Why real estate is the best investment

What I Learned On Wall Street - Why Real Estate Is the Best Investment

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By Lex Levinrad

Part One
My Story

Chapter 1
The Boiler Room

If you have seen the movie “Boiler Room” then you would think that it plays like fiction. Well unfortunately I got my start on Wall Street in Chicago in 1991 working for a small boiler room outfit that was not that different from the movie.

I had just completed a short stint at the Chicago Board of Trade as a trading clerk in the Ten-Year Treasury Note Pit, and had decided that I would like to pursue a career as a stockbroker.

I answered a small classified ad in the Chicago Tribune that offered a job with a brokerage firm. Upon completing the interview process I learned that in order to be a broker I would need to complete the Series 7 license. I was offered the chance to study for the exam and upon completion would be allowed to be a stockbroker with this firm. The position did not pay a salary and was commission only. There was no salary draw but we were told that some of the brokers in the office were making six figure incomes. I was fascinated by the idea of working as a broker on Wall Street. It seemed like the perfect career for me. Like most brokers I could recite verbatim lines from the movie “Wall Street”. I had also read countless books about the stock market. Books like “Market Wizards” by Jack D. Schwager, and “Reminiscences of a Stock Operator” by Edwin Lefevre.

I spent the next two months studying for my Series 7 Exam. I was very eager to learn about investing. Unfortunately the exam did not cover investing at all. Rather it focused on things such as whether or not an investment was suitable for a client and various regulations. The exam itself was administered on a computer and was in a multiple choice format. Two months later freshly armed with my Series 7 license I sat in a room of around twenty new brokers. Our first lesson was about sales. We had a sales manager who was explaining to us the intricacies of cold-calling and how this business was really just a numbers game. The more people we cold-called the more likely we would find a new client that had some money to invest. We were told that if we called 250 people a day we could expect a 2% response rate meaning we would find 5 people that were willing to talk to us. If we managed to get one of these people to open an account then we would be opening a new account every day. We were instructed that if we could open 20 new accounts a month we would do very well in this business.

I asked what investment we would be recommending and was told not to worry about that for the time being. For now we were to practice scripts about a particular stock that the company was selling. We were instructed to cold-call 250 people a day from leads that were provided to us by the firm. These leads were people that supposedly had a net worth of over $500,000 but from what I could tell it seemed like a list of homeowners. After sitting in a sales meeting for two hours we were “turned loose” and instructed to start calling people. None of us knew what to say so we started out by listening to the more established brokers calling leads and we tried to mimic them as best as we could.

After a week of spending the morning in a sales meeting and the rest of the day on the phone we were finished with our training. No one had bothered to tell us a thing about investments, stocks, bonds etc. The only reason we knew the difference between a stock and a bond is because we had learned it for the exam. Less than one week into the business I was on the phone trying to persuade some stranger to buy 1,000 shares of some company I had never heard of before. The stocks that we were recommending were listed on the “pink sheets”. They were not even on a listed stock exchange and so they did not appear on any quote machine. I wasn't even sure that they existed. The price of the stock was marked on a blackboard at the front of the office and every now and then the manager would walk up to the front of the room and change the price a little higher.

My first sale came a week into the business. We were very excited about the prospects of this company that we were pitching. The price of this stock had moved up from about 80 cents to $1.08 in the past few days. Every day that I looked at the blackboard I regretted not finding a client the previous day that wanted to invest. I asked the sales manager where the price change was coming from and was told that there were more buyers than sellers. Of course there were. I was in a room with over 100 brokers all recommending their clients to buy the same stock. I didn't know it at the time but we were prohibited from selling. In hindsight I know why. The owners of the company needed to unload their stock at a huge profit before they let their brokers tell their clients to sell. I don't know if anyone ever did try to sell but the brokers were discouraged from doing so. In the language of the business this is called a "pump and dump". You pump up the stock and then you dump it. We were the unwilling accomplices of our managers. We just didn't know it at the time.

