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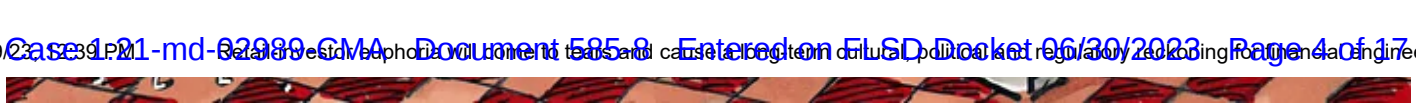
Retail-investor euphoria will come to tears and cause a long-term cultural, political and regulatory reckoning for financial engineering.

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For years, we have studied the ever-intensifying threat of a retail-investor disaster


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The following article was originally published in "What I Learned This Week" on June 18, 2020. To learn more about 13D's investment research, ***please visit our website****.*

Last weekend, Sullimar Capital Group founder Bill Brewster shared a tragic personal story with his Twitter following. His poignant words resonated deeply with us:

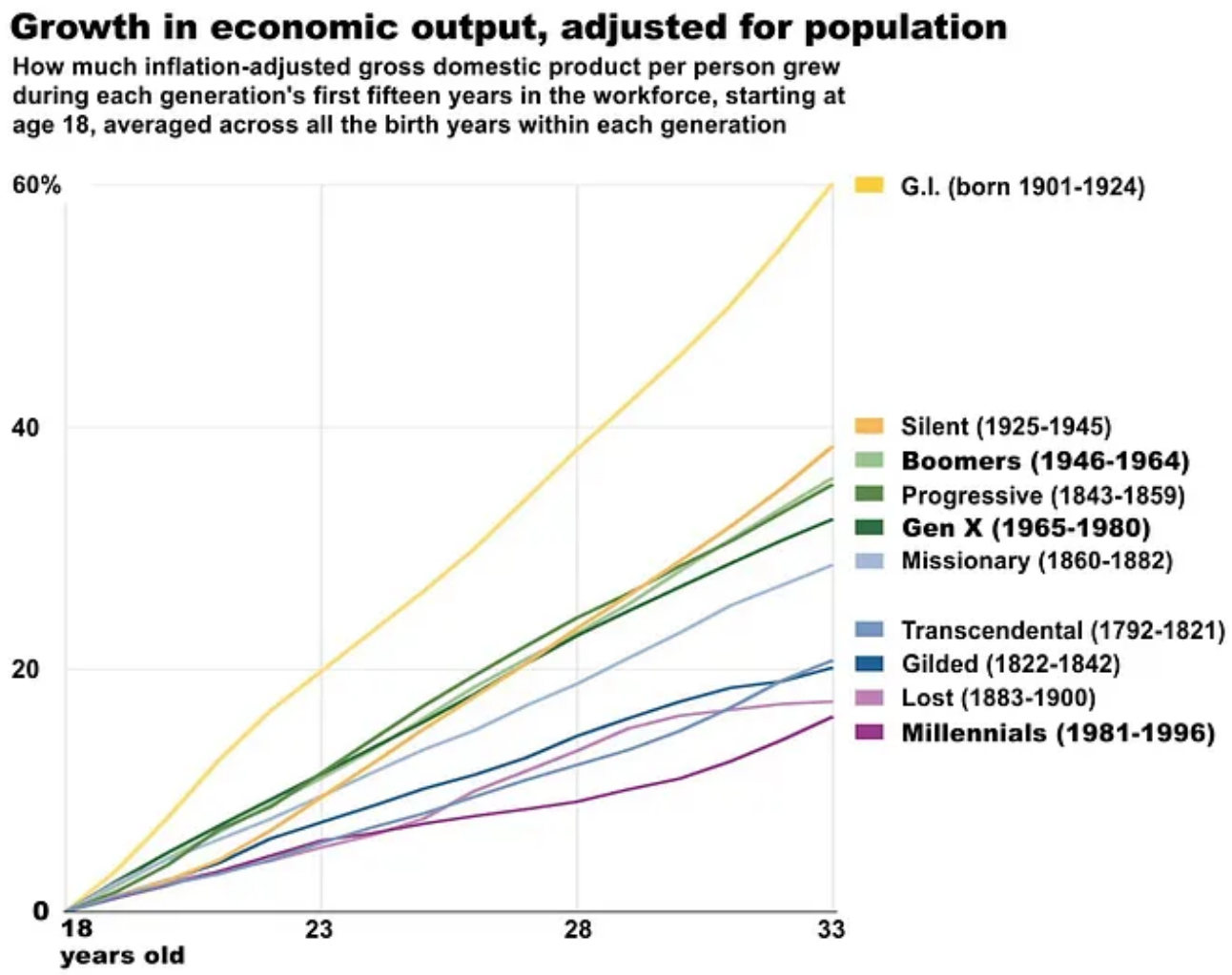
> *This is still really raw and I have more questions than answers. But, it's very important and intersects with what I speak about here.* ***Hopefully my family's tragedy can help another family avoid tragedy****…My cousin in law was interested in investing. He opened a Robinhood account. And, he seemed to be enjoying the markets. As many of us do, or have done, he got interested in options. He believed he had "no margin" selected on his account…So, he began buying and selling options. Fast forward to sometime this past week and his account showed him owing $700k+.* ***How does a 20 year old with no income get access to that kind of leverage/exposure?!****…The emotional stress from the exposure caused him to take his own life.* ***I don't feel right sharing this, but I also don't feel right keeping it from the world.***

