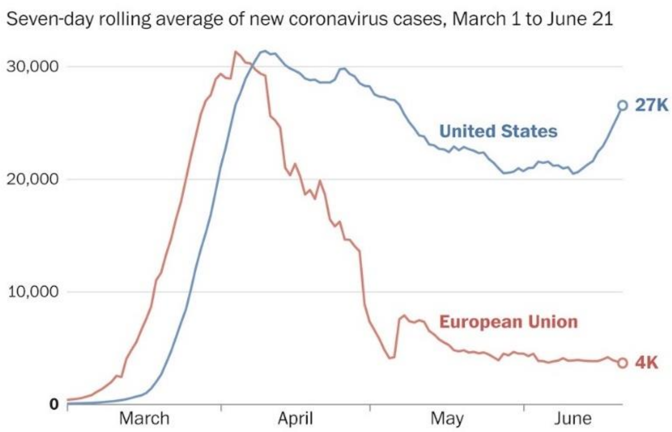
Be Careful Out There

Recent days have brought into sharp focus a lesson that is always good to keep in mind: nobody is looking out for you, so you should be vigilant in protecting yourself.

First our Surgeon General tells us in February and March not to buy masks or wear them out in public, but now he's telling us that we should. First our President tells us that the coronavirus will miraculously dissipate as the months tick by and warmer weather sets in, implying there was not much need for countermeasures such as social distancing or lockdowns, but now we can see that was nowhere near the truth. First the lieutenant governor of Texas in March and April tells his constituents that his state's economic well-being is more important than their health and even their life, but now the governor is urging Texans to stay at home as much as possible.

In short, many of our leaders have failed miserably and spectacularly in one of their most important jobs: protecting the life and health of American citizens. A picture is worth a thousand words, and this graph does a great job in comparing the effectiveness of American leaders with their European counterparts over the last few months:



source: Washington Post, Johns Hopkins

But this is not a public health column. This is a column on investing, and—wouldn't you know it?—there are plenty of recent examples showing how no one is looking out for us on that front, either.

What's the German Word for WhoCouldaKnowed?

Our first story comes from Germany, an advanced society with the fourth-largest economy on Earth and a stock exchange that's home to trillions of dollars' worth of capital. And even though it has an otherwise-respected financial regulatory authority (Bundesanstalt für Finanzdienstleistungsaufsicht, or BaFin for short), and several investigative journalists and short sellers had been calling attention to a potential fraud for the last couple of years, regulators not only turned a blind eye to it but actually enabled the wrong-doers. Well, in June it finally came to light that the journalists and short sellers were right, and now the list of entities with egg on their face is not short.

The specifics of the story are not terribly important for the lesson of this article, but suffice it to say that a publicly-traded German company named Wirecard has been perpetrating a rampant accounting fraud for the last several years. When the truth was finally openly acknowledged a few weeks ago, it was discovered that €1.9 *billion* in cash that Wirecard claimed to have in the bank *never existed*. We're old enough to remember the accounting shenanigans of twenty years ago from Enron, Worldcom, and others, but for a company to *invent* two billion dollars' worth of cash? That's a level of brazenness we were unfamiliar with.

As we write these words, Wirecard's stock is down 75% today, 97% in the last week, and 98% from its high last year. That is *a lot* of wealth wiped out for Wirecard shareholders.

BaFin not only ignored the warning signs, but it actually took Wirecard's side and launched a criminal investigation of the Financial Times for reporting on the fraud. The entity that is supposed to act as Germany's regulator, protecting the interests of German investors and cracking down on malfeasance, actually attacked the good guys who were trying to protect Wirecard's shareholders!

The Frankfurt stock exchange, Deutsche Börse, also enabled the fraud to continue by not only allowing Wirecard's listing to stay active but by including it in the premier German equity index, ensuring that it was not only Wirecard's direct shareholders that suffered but many individual investors who were just trying to diversify themselves.

EY, the accounting firm formerly known as Ernst & Young, served as Wirecard's auditor. How is it possible that EY was not able to verify the cash that Wirecard claimed it had in the bank? Why did EY sign off on any accounting presentations which included this fake cash?

German financial media, including the otherwise-respected Handelsblatt, also helped the fraud along by repeating Wirecard and BaFin talking points without critical analysis of the other side of the argument. Even our own CNBC got in on the act by hosting Wirecard's former CEO several times over the last couple of years, allowing him to refute the fraud charges with minimal pushback.

For Sale: Bridge in Brooklyn

Here in America we have another excellent object lesson that nobody is looking out for you in the story of Hertz. As the virus swept the globe, slashing travel budgets everywhere, airlines, hotels, and rental car agencies like Hertz felt the pinch.

Hertz was pinched so much, in fact, that it was forced to declare bankruptcy. This simply means that Hertz became unable to make its debt payments. In other words, Hertz borrowed money from investors in the form of bonds, then Hertz would make semi-annual interest payments on those bonds every six months, culminating in a return of the bondholders' principal upon the bond's maturity. When Hertz realized that it was not earning enough money to make those payments, it sought protection from its creditors in the form of bankruptcy.

So far, so good. This is how capitalism is supposed to work. Investors take risks by lending money to companies. Most times, investors are rewarded for that risk in the form of periodic interest or dividend payments with the eventual return of their principal. Sometimes, though, the company goes belly up and the investors have to take a loss.

Bondholders usually take a partial loss on their investment in the event of bankruptcy. Instead of receiving 100 cents back for every dollar they loaned a company, they might only receive 20 cents or 40 cents back. Stockholders, however, are lower in seniority to bondholders. Stockholders are only entitled to get their money back once bondholders have been paid off in full. Therefore, in most bankruptcies involving public companies, the price of the stock goes to zero and equity owners are thus completely wiped out.