My first client after listening to my sales pitch decided that he would like to buy 5,000 shares. I was ecstatic. After all I was working on a commission only job and finally looked like I was going to be making some money. I placed the order for 5,000 shares at $1.08 and my manager got on the phone with the client to confirm the order. My commission was supposed to be 5 cents a share and I was pleased that I had made my first sale.

In the brokerage business, when you open your first account you get your tie cut. At the end of the trading day all new brokers that opened their first account would stand on a desk and proudly have their tie cut. Also at the end of the day every new broker had to recite how many leads they had for potential new accounts. At the end of each month there was a sales contest. If a broker produced $30,000 commissions in one month then they won a Rolex Presidential watch. One broker in the office had a Rolex for himself, one for his girlfriend and one for his mom! Needless to say this made quite an impression on the new brokers to give them the incentive to make lots of commissions.

A few days went by and the client had still not sent the money in to pay for the trade. I had opened an account for a complete stranger over the phone and had purchased over $5,000 worth of stock in his name and now he was not paying for the transaction. When I called the client he asked me what the price of the stock was and I told him it was now 88 cents. Since the stock was now at a loss he flat out told me he was not paying and would not be sending a check in. When my manager got on the phone with him his answer was “so sue me”.

The firm promptly sold the 5,000 shares at 88 cents and the loss of $1,000 was debited from my commission account. What a great start. Not only was I working for no money but now I owed them $1,000!

Each day we were called in to the manager’s office and our phone log was reviewed. I never did manage to speak to 250 people per day as evidenced by my phone log. The manager would tell me I needed to call more people and then I would be sent back to the phone to call some more strangers.

I decided that this firm was not what a real brokerage firm should be like and promptly quit my job. I felt that going to University to study Finance was a waste if all I was going to be doing was cold calling strangers with bogus stocks. I wanted to recommend GE and Coca Cola, instead of their “recommended” stocks. On the day that I quit, there was a room full of 30 more recruits studying for their exam and eager to get their license. There was no shortage of people willing to work with no salary for a chance to make it big on Wall Street. I learned a few years later that this firm was raided by the FBI. Clearly I was not the only one who thought something was not right.

If a stranger calls you on the phone to solicit stocks, perhaps you should consider hanging up. I know that many legitimate brokerage firms employ this tactic to recruit new clients but I think you should choose your broker instead of your broker choosing you. A stockbroker with many clients and a reputable business does not need to be cold calling strangers to solicit stocks. For this reason, chances are that the person calling you does not have much experience with investing. It is more likely that you have a kid on the other end of the phone that just got his license.

Chapter 2
The Discount Broker

I moved to Los Angeles in December 1992 and got hired by a large discount brokerage firm for their trading desk. Really we were glorified order takers. We would write up to 180 orders a day to buy and sell stocks. The difference was that was everything was unsolicited – meaning we did not recommend any investments. The clients simply called in with their orders to buy or sell stocks which we executed for them. Another big difference is that this was a salaried position. The only good thing about my previous firm was that I got a stockbrokers license which enabled me to get this job.

Compared to the previous firm I had worked at, this was a legitimate outfit. The firm had about 125,000 accounts and our clientele were mainly people that wanted discount commissions because they didn't want advice or traded very frequently. Some of our clients would sit around the office all day watching the stock ticker and chatting with each other. Every now and then they would walk over and place a trade to buy or sell a stock. From the balance in their accounts they did not seem to be very good at investing.

Even though we were not supposed to give advice, clients would often ask our opinions on what we thought about a particular stock. Often we would give them our opinion. However I don't think any of us were particularly qualified to do so. I was probably more qualified than most since I had majored in Finance and read a lot of investing books and periodicals. Most of the guys on the trading desk had no interest or very little interest in the stock market. The real clue was that none of them were making any money in their own accounts. They were buying into story stocks just like a lot of the clients, and when the story changed, they would sell the stock and move onto something else.