For years, we have studied the ever-intensifying threat of a retail-investor disaster (see *WILTW* December 21, 2017). The share of total investments that are self-managed has boomed since the GFC — **in 2016, 103% of net new global flows were from retail investors.** Meanwhile, from volatility trading to double- and triple-leveraged ETFs, **previously-inaccessible strategies and market segments have been rapidly and progressively opened to retail money.**

February 2018's "Volmageddon" gave markets a vivid glimpse of the sudden pain that could ruin underprepared retail speculators. March's COVID-driven meltdown provided another warning, from the USO implosion (see *WILTW* April 23, 2020) to the deep pain suffered by retail investors staked in the $7 trillion market for structured products (ETNs, options-based strategies, etc.).

Yet, despite these red flags, **retail enthusiasm is now at heights seen few times in modern market history.** Evidence of this is apparent from the unprecedented increase in activity on trading apps to the herd behavior that has driven extreme-price spikes for high-risk equities.

A reckoning could begin at any time. As retail investor enthusiasm collapses, it will drag on equity values. But that will likely not prove the most-significant implication. Many of the participants in this rally are young — **the median age of a Robinhood user is just 31.** Millennials are the worst-off American generation since WWII (see *WILTW* August 2, 2018) and have experienced **slower economic growth since entering the workforce than any generation in U.S. history:**



Source: The Washington Post

Millennials and Gen Z appear to be gambling in markets out of financial desperation. And when euphoria inevitably backfires, the backlash will be severe. It could further fuel social unrest, with anger directed at the inequities of financialization. It could trigger a political sea change in November. And **it could instigate a large-scale regulatory reevaluation of retail access to modern market structures.**

In 1Q20, **weekly hours spent in the top-ten stock-market monitoring and trading apps surged 82%**, according to *CNBC*. Online trading platform **Robinhood has reported a 30% increase in members (10 million to 13 million), and a 600% surge in usership.** Comparing 1Q19 to 1Q20, Charles Schwab saw an increase in new accounts of 58%. For TD Ameritrade, that number was 149%. And for ETrade, it was 169%.

How much influence this surge in retail investor activity has had on the recent rally remains up for debate. In a recent note to clients, Deutsche Bank analyst Parag Thatte argued that by overlaying Robinhood trading app data on top of general market activity, it is clear that **"small investors have been behind much of the recent buying."**

Brian Reynolds of New Albion Partners came to a similar conclusion in a client note last week. At nearly $3 billion per day, **equity inflows are now at seven times pre-COVID levels.** Hedge-fund positioning, short

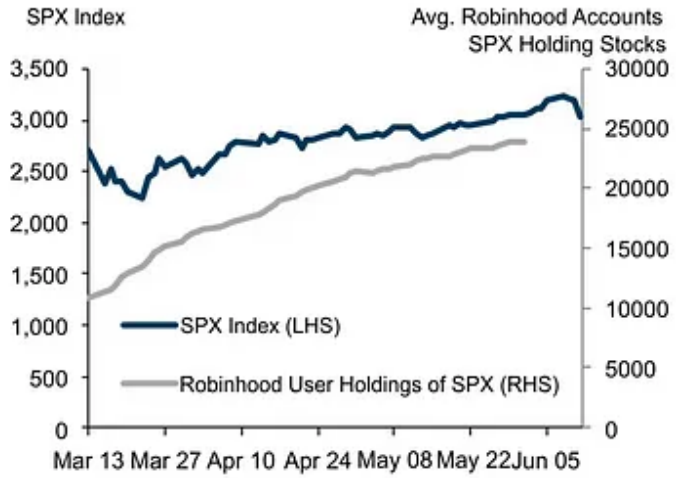
covering, and mutual fund and ETF inflows do not account for the spike, which suggests **"this is people buying individual stocks."**

On the other hand, Barclays analyst Ryan Preclaw has concluded that there is "no clear relationship between Robinhood customers adding shares and S&P 500 index moves." As he argues in a recent report:

> *While it's true that many high-return stocks have had a substantial increase in retail ownership, low-return stocks have also had a big increase.* ***More Robinhood customers moving into a stock has corresponded to lower returns, rather than higher.***

FIGURE 2

The S&P 500 has rallied since mid-March 2020, and Robinhood customer holdings jumped at the same time...



