access

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How Bernie Madoff with the money

There is a foolish corner in the part of the brain of the wisest man. – Aristotle

In January I usually take time to look back over the events of the past year to see what lessons I learned. In 2008 there were so many milestones that it's hard to pick just one to write about. After all, this was the year we elected our first African American President, the year that the stock and bond market took a downturn the likes of which had not been seen since 1929, the year that home prices took historic hits (40% declines in Phoenix for example), the year that we (temporarily?) nationalized many of our largest financial institutions, and of course the year that marked the official end of American dominance in the auto industry.

Why then settle on the mess left by Bernard L. Madoff, the patriarch of Madoff Investment Securities, as my pick for lesson of the Year? The obvious reason would be the magnitude of the destruction left in his wake – estimated at $50 billion (it makes the measly $35 billion originally requested by the Detroit 3 look like chump change). I chose this event for other reasons, however. It's a fascinating case into the psyche of a man and his investors.

In the coming weeks and months much more will be written about this case, but I believe we already know most of the important details. First, I believe that most of the money is gone. This week SIPC investigators were all a twitter about finding $860 million in cash and securities (that only leaves about $49 billion and change to go fellas). Second, although Bernie lavished gifts on himself and his family (he sent gifts to his children valued at close to $1million for the holidays), I suspect that most of the money will be proven to have been lost through bad trades rather than having been spent by Bernie and family.

What makes this case unusual is not just its magnitude, but the length of time that Madoff was able to keep the Ponzi scheme afloat (for those etymologists in the room, the term Ponzi Scheme was coined after Carlo Ponzi, an émigré from Italy in 1903 who promised investors a 100% return in 90 days buying and selling discounted postal reply coupons from other countries). Normally these deals collapse after a couple of years unless the flow of new investors continues at a brisk pace allowing this new money to be paid out to existing investors as "investment return". Mr. Madoff was able to keep all the plates spinning for over 20 years until the recent market meltdown had investors clamoring for money that didn't exist.

Were there red flags? You bet. First, no equity investment always makes money. Bernie bragged that he was able to make money in good markets and bad – with uncanny consistency. He claimed that his fund generated about a 10% return year after year (this lie was actually quite clever because most of the crooks before him promised outlandish returns over short periods – easier to sniff out. Bernie reversed this idea – lower, consistent returns over a longer period). Second, a hedge fund of this size should have been audited by a national, or at least a large regional CPA firm, not the three person firm of Friehling and Horowitz (who, by the way indicated annually to their supervisory authority, the AICPA, that they hadn't performed an audit in the past 15 years). Third, the investment manager and the custodian should have been two separate parties. Madoff held all the money *and* generated his own statements (amazing things these word processors). If a third party custodian was involved and had generated independent monthly statements, discrepancies wouldn't have gone unnoticed for very long. Fourth, the investment strategy that Madoff was purportedly using would have required buying and selling options in amounts that were significantly greater than the total average daily trade volume for those options – not possible. There were plenty more flares, but you get the idea.

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With all these warning signs, how was Bernie so successful at this subterfuge for better than 20 years? Partly it was good timing. With a market that was generally positive during this time he had investors knocking down his door to get in (fresh money to pay out "returns" to existing investors). Additionally, there was a certain cachet attached to being a Madoff client. He created an air of exclusivity. In fact, one of the country clubs that Mr. Madoff belonged to, The Palm Beach Country Club, listed as one of its benefits of membership access to the Madoff hedge fund. He was philanthropic and attracted large charity accounts that invested with him lending an air of legitimacy to his fund.

Ok, so what can we learn from Bernard?

- **Trust but verify.** (thank Mr. Reagan for that one). At Access, we use third party custodians for all client accounts so that you get the numbers from us and from an independent party. As far as our own research goes, we rarely use materials published by the purveyor of a particular investment. We prefer to use third party research companies that have as few conflicts as possible when rendering an opinion or review.
- **If it sounds too good to be true…** It sure is tempting to want to believe that there is a magic bullet out there that will pierce the heart of any bear market and generate returns regardless of market conditions, but of course there isn't. Investing requires hard work and perseverance through the ugly times. It may be cliché, but it's true.
- **Diversify.** Many Madoff clients had all the money they had in the world in this hedge fund. This includes some sizeable charitable funds. Some are now before Congress begging for their own version of a bailout. Much like the Enron employees before them, they were swept up in the allure of easy money. At Access, we generally limit any single stock to 10% of total equity positions and any fund to less than 30%.
- **There is no such thing as a buy and hold investment.** The days of buying and holding onto an investment without review are long gone. We constantly ask ourselves the following questions of all of our holdings: Does this holding still represent value? Has anything changed from our original investment hypothesis? Can we find a better value elsewhere?
- **Regulatory oversight is not a substitute for proper due diligence.** As we have learned, the SEC did not investigate the hedge fund run by Mr. Madoff. It reviewed the brokerage operation, but did not look into the hedge fund operation. After having been through an audit by the SEC, I can tell you that they are good people, but woefully short of manpower and the time necessary to do thorough audits. We review investments as if there is no oversight, because there probably isn't.
- **Capitalism is bipolar – sometimes horrendous, sometimes magnificent.** This messy system of ours is the best of the worst. It is the most efficient system for allocating resources and meeting demand, but it is far from perfect. Our leaders try to use regulation like medication in an attempt to keep the cycles to a minimum, but like for many with the disorder the treatment is tenuous at best.

We close the books on the most challenging year since I have been in business. It is in times like these that I am reminded of how truly blessed I am to have a wonderful family and friends. Thank you for being a part of my life and for the confidence you have placed in our organization. I wish you health and happiness in the coming year.

One housekeeping note. You may have noticed that your statements from Schwab look different this month. Not only are they printed in "portrait" versus the normal "landscape" view, they also contain more condensed information. We have contacted Schwab and apparently the vendor they use to generate the statements keyed in the wrong template for our clients this month. Although the information is correct, it is in a different format than normal. Schwab tells us that the statements cannot be redone for this month, but will be corrected for the January run. If you have any questions on these, please call.