Harry Markopolos – Who Exposed Madoff – Has Uncovered a New Fraud

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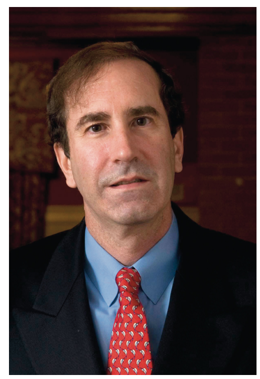
by Robert Huebscher

Harry Markopolos, the investigator who exposed the Bernie Madoff Ponzi scheme, has uncovered a new fraud. The unfunded status of the pension fund of the Boston Transit Authority (the "MBTA") is $500 million bigger than previously thought, according to Markopolos. This will have a significant impact on the municipal bond market, especially if it turns out that the MBTA's problems are endemic among similar pension funds.



Harry Markopolos

The unfunded status of a pension fund is the market value of the assets minus the present value of the liabilities, discounted at an actuarially determined interest rate. For most public pension plans, this number is negative; the liabilities exceed the assets and it is underfunded.

Although the full details are not yet known, Markopolos said the $500 gap is due to bad investments, fraudulent accounting and unrealistic actuarial assumptions.

Markopolos spoke on June 9 at Northfield Information Service's 22nd annual summer seminar, held in Newport, RI. Northfield is a provider of advanced analytics to institutional investment managers and wealth managers. Its CEO, Dan diBartolomeo, worked with Markopolos in the Madoff investigation and is helping with the MBTA case.

Markopolos called what is left of the MBTA's pension a "Tender Vittles retirement plan," meaning (sarcastically) that its participants would be eating cat food.

The underlying cause of the MBTA's problems was poor management and oversight. "No good outcomes result when you mix politics and money," Markopolos said.

The problems began with failed investments in two hedge funds and culminated in the more widespread problems that Markopolos uncovered.

Buddy Fletcher

The troubles at the MBTA began in 2012, when it was revealed that it had lost $25 million in an investment in Fletcher Asset Management, a hedge fund run by Alphonse "Buddy" Fletcher. The MBTA had been hiding this loss until it was exposed by an investigative reporter from *The Boston Globe.*

Fletcher had promised guaranteed returns of 12%, similar to Madoff's sales pitch. It was nothing more than a Ponzi scheme. In addition to the MBTA, three Louisiana pension funds lost $100 million in the scheme.

What made the Fletcher loss so galling, according to Markopolos, was that its chief investment officer, Karl White, had been the executive director of the MBTA pension fund. One year after leaving the MBTA, he convinced it to fund Fletcher.

"There are a lot of Ponzis," Markopolos said, "and they are stealing customers from legitimate managers."

Fletcher used the money it raised to invest in a movie, *Violet and Daisy*, which his brother was making and in a "penny stock" called ANTS, on which it booked a 1,000% return over a 16-day period. At one point, Fletcher reported 127 months of positive returns without a down month; it later revised this to show 14 down months.

The Fletcher irregularities went unnoticed by the MBTA's board, which Markopolos said consisted of mostly non-college graduates – union members who worked on or operated the city's busses and subways. The board had one person with an MBA and a couple of lawyers, who Markopolos said were not experts in investing.

Neither the MBTA's auditor, KPMG, nor Marco Consulting, its pension consultant, reported any problems with the Fletcher investment.

Weston Capital

In 2013, the MBTA invested approximately $10 million in Weston Capital, a hedge fund run by Jason Galanis, whose father had run a big Ponzi scheme in the 1970s, stealing approximately $400 million from mostly Hollywood investors.

Markopolos said in 2007 that Galanis bought shares in *Penthouse* magazine, filed a false 10Q with forged signature, and had caused its auditor, Deloitte, to resign. All this happened before the MBTA made its investment in 2009.

"How much due diligence do you have to do to invest with Weston Capital?" Markopolos asked, rhetorically.

By the end of 2013, the MBTA had written off the value of its Weston investment.

Galanis, Markopolos said, would look for struggling RIAs. He would overpay for an ownership interest in firm, with the stipulation that its minority interest not be disclosed on its form ADV (which is illegal).

He would then arrange to invest all or a portion of the RIA's fixed-income portfolio with a promise of 8-9% returns. He would then raid those funds to pay Ponzi-style interest, Markopolos said.