Source: robintrack.com, Barclays Research

FIGURE 3

...but the relationship between customer growth and SPX Index performance is not clear

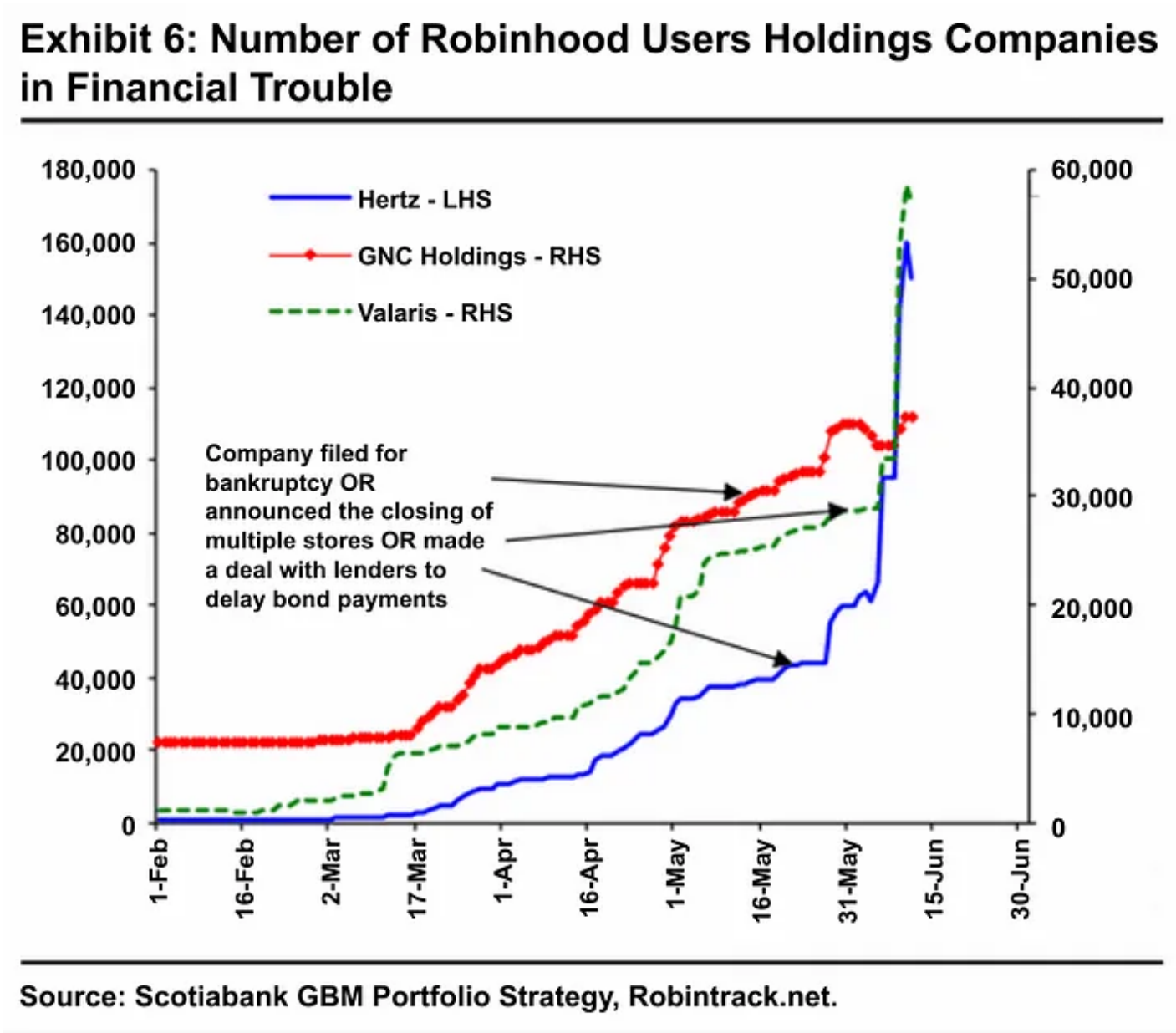


Source: robintrack.com, Barclays Research

Source: Barclays

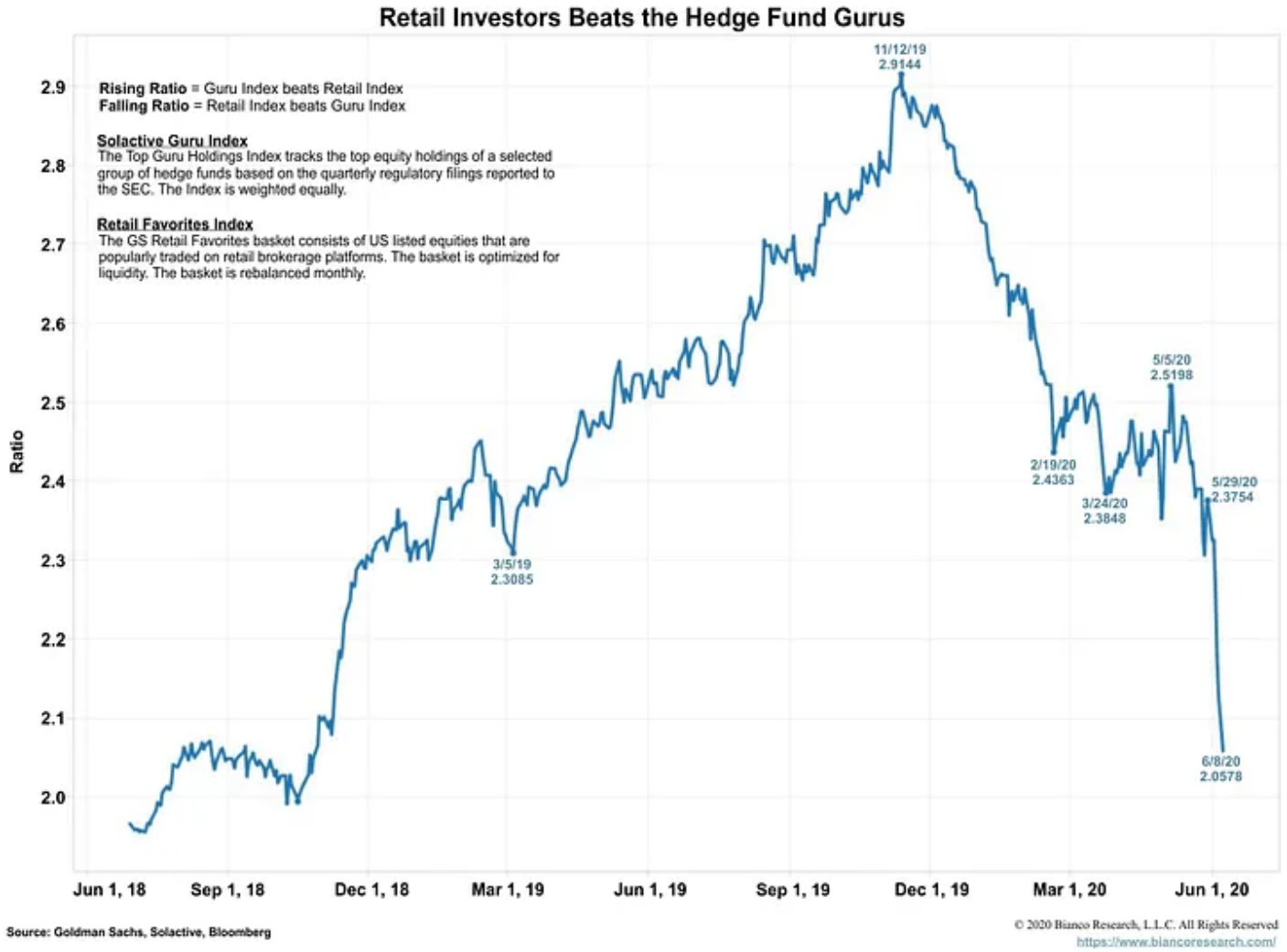
While the surge in retail investing may not have the power to decisively move the S&P 500, **it is clear how much it is moving the highest-risk corners of the U.S. equity market.** Retail investors have herded into "the recovery trade", with the list of most-popular stocks on the Robinhood app dominated by companies hardest hit by coronavirus, from airlines to cruise lines to casinos. **They have also herded into "penny stocks"**, with the 29 stocks in the Russell 2000 that trade below $1 up 79% on average through the week ending last Monday, according to Citadel Securities.

But **the trade that has most-defined the risk-appetite of euphoric retail investors has been "the bankruptcy trade".** Retail investors have driven spikes in the shares of everything from Chesapeake Energy and GNC to Valaris, JCPenney, Whiting Petroleum, and Hertz.



Just last week, 96,000 people on Robinhood opened a position in Hertz. As of earlier this week, Hertz shares were up a staggering 400% since May 26th, the first trading day after Hertz filed for bankruptcy. **Hertz was trying to capitalize on the fervor by issuing 250 million new shares. Then the SEC intervened and Hertz canceled its plans.** Nonetheless, the attempt was a shocking statement about retail euphoria. Hastings College of Law professor Jared Ellias "has studied hundreds of bankruptcies and **never seen a company try to fund a case with an equity offering at the start of chapter 11,**" according to *The Wall Street Journal*.

