BUSINESS INSIDER

Retail investors are revolutionizing the stock market. So stop calling them 'dumb money.'

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Are you "dumb money?" I am. You probably are too. Wall Street institutions — so-called "smart money" — usually throw around the phrase to describe investment activity they don't like. And by "dumb money," they usually mean individual, or "retail," investors.

Retail investors are big news these days. Retail trading has surged, buoyed by apps, zero-commission trading accounts, and, some argue, limited entertainment options during the COVID pandemic. Wall Street has been griping about how "dumb money" upsets the market's balance, bringing volatility and overinflated prices. And others are voicing concerns that retail investors cannot understand investment risks and will hurt themselves. Both have led to calls, heard by the SEC, for more regulation of retail investor market access.

But placing obstacles to market access for retail investors is a mistake. Retail investors are important participants in our markets, and lowered barriers to their participation should be celebrated. No matter who calls them "dumb money," retail investors deserve the freedom to make their own trading and investment decisions.

"Dumb money" isn't so dumb after all

First, let's put the term "dumb money" to rest. It's insulting and invites criticism about retail participation in the markets. It also implies a homogeneity to retail investing behavior that does not exist.

Retail investors should be recognized as important market participants. Like their institutional counterparts, retail investors provide market liquidity. The fact that retail investors behave differently from institutional ones, and sometimes behave differently from each other — far from being a bad thing —can be valuable in times of market stress. Having diverse strategies represented in the market can cabin wild market movements by decreasing herd behavior and allowing better matching of buyers and sellers.

Wall Street institutions complain that retail investors cause irrational market swings, but this claim doesn't hold up. Although approximately 38% of total U.S. equities are held by households, retail stock trading rarely moves the market. Most retail trades are too small, and individual decision-making results in diverse trading strategies.

Of course, there are exceptions. Those exceptions — like recent retail investment in Hertz and Kodak — tend to make headlines because they are unusual. On the whole, Wall Street should question its views, not amp up its criticism.

For instance, retail investing was much wiser in 2020. Non-institutional investors nailed the market bottom according to Societe Generale and generated better performance than a lot of hedge funds according to Goldman Sachs.

Retail investing is growing, but not overwhelming

Approximately 20% of market trading volume is now attributable to retail orders. This trading volume is a substantial increase over 2019, but retail's growing market presence is not new. From discount brokers in the 1970s to online trading in the 1990s, retail investors have flowed into the market whenever barriers to their access have decreased.

The adoption of zero-commission trading accounts by mainstream brokerages in late 2019 — following Robinhood's commission-free trading model — is widely viewed as sparking the retail investor boom, but other changes have also contributed. Tweaks to trading platforms such as fractional share trading, lowered account minimums, and app-based trading interfaces have all opened up retail trading.

These changes should be applauded for making it easier to invest with smaller amounts of capital. Although approximately 53% of households held stock in 2019, according to the Federal Reserve's Survey of Consumer Finances, stock ownership is strongly correlated with household income, education, age, and race.

Investors who have historically been left out of the markets are disproportionately jumping in now. For example, the median age of Robinhood customers is 31, and more than half of the new clients opening accounts at Charles Schwab since 2019 are under 40. More than half of Robinhood's new accounts in the first half of 2020 were opened by first time investors. And the average account size at Robinhood, for example, is estimated to be quite small, suggesting that those with lower household incomes are investing.

Whether you call this "democratization" or something else, expanded access gives individuals a chance to build wealth through the market, something traditionally viewed as reserved for the already wealthy.

No, it's not "gambling"

Still some investor protection advocates, pointing to the dismal state of financial literacy in this country, worry that those new to investing—or those enticed by more "fun" aspects of app-based trading—will make poor decisions. That's not a reason to create obstacles to market access.

The emphasis instead should be on empowering retail investors to make their own, informed, decisions about how to invest their money.

Although financial literacy may improve naturally as more people invest, investor education need not passively rely on exposure. While the SEC has an important role to play in promoting financial literacy, it doesn't stand alone. Some brokerages also have enhanced their investor education offerings in response to increasing retail interest. These efforts to help individuals—especially those new to investing—understand the risks of short-term trading and investing in complex products and the benefits of diversification will support, but not interfere, with their ability to invest.

None of this is to say all brokerages are without regulatory issues. Regulations govern many aspects of retail participation, like investing in options or on margin, and brokerages not meeting existing requirements may need reform. But when faced with increased retail investing, we should not create new regulatory requirements that push those investors back out of the markets.

The headlines should celebrate growing retail investor participation in the markets, not deride "dumb money" for investing. A focus on education — not taking investment opportunities away — can help individuals to take full advantage of the opportunities the markets can offer and help banish the phrase "dumb money" for good.

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