Markopolos warned that fraudulent schemes to buy struggling RIAs are ongoing. RIAs should be aware that the damage goes beyond the firm's assets, he said. A good criminal defense starts at $1 million, according to Markopolos, and even if you beat the charge anyone will be able to Google the result.

The larger problem

After recounting the Fletcher and Weston debacles, Markopolos described the larger problem facing the MBTA.

Based on audited financials, he said that the MBTA plan's assets are only 29% of its liabilities, an underfunding of approximately $470 million. But Markopolos claims the actual number is closer to $1 billion.

The gap is due to overstating of asset values and returns, underestimating employee's life expectancies and using an unrealistic discount rate for its liabilities.

The MBTA is "one bear market away from disaster," Markopolos said.

Markopolos presented data from the MBTA's 2012 and 2013 annual reports, when its market value jumped by $200 million. The most alarming aspect in those years was the outperformance of its public equity (large-cap, small-cap and emerging markets) and fixed-income holdings. Equities outperformed their benchmark by 6.28% and 5.63%; bonds beat its benchmark by 7.60% and 2.86%, respectively in the two years. Similar returns were reported for the MBTA's real estate holdings.

That degree of outperformance is highly unusual, since the MBTA was using multiple asset managers in both its equity and fixed-income allocations. Across all asset classes, it used 71 asset managers. According to diBartolomeo, a single manager might achieve such outstanding results, but the chances of a team of managers performing that well was "essentially zero."

The investigation is ongoing as to how the MBTA was able to report such spectacular results. Most likely, it was due to accounting manipulations. The MBTA may have switched the accounting standard it used (such as GAAP or GASB) in order to report the most favorable result. It may also have used provisions which allows pension plans to report performance smoothed over a five-year period to inflate its numbers.

By contrast, the MBTA reported dismal results for the 20% of its assets held in alternative funds – private equity, hedge funds and something it called "diversified beta." Each of those fund categories underperformed their benchmarks in 2012 and 2013 by between 9% and 17%.

Markopolos questioned the due diligence procedures that led to such poor investments and why those managers had not been fired after achieving such poor results.

“Why did it keep investing in alternatives?” he asked, rhetorically.

The MBTA used actuarial tables from 1994 to determine the expected lifetimes of its employees. This resulted in shorter lifetimes than the rest of the pension industry, which was using tables from 2000. By assuming its employees would have shorter lifetimes, it was able to artificially reduce its projected liabilities and underfunded status. This represents approximately $105 million of the half-billion shortfall.

Long-term implications

Of the roughly $500 million shortfall, Markopolos calculated that $106 million is due to using an unreasonable discount rate to calculate the present value of its liabilities. The MBTA used an 8% discount rate and had increased its rate in 2012 by 0.5%, when almost all pension plans were decreasing their rate or leaving it constant.

The use of unreasonable discount rates is well-known and its impact widely estimated. The plans justify the use of an unreasonably high rate by claiming adherence to an actuarial standard; in reality, the economically appropriate discount rate – one which reflects the riskiness of the liabilities – is much lower. Markopolos said it should be about 4.5%.

The more troubling problems uncovered by Markopolos are driven by other factors, such as poor due diligence on its investments, overstating of returns, overstating of asset values and faulty life-expectancy estimates. These problems appear to be driven by a pension board that, at best, was unable or unwilling to scrutinize its investments or, at worst, willingly investing its assets with known criminals and past employees.

Nobody knows how widespread problems like these are.

The MBTA falls into the category of multi-employer public pension plans, which are among the smaller state-run plans. According to diBartolomeo, there are approximately $3 trillion in assets in about 6,000 smaller plans, roughly about 30% of the total assets in public pension plans. Markopolos said there are “plenty of other plans in Massachusetts with similar problems.”

Don’t expect help from supporting vendors. In addition to KPMG and Marco, Markopolos said that neither State Street Bank, the MBTA’s custodian, nor Buck Consultants, the plan’s actuarial consultant, warned of any problems.

KPMG should have found the discrepancies. But Markopolos said its auditors are typically “22-year olds who catch more colds than frauds.”

The investigation into the MBTA plan will continue. But if the plan fails – as Markopolos warned – it will surely have an impact on the municipal market. If the state of Massachusetts needs to bail out the plan, it will need to raise money through the bond market. It would be politically unpopular to let the plan fail, since the blue-collar MBTA workers are unwitting victims of the fraud and incompetence.

If problems like this are endemic among multi-employer state pension plans, it will mean higher rates for municipal bonds.