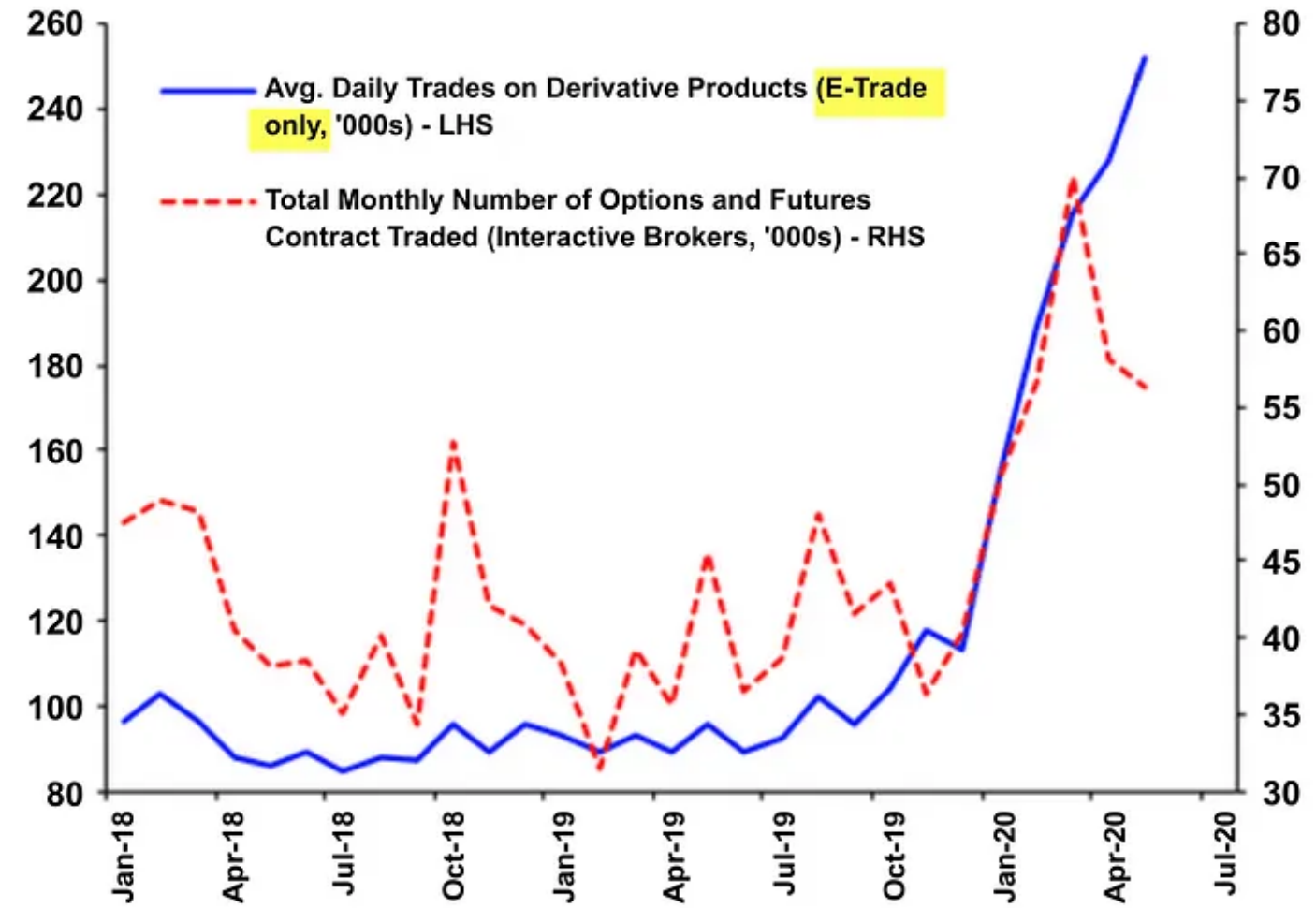
So far, many retail investors have fared well. As the following chart shows, stocks widely held by retail investors have outperformed stocks widely held by hedge funds:



Source: CCN

However, as John Kenneth Galbraith argued, all asset bubbles are inflated by price-trend chasers who believe, "their particular genius…will allow them to get out before the speculation runs its course." **History attests, the vast majority are always wrong.** And the pain will be severe. **Retail investors are leveraging their positions at historically high rates.** According to Sundial Capital Research, two weeks ago, **"small traders" accounted for more than 50% of total new call options, the highest number since the dot-com bubble.**

Exhibit 5: Retail Investors More Involved with Options



Source: Scotiabank GBM Portfolio Strategy, company reports.

Retail-investor enthusiasm has spiked for many reasons. Boredom has likely been a motivation — young people stuck at home with little to do. So has the fact that sports leagues are on hiatus — when there's no live sports, gamblers have to find another venue for gambling. But **one motivation is most concerning: desperation.**

According to software and data aggregation company Envestnet Yodlee, stock trading trails only "increased saving" and "cash withdrawals" as the most-common use for stimulus funds. And the increase in equity buying was the greatest amongst those with limited means. We quote *CNBC*: **"People earning between $35,000 and $75,000 annually increased stock trading by 90% more than the prior week** after receiving their stimulus check."

