



# The Bernie Madoff Fraud: Five Lessons for Investors from 'The Wizard of Lies'

June 5, 2017

by Seaborn Hall

HBO's *Wizard of Lies*, featuring Robert DeNiro as fraudster Bernie Madoff, premiered recently. It follows up *Madoff*, a 2016 mini-series that featured Richard Dreyfus. As background to *Wizard*, a series of follow-up articles reviewing Madoff's schemes and crimes have also appeared: *The New York Post*'s "Bernie Madoff's Closest Prison Pal Is A Crime Boss," *The Atlantic*'s, "No Movie Could Capture The Crazy Details Of Bernie Madoff's Story," and *Town & Country*'s, "How Bernie Madoff Took His Family Down."

It was not just naive individuals who were taken for about \$65 billion (net fraud of \$17.3 billion) by Madoff; it was countless professional investors, mutual fund and asset fund managers, bank executives, financial advisors and other professionals in the investment arena that should have known better. One would hope that from all of the financial crime coverage the average investor would learn some basics to protect him or herself. But none of the TV portrayals or the countless articles are talking about the real lessons that average Americans investing for profit and retirement need to learn to avoid the same fate.

Here are the top five red flags – and lessons – that more seasoned investors should have seen and that average investors should learn from the Bernie Madoff scandal:

## 1. There was no independent custodian

Investors should rarely if ever give their money to the same person or firm that is investing it.

Reputable advisors or management firms will have their clients fund accounts at independent financial firms, brokers or banks that have relationships with the advisors as third parties that clients give permission to manage the funds. In other words, the client writes a check or wires money to a custody holder who then holds the money in account until a third-party advisor registers with that firm with the proper paperwork signed by the client, which states they are the advisor directing the funds. Some respected custody holders are Pershing, TD Ameritrade, Charles Schwab and Fidelity.

Custody holders offer several protections. They are independent, well-known entities within the financial community that are accountable to federal and state laws and regulations, and governing organizations like the Financial Industry Regulatory Authority (FINRA), the Securities Exchange Commission (SEC) or the like. They also provide independent, secondary verifications, through their

own monthly or quarterly statements, of how the money is being invested and used (i.e. the expenses and the cash flow). They are also independent, professional verifiers of the authenticity and reputation of the advisors managing said funds.

In Madoff's case, there were two types of investors, those who invested directly with him and his firm, and feeder funds, like fund of funds companies. From various reports, it appears that investors sent money directly to a JP Morgan bank account that was not reflected on company records. Madoff, and his assistant, or assistants, who handled the investment arm's administrative affairs, knew funds being channeled through Bernard Madoff Investment Securities (BMIS), formed in 1960 as a broker-dealer, were deposited in a separate account.

His brokerage firm was engaged in real operations. But, the funds targeted for investment ended up in the JP Morgan and affiliate accounts, and were never invested. These funds were used for redemptions, operational expenses, and Madoff's own personal needs. There was no independent custody holder and financial statements and reporting only came from one source - Madoff's own firm.

## **2. There was no independent auditor of the firm**

FINRA-regulated firms, like Madoff's brokerage, are required to file an annual audited report not more than 60 calendar days after the date selected for their fiscal year end. Public companies are required to undergo periodic audits, particularly when submitting information to the SEC. According to the SEC, investment advisors that have the authority to access client funds or securities are required to undergo an annual surprise examination by an independent public accountant. Additionally the ADV form advisors are required to annually file with the SEC contains information on disciplinary action for potential investors.

Ideally, the above required audit should be conducted by a well-known firm in the accounting industry. Under no circumstances should the firm conducting the audit be related to, owned by or involved in any way financially with the firm it is auditing. This would be a major conflict of interest.

Of course, even an audit by a well-known professional firm does not always offer the protection for investors that it should. One example of this is the complicit behavior of Arthur Anderson and its employees in the Enron scandal years ago.

However, an independent auditor does offer some protection to clients in the event that government regulators or agencies that are supposed to be doing their job fail. In Madoff's case, for various reasons too complex for this article, the SEC – even though warned by industry whistleblowers, like Harry Markopolos – failed to do its job and uncover the Madoff fraud. Government and industry regulators offer the public some protection, but it is always the responsibility of investors to conduct due diligence and evaluate the risk of their own investment decisions.

One issue in Madoff's case was that he was not forced to register as an investment advisor until 2005-06. Regardless, the accounting firm (Friedling & Horowitz) hired to audit his firm was suspiciously too small for as large an operation as Madoff's. It was not a well-known firm and the address of the "firm" was in a rural location that should have made it immediately suspect. Even after registering as an advisor, Madoff was able to continue to circumvent fraud detection because his audits were "rubber-

stamped."

### 3. **There was too much mystery, and not enough that made sense**

One area both films do a fairly good job of representing is the way that Bernie Madoff was able to create an environment of mystery and allure that concealed what he was doing.

Firms will always attempt to protect information related to proprietary methods and strategies. However, for clients, there should always be clear explanations of how money is to be invested and the general strategies that will generate profits, as well as the levels of risk involved. Laura Goldman, who in 2009 post-scandal worked for Tel Aviv's LSG Capital, walked away from an opportunity with Madoff. According to her, he either couldn't answer or avoided answering basic questions about custody holder, audits, and other trading queries. Like Markopolos, she tried to warn others and was called an anti-Semite for her trouble. Markopolos realized "five minutes" into reading Madoff's strategy that something was wrong.

