Wednesday, December 17th, 2008

How to Avoid Madoff Mayhem

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Money Morning

Bernard Madoff, former chairman of the NASDAQ Stock Market Inc. (NDAQ), was turned into the authorities by his sons last Thursday after his firm, Bernard L. Madoff Securities LLC, was declared an insolvent "giant Ponzi scheme," with estimated losses of $50 billion.

Madoff had provided investors with modest, steady returns, claiming to be making money by trading in Standard & Poor's 500 Index options, and closing all positions prior to mandatory reporting dates so that investors had no window into the fund's holdings.

Apart from individuals, charities and numerous "funds of funds" investing in hedge funds, such as HSBC Holdings PLC (ADR: HBC) and Banco Santander SA (ADR: STD), lent billions to investors participating in the Madoff fund, secured only by holdings in a fund that is now insolvent. The debacle is likely to strengthen criticism of the U.S. Securities and Exchange Commission, for its failure to protect investors, and to cast doubt on the hedge fund sector and on "alternative investments" in general.

It is *not* surprising that the recent unpleasantness on Wall Street has exposed a gigantic Ponzi scheme. It wasn't even really even surprising that the Ponzi-scheme losses were an enormous $50 billion: After all, 13 years of excessive money creation have allowed bad Wall Street behavior to grow like weeds, so you'd expect the inevitable Ponzi scheme to be huge, like an out-of-control, possibly radioactive bindweed.

However, it *is* surprising that the major investors in Madoff's scheme were not a bunch of suckers he met at a country club, nor a set of unworldly charities seduced by a smooth sales pitch (though both of those were involved), but instead were actually hedge funds, the most obnoxiously professional of professional investors. This raises a hugely heretical question: Is it possible that hedge fund managers aren't the "best and the brightest" after all?

The Life and Times of Charles Ponzi

The original Ponzi scheme was a much smaller-scale operation, with losses of only few million. In the disturbed years after World War I, Charles Ponzi got the idea that postal reply coupons could be purchased in Italy and exchanged for U.S. stamps at a substantial profit – essentially an early form of arbitrage.

The anomaly existed because the international postal agreements had been designed in a pre-1914 Gold Standard world, which had disappeared, with different currencies having devalued by different amounts. The kernel of Ponzi's scheme was thus a genuine moneymaker, albeit on a tiny scale (at its peak, 160 million postal coupons should have been shipped from Italy to the United States, compared with 27,000 actually outstanding worldwide). However, using this moneymaker as incentive, Ponzi attracted millions of dollars in deposits, paying profits on the early deposits from the proceeds of later ones.

This is the essence of a Ponzi scheme; if there is a genuine moneymaking operation at its center, it is swamped by the amount of money invested, which can only appear to make profits through later investments being used to pay out earlier ones. Even in 1920, the authorities realized this was a no-no. Ponzi was convicted of mail fraud and sentenced to five years in prison on federal charges. Released after three and a half years, Ponzi then faced state charges in Massachusetts. He fled and remained at large for a time, but was eventually captured, tried and sentenced to nine years imprisonment in Massachusetts, where the bulk of his schemes took place.

Modern-Day Schemes Abound

Ponzi schemes are a well-known hazard in the banking world, and the SEC and other regulatory authorities have great experience unraveling them. They are fairly easy to detect by any reasonably suspicious professional: when offered an investment opportunity you simply keep asking questions of the promoter until you are absolutely confident of the mechanism by which money is made.

If you can't figure it out, you don't invest – you are, after all, a financial professional and finance is an area in which there should be no impenetrable mysteries to the experienced and competent. In the emerging capitalism of 1990s Eastern Europe, Ponzi schemes were a well-known hazard, because the populace didn't understand how capitalism worked and regulation was weak. The MMM scheme in Russia collected $1.5 billion, the Caritas scheme in Romania collected $1 billion, and in Albania in 1997, the entire banking system and the government collapsed under a $1.2 billion scheme.

In the West, successful Ponzi schemes rest on the gullibility of simple folk. Two groups in particular stand out. Some rich country club types tend to believe far too much in "connections" – to the exclusion of everything else – and neither understands nor cares about the details of how investment returns are generated.

Thus, rather than invest through well-qualified specialist investment managers, they buy rubbish investment products from people whose "connections" are believed to provide an "inside track" to extra returns. Madoff, a former chairman of NASDAQ with a charming personality, was naturally well qualified to appeal to these gullible amateur investors. Charitable organizations and state funds often have substantial endowments that are run by under-qualified people, because the charities and states don't pay enough; these people can also be seduced by the well-connected, and are not necessarily competent to assess the details of how investment returns are generated.

Ponzi schemes were given an enormous boost by the advent of derivatives and trading desks in the 1980s. Whereas the doziest country club member or charitable trustee has some idea of how bonds or stocks make money, even many financial professionals are a bit hazy about derivatives and trading profits. Hence, Madoff was able to maintain a plausible smokescreen over his activities. Since private partnerships do not have the same disclosure rules as public investment funds, he had no need to disclose the precise trades by which profits were made, nor any details about his methodology.

The increased complexity of modern investment does not however excuse the gullibility of professionals such as those who manage hedge funds and "funds of funds," both of which invested in Madoff's schemes. These people are paid inordinate amounts of money to provide superior investment returns to individuals and institutions that – perhaps naively – believe that by paying excessive management fees, one can obtain truly superior investment management. They should not be able to claim inexperience, a lack of an understanding of complex investment products, or even a lack of intelligence, since most of these people have degrees from top schools.