Consumers that received stimulus checks made stock trades

Categories which saw highest week-over-week changes in bank account transfers, from households which received stimulus checks compared to those that did not

Rank	<$35K	$35K-$50K	$50K-$75K	$75K-$100K	$100K-$150K	$150K+
1	Savings +250%	Savings +197%	Savings +188%	Savings +234%	Savings +223%	Loans +84%
2	ATM/Cash Withdrawals +199%	ATM/Cash Withdrawals +137%	ATM/Cash Withdrawals +102%	ATM/Cash Withdrawals +111%	Securities Trades +82%	Insurance +69%
3	Home Improvement +129%	Securities Trades +93%	Securities Trades +90%	Home Improvement +90%	ATM/Cash Withdrawals +76%	Savings +57%
4	Transfers +126%	Home Improvement +93%	Home Improvement +80%	Education +86%	Loans +70%	Travel +52%
5	Utilities +111%	Transfers +85%	Utilities +68%	Loans +70%	Home Improvement +69%	Home Improvement +52%
6	Electronics/ Gen. Merch. +100%	Utilities +75%	Travel +63%	Utilities +66%	Insurance +66%	Entertainment/ Recreation +48%
7	Education +99%	Electronics/ Gen. Merch. +67%	Electronics/ Gen. Merch. +61%	Rent +64%	Education +61%	Securities Trades +46%

SOURCE: Envestnet Yodlee

CNBC

As we've written previously, **when retail loses big money, watch out** (*WILTW* March 26, 2020). The more retail investor speculation escalates to unsustainable extremes and the financially-fragile get swept up by the euphoria, **the more a cultural, political, and regulatory reckoning appears near-inevitable.**

The following article was originally published in "What I Learned This Week" on June 18, 2020. To learn more about 13D's investment research, ***please visit our website****.*

