Stock Market Perspective: Mad about Madoff

While that makes a nice visual play on his last name, it is pronounced “made-off.” Come to think of it, that may be even better since it appears that is what he did with billions, 50 being the most commonly reported number, of his investors’ money. That raises the question in my mind of where did the money go? That does not count what was paid back to those who made withdrawals. While he has a lavish life style with a large house in Palm Beach, $200-$300 million he was trying to transfer, and at least a million dollars worth of jewelry that he has tried to send to relatives, all that likely does not add up to anything more than mere billion. What happened to the remaining 49 billion?

Lessons from the Madoff scam fit some wise old sayings that you may have heard from your mother.

One possibility is that a good chunk of it is stashed somewhere, perhaps in hidden accounts. If so and if it can be located, that would be relatively good news for his victims. Bernard Madoff is a prominent supporter of several philanthropic organizations, so he may have used a substantial amount over the years for that purpose. That would be ironic because some of his victims are also philanthropic groups that placed all or a substantial portion of their assets with him.

By now you probably have seen, heard, and read more about his Ponzi scheme and its victims than you really wanted to know. I won’t add much to that. Instead, I will look at some of the lessons individual investors can learn from this affair. Much of it will be in the form of wise sayings or maxims that you have almost certainly heard before.

One worry among those in the investment advisory and management business is that too many will think “they’re all a bunch of crooks.” As I will discuss in a bit, there is no way I could pull off a Ponzi scheme, even if I could raise the huge amounts that Madoff could, due to the way my business is structured. This is also true for virtually all registered investment advisory firms (RIAs). That does not mean that our advice and actions taken in your accounts won’t be wrong at times. It certainly will, but that will not be the result of trying to separate you from your money.

Although he was not the first to dupe investors using the technique, Charles Ponzi’s name sounds so right for the pyramid scheme he ran around 1920. The basic idea is to promise fantastic profits and pay off the early “investors” who are normally collaborators with money taken in from the later victims. The “real” payouts encourage new participants to hand over their money. Eventually the scheme collapses when there are not enough new victims to be found. Along the way the perpetrators rake off a large take for themselves.

Madoff’s was fundamentally different in that he did NOT promise huge returns, just very steady ones in the 10-12 percent a year range with almost no losing months. It is an example of what might be called a slow Ponzi scheme. His might have gone on quite a bit longer if the financial crisis had not caused too many to make withdrawals. I have seen reports that he had about seven billion in such requests, and although he tried to raise that much, the financial environment made that impossible.

Getting a bit off the Madoff track, several writers, usually with a libertarian bent, claim that Social Security is really a Ponzi scheme. In the same vein, so are Medicare, Medicaid, and to the extent that we run deficits, much of government spending. If so, these are clearly slow schemes since they do not promise sensational returns. Unlike the real Ponzis, the government is not going to run out of future “investors” who are commonly known as taxpayers. In addition, if these contributors prove to be reluctant to provide enough funding, the government has the ultimate fallback source, the ability to print money.

Whether that is wise or not is a frequently and thoroughly discussed topic, but it is nothing but inflammatory rhetoric to describe Social Security as a Ponzi scheme.

I would love to tell you how to avoid falling victim to another Madoff, but I don't think that I could have told you how to stay out of his. It would have been almost impossible for someone without exceptional knowledge of his operations to have figured out that something did not ring true. A well implemented plan using options to produce income and to hedge downside risks has the potential to produce consistent healthy returns. It is possible that the best at this (a Warren Buffet of this method) with sufficient assets could pull off something like Madoff claimed. Those who figured out that he was not for real knew the high level of assets he said he had and saw there was not nearly enough option volume to support his purported trading. I don't think most investors would have this level of information, and the majority of the victims invested through feeder funds that sent their money to Madoff. Those funds supposedly did "due diligence," but in fact were also willing enablers who collected a middleman's fee.

Now let's look at some of the maxims:

▶**Sunshine is the best disinfectant.** The critical difference between Madoff and just about all RIA firms is that he did not use an independent custodian to hold his clients' funds. Instead he had his own brokerage firm for that purpose. In my case, your accounts are held at either brokersXpress or Rydex mutual funds (and some used to be with Fidelity). All of the independent custodians are highly regulated and subject to frequent examinations by the regulatory authorities.

When you placed funds under my management, you sent the money directly to the custodian. I never had it, which would have made it impossible for me to pay it out to someone else as part of a Ponzi scheme or other illegal activity. You receive or have online access to regular statements, monthly or quarterly. That enables you to see that your investments are where you expect them to be. Moreover, you can always withdraw any or all of your holdings by directly contacting the custodian.

Since I do not have custody of your investments and do not collect fee payments more than six months in the advance, I am not subject to auditing by a CPA firm. Many RIA firms intentionally are set up that way to avoid the higher costs involved. Madoff had his own "in house" brokerage firm that had custody of his clients' assets. The statements it sent out were fraudulent, which should have been detected by its auditors or by an SEC inspection.