One stock that I remember was a company by the name of Spectrum Cellular. Apparently this company had invented a wireless modem and investors started buying this stock like crazy. The stock went from $1 to $4 in about a month or so. Then one day an announcement was made that John Sculley, the Ex CEO of Apple Computer was going to be their CEO. The stock went up as high as $11 before settling down at around $7. On that day, this stock had the highest volume of any stock on the stock exchange. I believe that 60 million shares were traded that day. Now for many companies that is not much volume but for a tiny unknown company that is a tremendous amount. I watched over the ensuing months and years as this stock gradually declined until ultimately it was back below $1. I think the company was de-listed a year or two later. Many clients lost a lot of money. Some clients had sold their other stocks in their account and had put as much money as they could into this stock. When the stock declined these clients lost all of their money. What was so fascinating about this whole thing was that it seemed like every single client at our firm was buying this stock.

This is what I mean when I say “story stock”. The stock had a story – something exciting that captivated Wall Street for a brief period of time. I am sure some investors made money. However the vast majority of people bought on the day of that big announcement. They paid between $9 and $10 per share for a stock that was at $1 a year later. I listened to so many clients complain about how much money they had lost in this stock. That was my first lesson on Wall Street. Do your own research. Don’t buy a stock because everyone else is buying. I would see this theme of a herd mentality many times throughout my career on Wall Street. In hindsight it always seems so obvious that we should have avoided the herd mentality. However when you are in the midst of it sometimes you don’t notice. For a great read about crowd mentality and market manias read: “Extraordinary Popular Delusions and the Madness of Crowds” by Charles Mackay and “The Crowd” by Gustave Le Bon.

Working at this discount brokerage firm was a great learning experience about investing. I was being paid a salary and was not working on commissions. I could spend every day watching clients and what they did with their accounts. Each time a client placed an order to buy or sell a stock we had to access their account to ensure that the funds were available (if they were buying) or that the stock was in the account (if they were selling). Many clients would often ask to speak to the same broker and so we became very familiar with what stocks the clients were buying or selling. I learned very quickly that the vast majority of clients did not know what they were doing. I did not see any clients buying GE or any other Fortune 500 Companies. They would purchase obscure stocks with names I had never heard of and then hold onto them. The clients would sometimes call every day to request a quote and to see how their stocks were doing. This was early 1993 and the World Wide Web would only become commonplace a year or two later. Two years later a company by the name of Netscape would go public and the words web browser and World Wide Web would become household words. But this was 1993. There were no online quotes for free like there are today. You needed to call a brokerage firm or subscribe to a quote service in order to get quotes.

Many clients loved Penny stocks or cheap stocks below $5. Invariably over the course of a year or two most of these stocks would get de-listed or simply disappear and become worthless. Occasionally there was a "hot stock" that was in play on the local stock market channel. Suddenly out of nowhere everyone would be buying the same stock. It seemed like on some days most of the orders were for one or two stocks. Most of these clients got burned. A few were lucky and managed to sell while the stock was still hot but most simply stayed with it hoping the gains would get bigger. Usually the momentum would die down and then the stock would start declining. Over the next few months, little by little the clients would sell the stock at a loss. Some die hard clients would simply hold the stock for years until it was worthless.

I found it fascinating that very few clients ever asked for quotes on common names like Coca Cola, Exxon or General Electric. It seemed that people were fascinated with the concept of buying a few thousand shares of a low priced stock with the hopes of it going up by a few points and making them thousands of dollars of profit. Unfortunately none of them seemed to be making a profit. The average client had less than $25,000 in their accounts. For many of them, the balance in their account was their only savings. After working at this firm for a few years and dealing with these clients on a daily basis it became frustrating to see how they invested. Watching from the sidelines I could see that they were basically gambling. No one seemed to be making any money and from what I could gather they were not interested in advice. I had been a broker since 1991 and when I first got my license the Dow Jones Industrial Average was at approximately 2,500. By the end of 1995 the Dow was at 5,000. I had seen the market double already in my brief period on Wall Street. It seemed to me that in this type of environment the clients should at least be making some money. However most of them were not. A book that I recommend that speaks about this concept of not making money on Wall Street is "Where Are the Customers Yachts?" by Fred Schwed Jr. This book shows how often the only ones making any money on Wall Street are the brokers.

