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The sleazy world of day trading

by Richard Freeman

On Aug. 9, the North American Securities Administrators Association (NASAA), an organization of state securities regulators, released a report based on a seven-month study of the volatile practice of day trading, which concluded that day-trading firms require closer supervision, and must do a better job of screening potential customers. It also presented a report, "An Analysis of Public Day Trading at a Retail Day Trading Firm," which showed that 70% of the day traders utilizing the firm lost money. Moreover, for the 70% of traders losing money, the risk of ruin—i.e., losing everything—was 100%.

The press conference at which the report was released came less than two weeks after the July 29 rampage by Mark Barton, a mentally unstable day trader in Atlanta who killed nine people working at day-trading firms, his wife, two children, and himself. Reportedly, Barton built up losses of more than $400,000 in day trading. The firms that Barton traded at, and carried out the killings at, All-Tech and Momentum Securities, are featured in the NASAA report.

David Schellenberg, chief of licensing at the Massachusetts Securities Division and chair of the NASAA task force on day trading which released the report, stated, "Day trading isn't investing, it's at best speculating. Most traders will lose all of their money." Peter Hildreth, president of NASAA, said, "We found problems at all the firms we examined." The problems involved marketing, suitability, loan arrangements, supervision, and traders trading with other people's money. Hildreth said that marketing by day-trading firms is often "irresponsible and predatory," and frequently amounts to "hucksterism."

In the United States, there are 62 day-trading firms with 287 branch offices. According to the Electronic Traders Association, there are 3-5,000 people who are full-time day traders, and another 225,000 who trade part time over the Internet, with day traders accounting for 8-15% of the daily volume of the NASDAQ stock exchange.

The NASAA report makes clear that some of the day-trading firms are like gambling dens, and that some of the operators who run day-trading firms are bottom fishing, looting the individuals who are lured in. There are several abusive practices outlined, but the NASAA report avoids the most compelling point: that day trading is just an outgrowth of the speculative financial system that dominates America, of which the derivatives market and the mainstream stock market are the two most important examples. The day traders exemplify the lower-level character of a human being who, driven by a compulsive belief that he can make it big in a "new lifestyle" of money-making, enters the lower end of the stock market-gambling food chain. A small percentage of day traders of a certain type, have success; most are bankrupted within less than two months.

Day traders attempt to make profits on small changes in the prices of stocks. They are known as day traders because they close out their positions by the end of each day. For example, let us take a day trader who makes a trade in which he buys Stock A at 20 1/16, and sells it at 20 2/16. He has made 1/16 of a dollar, or 6.25¢. To make $1 in trading, he must trade 16 shares of Stock A. The fee charged by a day trading firm to allow the trader to make the trade is often $25 per trade. So, the trader must trade 400 shares (16 × 25) to cover the $25 fee he must pay to the day trading firm, just for using its facilities. If he wishes to make $25 in profit, he must earn $50. This requires the trader to purchase 800 shares of Stock A, at a purchase cost of $1,605, just for the trader to make a $25 profit for himself.

For the day trader to earn $250 for the day, he would have to make 10 successful such trades, and avoid any unsuccessful trade (or something equivalent to that). The odds of that happening are very small.

The day-trading company furnishes the day trader with space in an office, a terminal, on-line trading connections to an electronic commerce network, and usually, a few days of trading courses, which frequently involve trading strategies. Some firms provide traders with computer software so that the trader can trade from home.

The average day trader, according to a study by NFO Worldwide, makes about 260 trades a year, some 11 times more than the activity of the average on-line investor; but some traders are much more active, at times making more than 100 trades a day, according to the day-trading firm Momentum Securities.

Most day traders lose money

Most day traders are taken to the cleaners.

The day-trading firms charge fees for permitting the day trader to make a trade, usually in the range of $15-25 per trade. The person who becomes a day trader usually puts up $30-75,000 to start with, to become a day trader with a firm. The trading and other fees that the trading firm assesses, begin eating into the trader's capital.

The firm that the NASAA study selected for study was All-Tech Investment Group, of Montvale, New Jersey. All-Tech is one of the biggest day-trading firms, with 23 offices in 15 states. The study assessed the effect of trading and other fee charges at All-Tech. It reported, "This initial analysis covered all trading in the 30 accounts (4,339 trades), over trading periods of between 1-10 months. . . . The average account was open four months, [and] had a . . . cost/equity

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ratio of 56%. . . . The annualized cost/equity ratio measures the amount of profit required on average equity [i.e., the capital the trader has], *just to pay transaction costs and break even*. Few traders can absorb transaction costs of 56% per annum and be profitable on a consistent basis" (emphasis added). Whether a trader calculates the cost/equity ratio, he certainly feels it.

The study started by scrutinizing a sampling of the records of 30 accounts traded at All-Tech, but after sorting out individuals who held more than one account, it focussed on 26 accounts. Of the 26 accounts, it found that 18, or 70%, lost money. Of the eight accounts that were profitable, it found that five accounts were traded in such a manner (largely depending on one trade to make a lot of profit) that they ran the risk of ruin. Thus, only three of the 26 accounts analyzed met the investment criteria to be profitable over the medium term. This represented just 11.5% of the total accounts.

However, of the 70% of the All-Tech accounts analyzed that lost money, the crucial point is that all of them ran the "risk of ruin," that is, of losing every penny in every one of the accounts. The study concluded, "In fact, this study shows that 70% of the public traders analyzed will not only lose money, but almost certainly lose everything they invest."

NASAA reported that in the case of one firm, Block Trading of Massachusetts, according to testimony by a former branch manager of the company, 67 of the 68 accounts in a branch office lost money.

A national survey of the profits/losses of all the accounts of all day-trading firms, does not exist, almost exclusively because the day-trading firms will not allow such a survey. But, it is probably a conservative estimate to say that 50-70% of all day-trading accounts fail; they usually fail within two months.