Warning Signs to Watch For

In reality, professional investors were infected with the "get-rich-quick" fever that reached epidemic proportions during the 13 years of easy money and lax regulation. As a result, these "professional" investors failed to exercise their "due diligence" in investigating how Madoff's investment operation made money before investing in it. To the extent they were investing other people's money, they deserve to be sued for failing in their fiduciary duty. To the extent they were investing their own money, they deserve to have their fancy degrees removed at some suitably ignominious ceremony, for crass stupidity and incompetence.

As for the lessons the rest of us should take away from this event, allow me to say that there are several:

- First and foremost, don't invest in something you don't understand, just because the promoter has good connections. If he can't explain to you in terms you can understand how he makes money, there's probably something fishy involved.
- Second, don't believe the hype about "alternative asset classes" – most of it is just jargon designed to remove extra fees from you.
- And third, if you obey the three cardinal rules of investing – diversify, buy over an extended period, and research well what you intend to buy – you will probably do as well as most professionals, and far

better than that substantial minority of professionals who are in reality utter incompetents.

- One great consolation about this recession: Ponzi schemes do much less well in recessions, because people are more suspicious. Ponzi flourished in the modest hot-money boom after World War I and Madoff made hugely more money in the correspondingly larger bubble from 1995-2008. Recessions, unlike bubbles, are relatively safe times to buy investments, because the investments themselves are cheaper and there are fewer crooks around.

News and Related Story Links:

- **Wikipedia**:
  Ponzi Scheme.
- **Money Morning Market Analysis**:
  Why Fed Policies and Treasury Department Bailouts Will Lead to Inflation Rather Than Deflation.
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1. *Comment by Jon Mc* on 17 December 2008:

   Outstanding article. This really clarifies how these things can happen, when they're likely to happen, and what to do to avoid them, and help family and friends avoid them.

   It's too bad that charities and hard-working people suffer simply for not having the know-how to figure out who to trust. How do we raise people's understanding of finance?

2. *Comment by Marcos F Mendez* on 17 December 2008:

   It has been my practice to access EDGAR or SEDAR(the Canadian Securities Website) and read the 10Q/K of every company that I invest in. There have been instances (such as ENRON) where I was unable to understand or see any assets that were behind the hype. In those cases I simply passed on the investment and went on to the next one.

   There are literally thousands of companies that are viable and solvent with great ideas that will have good to great returns. You simply have to do the due diligence that is required in order to not get burned and if you do get burned then it is your own fault.

   Once the investment is made then it requires another type of mental acumen to realize any returns on your investments and that is patience.

   Marcos F Mendez

3. *Comment by K.Granucci* on 18 December 2008:

   It's really too bad that there isn't an outside investigative department to help check things out also & give a BBB type of approval that can't be bought.

   The magnitude of the this is staggering. It seems it will surely have a staggering effect on the economy as well.

   This got way too out of hand.

4. *Comment by Shorty* on 18 December 2008:

   Another series of Ponzi Scams for your readers to be aware of, operating In Australia, Indonesia, East Timor,Switzerland. Are the So called China Sugar Project, East Timor & Indonesian Rice Projects, Thailand Infastructure project (Airport, Roads, Telecommunications, Billboards). And The UBS Bank President Soekarno Gold Project. Which has operated in the USA around ten years ago… Currently in Australia..
   By Donovan Cox Investments Sydney Australia.
   Directors Mr. Stephen James Donovan, Mr. Vittorio Zane Cox, Mr. Darryn Wilfred Ferris, Mr.James Roy Ross, Mrs Yora Lovita Elmasarach Haloho from Jakarta Malaysia. Do not invest funds with these people, as they have taken millions from investors in Australia…Any further info needed, please contact me anytime…Good luck investing..Merry xmas…and thankyou for all your graet work… Cheers Shorty..Melbourne Australia….

5. *Comment by Shorty* on 18 December 2008:

   Oh PS please note: Mrs Yora Lovita Elmasarch Haloho is from Jakarta Indonesia (Not Malaysia as early stated) and Mr. Sephen James Donovan also operates in Bali Indonesesia & New Zealand…

6. *Comment by a ziler* on 22 December 2008:

   ??? Was the kicker ro get supposely smart investors to invest with Madoff unreported income ti IRS??????

7. *Pingback by If Holiday Retail Stats Don't Have Economists Saying "Humbug," Tuesday's GDP Report Certainly Will* on 22 December 2008:

   [...] Bernie Madoff saw to it that his investors will have a holiday season to forget as the list of prominent victims grew each day: Real estate mogul Mort Zuckerman, U.S. Sen. Frank [...]

8. *Comment by Adam Potgieter* on 22 December 2008:

   Ponzi schemes, Nigerian 419's, get rich quick schemes and work from home and make a fortune schemes have a common denominator. GREED. But the "modest returns" deal in the Maddoff scheme, and obviously his former connection to the Nasdaq must have fooled plenty an investor, and sadly greed can not be cited as the downfall of innocent investors in the Maddoff scheme. Seems like Warren has it spot on with the research before you invest thing………

9. *Pingback by Jutia Group - Market Jitters & Political Critters* on 22 December 2008:

   [...] Bernie Madoff saw to it that his investors will have a holiday season to forget as the list of prominent victims grew each day: Real estate mogul Mort Zuckerman, U.S. Sen. Frank [...]

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