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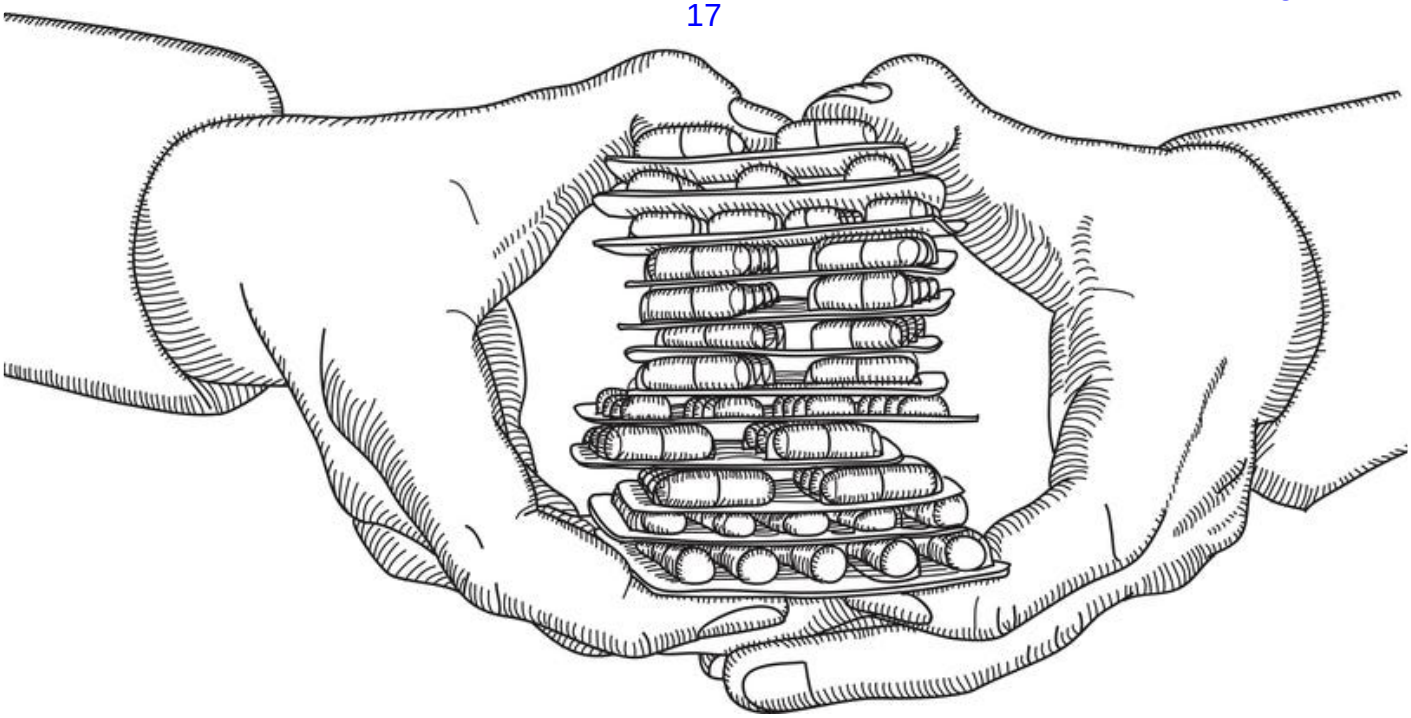
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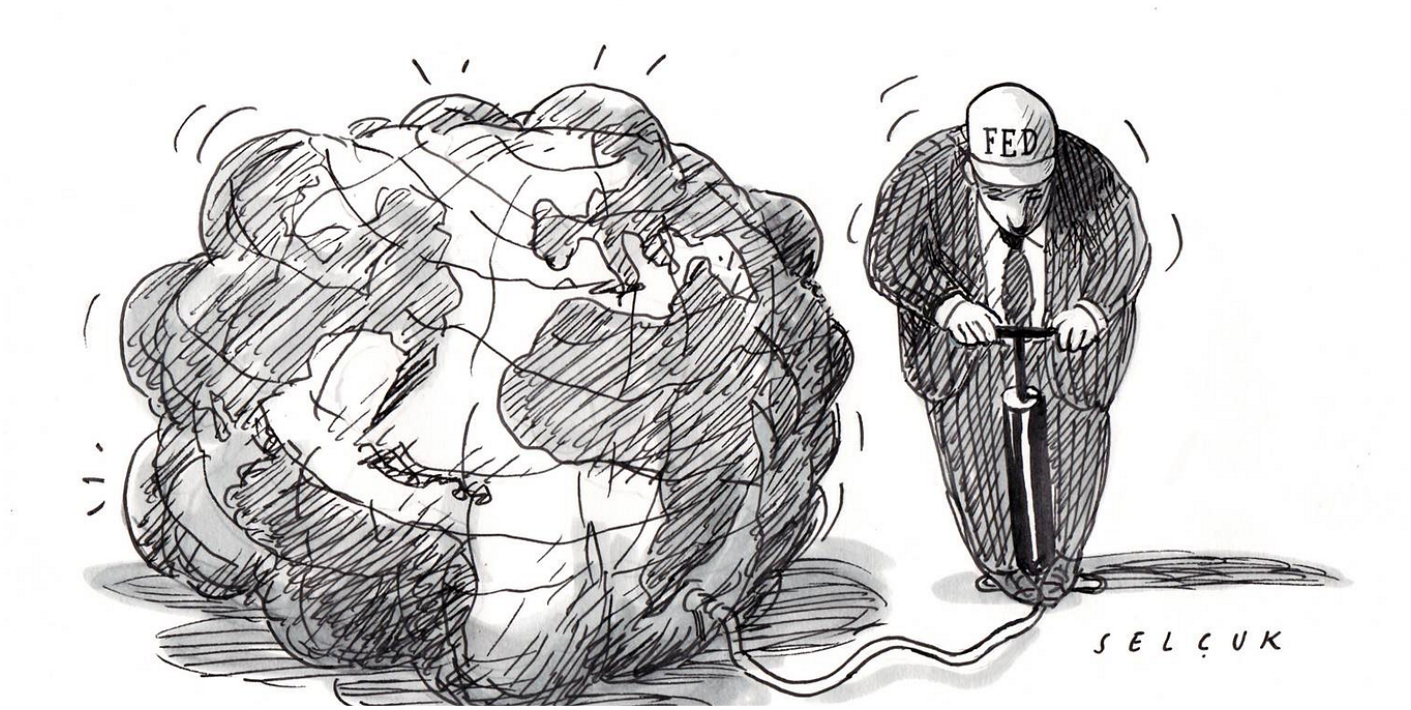
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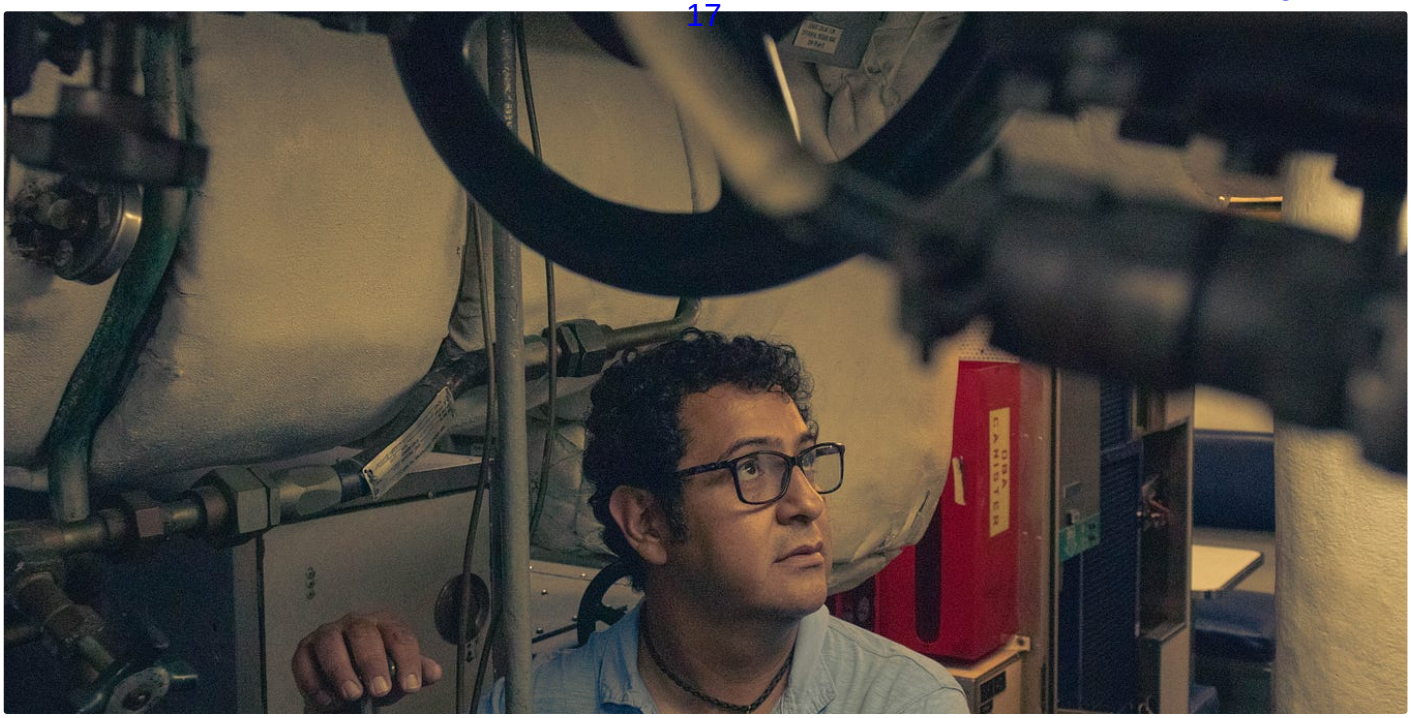