The abuses

How does someone get attracted to day trading? Consider one come-on placed on the website of All-Tech: "Electronic Day Trading appeals to executives, *victims of downsizing or layoffs, retirees, graduating college students* and anyone who recognizes the unlimited earnings potential and quality of life which an Electronic Day Trader may achieve. Trading allows people to work a 6½ trading day, to take vacations on demand, and to leave for the day on a whim."

Thus, the day trading firms try to bring in retirees, victims of layoffs, and college students, who usually have no knowledge of the risks involved. Even traders who have years of experience can build up big losses in a volatile market. Novices, who may be given a two-day training course, have little chance of surviving—and that's before the various fees which consume 56% of their capital. Yet, the come-on makes it sound like day trading is a successful life, where you have little authority over you, where you can call the shots on when you work, and so on.

State regulatory authorities have documented instances in which day-trading firms, recognizing that individuals are below the income and net worth levels that would make them suitable candidates for day trading, have simply doctored the application forms. For example, Massachusetts authorities brought a case against a company based in that state, Landmark Securities. A manager of a branch of the firm allegedly misreported information on an account application. The manager reported the income of an individual signing up to be a day trader to be $25,000, when it was actually $15,000. The net worth was reported as $50,000, when it was only $10-15,000. The manager checked the box that the individual had investment experience, when the individual had none. Before signing up an individual, according to National Association of Securities Dealers rules, an investment firm must determine beforehand if an individual is a suitable candidate for the investment being offered, because it may be too risky. With a non-suitable individual, this firm simply misrepresented the individual's financial status, and signed him up anyway.

The NASAA, in another study entitled "Day Trading Project Group Report: Findings and Recommendations," also released on Aug. 9, reported that many day traders take out margin loans in order to increase their trading earning returns. However, it is a commonplace occurrence, the NASAA report says, for a day trader to incur a loss that exceeds the pledged equity in his margin account. The day trader receives a margin call, to put more funds into his account, restoring it to an acceptable level. Were the day trader not to meet the margin call, by Securities and Exchange Commission regulations, the account is closed. At this point, the day trading firm would lose an account—an account on which it could charge fees.

So, the NASAA report documents, day-trading firms arrange for day traders who cannot meet their margin call to borrow from "third parties." However, as the NASAA report identifies, some of the "third parties" from whom loans are arranged may not legally be permitted to make such loans. In the case of Landmark Securities, it arranged overnight loans that typically charged a daily interest rate of 0.1%, or 36.5% annualized. The NASAA report calls this a usurious loan, and states, "Massachusetts law prohibits the making of loans with interest rates in excess of 20%." By arranging loans with such high interest rates, the day trader is thrown deeper into debt. The day trader is hit coming and going.

The NASAA Analysis of Public Day Trading study notes that while most experienced traders stay with rising positions for a few days, and cut their losses as quickly as possible, the day traders at All-Tech did the opposite, holding losing positions too long, and selling too quickly out of rising positions. Led by their desire to make money quickly, and end up on Easy Street, instead, they end up on Skid Row.

The supposedly 'smart investor'

While NASAA quite accurately dissects the dark and sleazy day-trading practices, it also obfuscates a fundamental reality. As well, it makes an unexpected admission.

In "Day Trading Project: Findings and Recommenda-

tions," the NASAA states, "The very existence of an industry devoted to offering day trading of stocks is paradoxical. For those who wish to speculate, futures and options provide much greater leverage than stocks. . . . Futures and options [i.e., derivatives] also provide the ability to speculate on the direction of the market, rather than on the price of individual stocks. *In short, futures and options may be more effective speculative trading vehicles than stocks*" (emphasis added).

This is a rare, and damning piece of candor. The NASAA report labels day trading as "gambling"; and, it counsels that futures and options are "more effective speculative trading vehicles." By NASAA's own admission, options and futures are a more effective form of gambling. *EIR* has long charged that dealing in such instruments is gambling.

But, NASAA puts great stress on what it sees as a fundamental distinction between day trading and "mainstream" stock investing. It dons high moral tone against day trading. The NASAA report cites a 1985 article in *Forbes* magazine, which states:

"If you could make good money with short-term approaches, there would lots of visible folks who had done so.

"Take a look at John Train's book, *The Money Masters*. One thing you will see in common among the big successes—is that they bought stocks to hold for several years or longer."

The claim that holding stocks longer is a more stable strategy, is certainly accurate. But, look at the man cited as an authority. John Train is part of the filthiest, most illegal part of the intelligence apparatus on Wall Street. He coordinated dirty activities against Lyndon LaRouche, as a leader of the Federal, state, and private multi-agency "Get LaRouche" task force. He is hardly an exemplar of moral rectitude.

While some of the specific day-trader practices may not go on, in that form, at bigger Wall Street firms, many practices of large firms are cumulatively far worse. The proprietary trading desks of firms ranging from J.P. Morgan to Citigroup Salomon Smith Barney to Goldman Sachs, carry on day trades with powerful computers that dwarf whatever the average day trader does. Using derivatives, they can often guarantee the outcome of a successful trade. If they fail, as did Long Term Capital Management in September 1998, the Federal Reserve Board will intervene to ensure that they are saved.

Most important of all, day-trading activity is simply the outgrowth of the ongoing stock market bubble, which is run and manipulated by "mainstream" Wall Street. No day-trading company could exist for one second, if the Wall Street bubble were not functioning.

Day trading is simply a lower-level vehicle for financially reducing to poverty an investor caught up in the compulsive drive to make something for nothing. It reflects the gambling psychosis that has gripped America. Its abuses should be strongly addressed, but the cause for those abuses lies at a higher level.

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