With us so far? Companies sometimes go bankrupt, which forces bondholders to take a partial loss and usually wiping out shareholders. OK, fine. Here's where the story gets crazy, though.

Some of us have used the virus-related lockdown time to take up new hobbies, and certain segments of younger Americans have revived the playing-with-financial-dynamite pastime of day trading. When day trading occasionally comes back into favor among a new generation, these unsophisticated traders usually gravitate toward penny stocks. "Why use my $1,000 to buy 3 shares of Apple when I can buy 20,000 shares of this other thing nobody has heard of?"

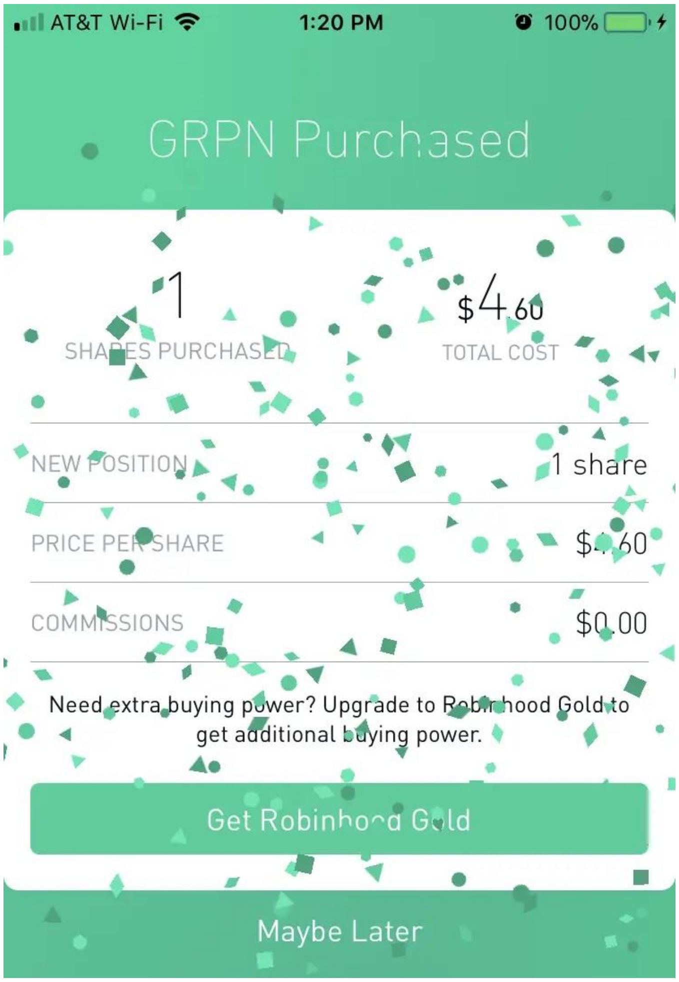
Hertz, which traded at $20 per share in late February, declined to less than $1 by late May when bankruptcy loomed. Day traders noticed this and thought Hertz shares might be a good purchase for just $0.60 each. There are only so many shares of Hertz available to trade, and when the demand for something goes up while the supply remains the same, the price has to adjust accordingly. Hertz's stock started to rise precipitously, going above $5 in early June: a nearly 10x increase in about a week!

Hertz bondholders noticed this increased appetite for the stock, and what do you suppose they did? Well, with the cash the company had on hand, Hertz bondholders knew that they could only expect to receive a partial payout of their principal. They also realized that, if Hertz was able to sell more shares to the investing public, then Hertz would have more cash on hand, and bondholders would then receive a higher payout. So they pushed Hertz to sell more shares.

Fortunately, the Securities and Exchange Commission stepped in to stop this ludicrous stock sale before it could happen, because every single dollar coughed up by new Hertz shareholders would have become almost immediately worth zero, with every bit of it transferred to Hertz bondholders. Sure, capitalism is a brutal dog-eat-dog world, but come on. Just because you *can* take candy from a baby doesn't mean that you *should*.

Your Own Worst Enemy

And speaking of day traders, we have saved our saddest cautionary tale for last. The platform many members of the millennial generation have turned to for trading stocks is called Robinhood. This app does not charge any trading commissions, has very low account balance minimums, and it even gamifies trading. Check out this screen shot after a one-share purchase of Groupon, complete with flying confetti:



source: Business Insider

Robinhood has grown in a big way during the coronavirus, adding 3 million new accounts in the first quarter of 2020. Many of these new accounts represent people who have never invested before. Robinhood allows these unsophisticated investors access to some very sophisticated and potentially dangerous tools, such as margin and options. A new investor who has not had the proper training to handle these tools can very quickly and very easily get wiped out, or worse.

Alexander Kearns, a college kid in Illinois, was having a lot of fun playing around with his Robinhood account earlier this year. He was buying and selling stocks at first, but then he discovered options, and then he discovered how to combine options. He was using a certain combination known as a bull put spread, which simultaneously uses two options. An option can obligate an investor to purchase a stock in certain circumstances, so trading platforms such as Robinhood are required to hold money back from an investor's account—at least virtually—to account for the potential purchase.

Alex apparently did not realize that this money was only virtually being held from his account, so when he logged in on June 12 and saw that his account had a negative $730,165 balance, he feared the worst. He wrote his family a brief note of goodbye, and then he stepped in front of a moving train. He is now gone forever.

Conclusion

Even though the calendar says we're in the 21st century, it's like the Wild West out there in so many ways. Nobody is looking out for you in the way you would look out for you, so use your own brain and make your own decisions. Be careful out there. And, for goodness' sake, wear a mask!

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