Morningstar Investment Management
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For Financial Advisers & Their Clients

Key Takeaways

- The recent meteoric rise and spectacular fall of stocks on Reddit and Robinhood should not present major risks to most investors, we believe, but this market behaviour is still concerning.
- We view equity markets as a vehicle for investors to participate in the potential growth of companies whose stocks are attractively priced. Expecting massive, short-term price increases is speculation, not investing.
- Young people with money to invest would do well to find a financial adviser who can help them develop a financial plan for their savings. Risky stock bets made to brag about on social media platforms might be more entertaining but won't likely serve them well in the long run.

What happened on Reddit and why is stock speculation causing a stir in markets?

Reddit is a much talked about social bookmarking platform, which attracts people in a forum like setting. As a collective, users have been active discussing stock opportunities and engaging in a Main Street versus Wall Street debate. Some people are putting their money where their mouth is, where we suddenly saw some selected small stocks spike tremendously, then fall spectacularly. It's like watching the price of any speculative asset, like Bitcoin—the market can bounce around without much reason.

Specifically fueling the speculation around these stocks were individual traders. Not just any individuals. In fact, we see two trends here. First, social media like Reddit's WallStreetBets and other platforms drove much of the trading of these selected stocks, according to reports. Some sought to squeeze short-sellers, while others were just hopping on a fast-rising stock in hopes it would keep going.

The other trend is the rise of cheap trading and apps like Robinhood in the U.S., which adds gamification elements that we believe encourage more trading, especially among younger, inexperienced traders.

Consider this description of Robinhood by one 18-year-old: "You're able to put it on your homescreen and flip between Instagram and Snapchat; it doesn't feel as serious as it used to … . It's just an app you open up on your phone, there's graphs, and numbers, and it's easy to understand and learn really quickly," Zane Bannink, a high school student, told *The Wall Street Journal*. That doesn't sound like a formula for success for a long-term investor.[1]

1 In fact, the problem may be much larger than just trading. A wrongful death lawsuit was recently filed in a California state court alleging Robinhood Markets was responsible for the death of a 20-year-old college sophomore. According to the complaint by a U.S. based family, their son and brother committed suicide after a $700,000 derivatives trade went awry, although tragically the young man did not owe the money Robinhood suggested in communications to him.

What are the implications for investors?
Well, we don't see major risks at this point for investors, but this is an unfortunate introduction to the market for a new generation.

Regarding risks, these are small stocks that, even after rising 1,000% or more, don't constitute much of the U.S. market. Assuming their prices return to more normal levels, they won't become part of major indexes. We expect these to be blips that don't affect most investors.

That said, we're somewhat concerned about the attitudes of some market participants, who seem to view stocks as get-rich-quick schemes. This perhaps started recently with the atmospheric rises of Bitcoin and fast-growing technology stocks, turning some folks into millionaires (at least on paper). Now there seems to be a hunt for the next pot of gold at the end of the rainbow.

We tend to see that type of next-pot-of-gold thinking rise just before a major market correction. That's not to say this latest activity points to an imminent crash—to say so would itself be speculation.

Still, we've seen time and time again that many people eventually end up losing everything when joining a speculative frenzy (e.g., Tulip mania in 17th Century Holland, the Roaring '20s, Nifty Fifty, dot-com bubble, Great Recession, etc.). This is especially true for novices buying on margin. To make matters worse, many losers often swear off making future investments and miss the potential for building wealth slowly with a more prudent approach.

This is very different from the tried-and-tested approach advocated by investing legends like Warren Buffett, Benjamin Graham, or otherwise. The old days of going to the mailbox to pick up dividend checks and then go to the bank to deposit them are gone. But the cash flows still matter.

Today, investors would be better off learning about the market in this manner, versus from Reddit users offering them get-rich-quick schemes or from a Robinhood-like app encouraging them to frequently trade stocks (not to mention options and cryptocurrencies) through the promise of free trades, push notifications, and bursts of digital confetti.[2]

How might this affect investors in multi-asset portfolios?
We're watching the Reddit WallStreetBets circus from a distance, certainly not participating, with an eye toward assessing whether this social-media-driven volatility is a new risk in the markets, or just the same thing we've seen in past manias (and 1999 Yahoo chat rooms) in a 2021 wrapper.

We look for portfolio managers who have years of experience and follow investment philosophies grounded in fundamental research, with the ultimate aim of figuring out an assets true value. We are not in the business of investing on the thesis that a greater fool might pay an even higher price for a moribund company's stock bid up by a frenzied crowd—much less when the underpinning is a technical dislocation like a short squeeze.

Do you expect this type of frenzied trading to be regulated?
We don't know if regulation will follow—that's a question for lawyers and policymakers. And of course, we don't have any special information on this event and therefore can't comment directly on it. Generally

2 According to the complaint mentioned in footnote 1, "Robinhood built out its trading platform to look much like a videogame to attract young users and minimize the appearance of real-world risk. Though [the family's son] was merely a senior in high school when he opened an account with Robinhood and had little or no income, Robinhood determined he was qualified enough to enter into the world of trading sophisticated financial options."

speaking, market manipulation is already against the law. Pump and dump is already prohibited. Collusion (even in a chat room) is already illegal. Regulators might take a look at the practice of firms participating in this speculative space, and our only hope is that any regulatory change helps empower the long-term financial success of individuals.

How will Morningstar Investment Management navigate through this?

At Morningstar Investment Management, we won't treat the market like a game of Candy Crush. Rather, we'll stick to our enduring philosophy and disciplined approach to investing. We'll aim to build wealth for our clients, not by frequently trading, but by seeking to be long-term owners of profitable and cash-generative assets. That said, if the irrational behavior of others creates opportunities for disciplined, long-term investors like us, we will certainly try to seize them! From Warren Buffett's 1987 letter to Berkshire Hathaway shareholders:

> *But, like Cinderella at the ball, you must heed one warning or everything will turn into pumpkins and mice: Mr. Market is there to serve you, not to guide you. It is his pocketbook, not his wisdom, that you will find useful. If he shows up some day in a particularly foolish mood, you are free to either ignore him or to take advantage of him, but it will be disastrous if you fall under his influence. Indeed, if you aren't certain that you understand and can value your business far better than Mr. Market, you don't belong in the game. As they say in poker, "If you've been in the game 30 minutes and you don't know who the patsy is, you're the patsy."*

Investing is challenging and markets are competitive. We aren't right on every call we make, but we spend hours of dedicated research, analysis, and reflection on every investment we make. We also employ our education, credentials, and years of experience, not to mention a small army of analysts at our disposal, in this endeavor. Even so, we humbly enter the ring (i.e., markets) with great respect for our opponents (i.e., other investors) while striving to maintain our independence. If individual investors are eager to step into the fray, so be it. But generally we think times like these underscore why novice investors should consider hiring a financial adviser who can recommend an appropriate investment strategy that will help them reach their financial goals.

Since its original publication, this piece may have been edited to reflect the regulatory requirements of regions outside of the country it was originally published in.

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