The level of secrecy and mystery Madoff generated among clients and employees of his own firm should have been a red flag, as should the fact that Madoff charged no investment fees. According to Markopolos, the complexity of Madoff's strategy worked to perpetuate the fraud.

Madoff's charisma and industry experience and "qualifications" mesmerized potential investors. Therefore, the corollary of this axiom is that industry experience or success, awards, degrees and certifications – in addition to the mystery – can be a smoke screen that hides lack of integrity.

As one potential investor, portrayed in the *Wizard* film, said after a Q & A in which Madoff explained his investment rationale, "This is bull\*\*\*\*." He walked out and never looked back. When encountering too much mystery – or when their bull-meter goes off – all potential investors should do the same.

### 4. **Returns lacked volatility similar to the markets**

Investment returns never go up in a straight line, they vary. Markopolos noted this immediately. Markopolos reported on what he felt was Madoff's fraud several times over years to both the SEC and the *Wall Street Journal*, but was largely ignored.

The first thing Markopolos noted was Madoff's returns never varied and went up in a straight line for years, regardless of the volatility of the markets. Over a 14-year period, Madoff only had seven losing months, a virtual statistical impossibility. Markopolos stated that this was similar to a baseball batter hitting over .950. Lack of volatility in returns should always be a red flag.

### 5. **Returns were too high**

Only the top 1% of hedge fund managers are able to generate high returns year after year.

Ray Dalio, who was for years the head of one of the top hedge funds in the world, Bridgewater & Associates, generated consistent returns of almost 20% in his Pure Alpha Fund. According to Wikipedia, "As of 2011, the fund is reported to have lost money in only three of its 20 years of existence and had an average annualized return of 18%." But returns of this nature are rare and

almost unheard of, and even Dalio's fund was down for three years, and fell 12% in the first half of 2016.

Mutual funds or exchange traded funds (ETFs) that cater to the average retail investor or financial advisor typically offer returns slightly above or slightly below market index returns for any given year. This means that there is volatility in the returns that roughly matches the volatility in the markets.

Hedge fund profits are typically generated using complex algorithms and investment strategies, and usually incur more risk than typical investments. Most hedge fund start-ups struggle and then fail. Hedge funds charge higher fees and require higher minimums for investors. Madoff's consistent, stellar returns – in the midst of low or non-existent fees – should have been a red flag.

According to *Town & Country*, "Bernie promised (and delivered) 12 to 20 percent returns for his clients, no matter how the market was moving." According to another source, one of his funds returned 10.5% consistently for 17 years. But some of the other funds offered more modest returns, creating the illusion of a realistic, but profitable strategy.

Higher returns always mean higher risk. Since Madoff was paying feeder funds for sending him client money, his real returns would have needed to be even higher, by 4% or more. Returns of this level and consistency would have made him a better money manager than Dalio – and Dalio's methods and investments were much better understood. Madoff's practices should have invited wider-spread scrutiny from investment professionals.

No money manager, professional or otherwise, no matter how smart, is perfect. This means there will be evidence of failure and some lower returns somewhere along the way. If failure is not evident in the history of an investment manager, best to stay away.

### **Who got hurt by Madoff? Why did the professionals miss the warnings?**

According to one report, Madoff's fraud had been ongoing since at least 1975 and his investment firm enlisted over 4500 individual clients, encompassing 13,500 investors. As of 2016, investigators had so far recovered about 65 cents of every dollar invested with Madoff.

Who got hurt by Madoff? Celebrities like Steven Spielberg, Kevin Bacon, Sandy Koufax, Larry King and John Malkovich lost money through Madoff's fraud, as did executives like Jeffrey Katzenberg and trusts from Henry Kissinger's family. Politicians, big banks like Deutsche and Bank of America, English royalty, attorneys, hedge fund and mutual fund managers, family offices and property magnates were affected, as were thousands of others, including ordinary people. One person who had the chance to invest with Madoff, but refused? Donald Trump.

Average investors lost their life savings. Some took their lives. Financial advisors, mutual fund executives and other investment professionals who were responsible for investing the money of their clients missed the obvious red flags and warning signs. Why?

According to Diana B. Henriques, who wrote the book, *The Wizard of Lies*, two factors allowed Madoff

to fool sophisticated investors: a modification of the usual Ponzi-like charisma and a Potemkin village-like set-up that fooled regulators. But, this doesn't help the average potential investor spot a fraud.

Just like in the film *Wizard*, and the SEC investigator who failed to make one phone call to check on Madoff's Depository Trust Company (DTC) filing (every brokerage company is assigned one; it tracks your buys/sells), investors and advisors relied on personal relationships and Madoff's reputation and charisma. Instead, they should have conducted due diligence and checked the five basic indicators that would have told them whether they were dealing with a fiduciary and if this was a safe investment opportunity.

These five red flags are not a foolproof plan to avoid risk and loss when you invest. But they are a good place to start to ensure that your money will not only be safe for now, but also for generations to come.

*Seaborn Hall has a degree in management from Georgia Tech, two masters degrees and has studied at the doctoral level. Formerly he was a regional director at a national top-50 RIA; he currently manages a family investment company, writes, and publishes the Common Sense Group websites.*