After two years at this firm I took another two licenses to become a Registered Options Principal (series 4) and General Securities Principal (series 24). I was promoted to an office and no longer sat on the trading desk with the other brokers. One of my responsibilities was supervising the wire operator (person that enters trades into the system) I was also in charge of sell outs (margin calls) and re-organizations for the branch. Another responsibility that I had was approving the option transactions that were taken by the brokers. Before an option ticket could be entered into the system I had to personally review the transaction and the account.

With my new position came a higher level of access to the computer system. I could see how many clients had margin calls on a given day, or how many shares of a certain stock were owned by clients at our firm. I could rank the client's by equity in their accounts, name or account number. I could also run an equity change analysis which would show me which clients were losing the most money. This was useful since some of these clients were often on margin call and I was the one that had to perform the sell out to sell their stock. If a client consistently lost money we would have "a chat" with them. This was solely for the purpose of making sure no one sued us. I tried to recommend to some of these clients that they stop trading but I soon learned that they could not. Some of them were compulsive gamblers and would have probably lost their money at the track or elsewhere if they were not allowed to trade.

When I ran equity lines I would also see which accounts were performing the best. Since so few accounts were making money I simply ran an equity line looking for anyone that had more equity in their account than the previous year. I was shocked to see that almost 80% of clients were losing money. And this was in a year where the stock market was going up. It seemed that at the end of the day most of our clients viewed the stock market as a place to gamble. For example people call it "playing the market". It is like a game to them, a form of entertainment much like going to Las Vegas for a weekend would be. I think that since the advent of web based trading this has become the norm. I also found it fascinating that many people would go to their dentist or doctor for advice but would never ask for advice when it came to investing.

One of the unpleasant jobs that I had to do is called sell-outs. This is when customers have a margin call and do not deposit sufficient money to meet the margin call. Their stock position or usually part of it is "sold out". Customers would beg and plead with me to give them more time and sometimes I would. However in just about every case I saw that the customer would only lose more money as a result of waiting an extra day or two to sell.

The reason for this is quite simple. Stocks that are above $10 are usually "marginable" meaning you can borrow money on margin to purchase them. However if the stock drops below $5 then it is no longer allowed to be on margin. What happens is that when a stock goes below $5, then everyone who owns that stock on margin gets a margin call at the same time! Naturally not everyone can come up with the money to deposit in their account and meet the margin call. Like clockwork, three days later (you usually get 72 hours to deposit more money) the orders to sell start coming in. This of course hammers the stock even worse. More sellers than buyers will usually send a stock into a tailspin. Market makers and other traders will take advantage of this if they think a stock will drop below $5. They will short the stock themselves ahead of the decline in order to profit from the margin call. They will gain while the ordinary client will lose. Such is the way of Wall Street. People that trade for a living will exploit any opportunity they can get to make money. I would learn this personally through a bad experience later on in my career.

I have witnessed a stock decline like this because of margin calls on numerous occasions. Often what happens is that after all the margin selling is completed the stock often recovers. This makes common sense. If everyone that has to sell has finally sold then the order imbalance (more sellers than buyers) is complete. Other buyers then seek to take advantage of this decline to purchase the stock at a bargain price. The stock often rallies right back to where it was before the margin calls began. The clients are heart broken when they see that they were "sold out" at the low of the year and then a week or two later the stock has recovered. Many of these customers would become very angry with me and with the brokerage firm. They would feel like the brokerage firm was out to get them. However the brokerage firm needs to protect themselves in this situation because otherwise the firm risks having an account go negative equity. Negative equity is when the clients account is worth less than zero. If a client account is negative equity then the brokerage firm will have to pay for this loss. For this reason, rules were established that govern margin accounts. One of these rules is that if the equity declines to 30% of the market value then the account holder is required to deposit funds within 72 hours in order to bring the equity back up to 50%. If the client cannot deposit money then the brokerage firm is responsible for liquidating enough stock to bring the equity to 50% of market value. As a margin clerk, my job was to sell on the 3rd day. If I did not and the account went negative I would be held responsible. The perils of margin were another valuable lesson that I learned on Wall Street.

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