Brokerage firms, mutual fund companies, and others with custody of investments are subject to strict auditing. One danger sign with Madoff was that his auditors were small, inexperienced firms that are not registered with Public Company Accounting Oversight Board, the self-regulatory mechanism for reputable CPA firms. (However, being large and Board registered is not a guarantee that nothing funny is going on as the Enron and Arthur Andersen debacle shows.) Quite likely, Madoff's auditors did not have the capability of understanding what he was doing and were deceived by what he told them.

It is also clear that the SEC received several tips that something was funny. It is also clear, and this is being investigated now, that they did not come close to fulfilling their investor protection mission in this case although they looked into Madoff several times over the years. Although his business is often referred to as a hedge fund, and those currently are subject to a very low level of regulation, it was actually and investment advisory firm. The regulations required him to be registered with the SEC as such, but that did not happen until 2006. Even then, the SEC considered that to be a technical violation that he could correct by registering. Madoff certainly knew the regulations, so why did the SEC think it was just a technicality that

he had gone fifteen years without registering and subjecting his business the periodic inspections that might have revealed his scam many years earlier? Being well connected is quite likely part of the answer, but that does not excuse the SEC's failures.

▶**Don't put all your eggs in one basket.** It is sad to read about those who placed their entire investments or a substantial portion with Madoff. Some of those are charities that now are defunct as a result, and others are formerly quite wealthy (hundreds of millions) families.

The standard remedy is diversification, but that goes beyond what you may think. As this past year shows, the old saw that "in a bear market the only things that goes up are correlations" contains a lot of wisdom. Those who thought they were diversified by owning foreign company stocks and bonds other than Treasuries discovered that the supposed diversification did little to reduce the pain when stock prices collapsed.

As the Madoff affair shows, being genuinely diversified means more than being invested in multiple asset classes. It also means having different investment approaches, usually implemented by different investment managers. My methods work well in some types of markets and not so well in other types. One form of diversification is using methods that have different strengths and weaknesses. There are a number of ways that can be done. While I manage a substantial portion of my personal accounts as I do for clients using market timing and sector fund trading, I also do some different things for myself such as trading options based on ideas I get from newsletters and having a bank's trust department handle a portfolio of mainly blue chip stocks.

▶**Just because all your friends are doing it…** If your upbringing was like mine, at some point a parent, most likely your mother, asked you why you did something dumb. A common answer and response is "all my friends were doing it" and "if your friends were jumping off of a cliff, …" Psychological studies have shown that it is easy and common to go along with group behavior, particularly when doing so is thought to provide personal benefits. One trick used by scammers is to get in with a social or religious group and use the group pressure to produce recruits.

That was the case for many with Madoff. Wealthy retirees in Florida would talk with others in their circle and hear about how well their investments with him were doing. Many felt left out if they did not also put some money with him. Some went as far as joining the country club he was in so they could meet and "invest" with him. Common support of Jewish philanthropies was also a strong social factor. Others invested through the feeder funds that came highly recommended, often by reputable firms, and may not have known the money was going to Madoff.

▶**If it is too good to be true …** it almost always is. The reputed quite consistent returns with no losing months fit that category. Even the greatest investors with public records such as Warren Buffet and Peter Lynch have had bad periods. As I said previously, the techniques Madoff purportedly used might have produced quite consistent returns with very few down periods, but that was not very likely (hence the almost always above). That means it is worthwhile to dig deeper to find out what is behind the reported numbers. In some cases, there may be a carefully chosen period, selected accounts, or group of results that are not typical. I recently saw an ad from a well known options trading guru guaranteeing at least 12 trades in the next year with at least a 100% profit each, and the ad showed some recent ones. (The guarantee is a return of the subscription price. A meaningful guarantee that will never be made would be to cover any losses from correctly following advice.) His organization to its credit sent me the complete list of trades for the past year. There were indeed that many (and more) 100% gainers. However, there were a lot more losers and the overall returns for the year were quite bad.

In short, if you don’t understand how an investment approach works, don’t put your money in it. If there is an intermediary involved, make him, her, or them explain how and why what they are recommending works. Ask them how they know those they will be placing your money with are legitimate. While the best investors and traders are understandably reluctant to reveal too many details about their methods, they should be willing and able to explain in general what they do. Beware of magical black boxes.

▶**There is no free lunch.** A hedge fund, which Madoff often was perceived as running, charges a asset based small fee plus a usually hefty percentage of new profits. RIA firms like mine usually charge a percent of the assets under management. Those who invested directly with Madoff were told that there were no investment management fees. He said he made his money through the trades placed with the brokerage firm he owned. Unless the commissions charged on the transactions were unreasonably large, that arrangement sounds too much like the mythical free lunch. If they were much higher than even the most expensive full service brokers, that should also raise a large red flag. I suspect his victims looked only at the supposed returns and never knew or asked about the commissions or why Madoff was being so generous.