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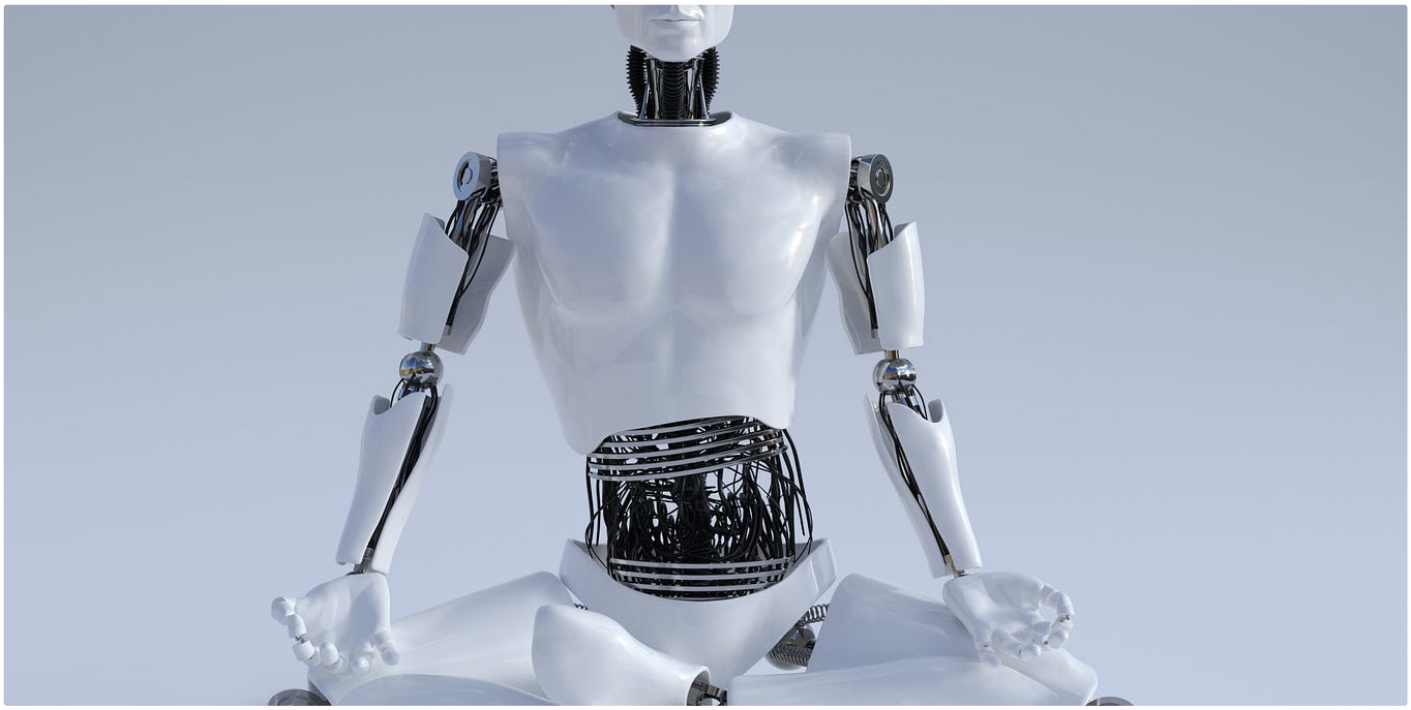
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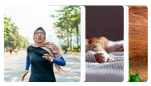
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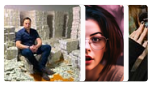
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