Lessons from Madoff
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Bernard Madoff has yet to share with the public the benefit of everything that he learned in his years of running what was likely the world's greatest Ponzi scheme ever. Perhaps he'll reveal all now that he has pleaded guilty, though that is by no means a legal requirement and he seems unlikely to do so. Nonetheless, we are already able to draw a number of lessons from this one disastrous episode in the endless history of financial scandals.

Some lessons are for legislators and regulators, and some are for the supposed experts who advise others on where to invest. Those are not my concern here. I want to consider five lessons in particular, ones that should matter to anyone investing his or her money and financial well-being. None of these lessons is new, and indeed, three at least should be very familiar, but the Madoff affair gives us reason to consider them afresh. I have seen in the press that one lesson is being learned incorrectly, and I hope to remedy that.

I do not suggest that all of those who lost money to Madoff failed to heed these lessons. Some victims were innocent in the deepest sense. These include individuals and charitable organizations who entrusted their money to reputable and well-meaning others who in turn gave the money to Madoff without their knowledge, and charities that depended on annual gifts from wealthy donors who lost their own fortunes to Madoff. But the lessons are worth considering all the same.

1. If a promised investment looks too good to be true, it probably isn't good or isn't true.

To apply this ageless lesson requires that one have a standard of what is good enough to be true. That is, one needs a familiarity with the kinds of returns that have been available in the financial markets. With press coverage of the extraordinary returns genuinely earned by some distinguished hedge funds during the last decade and by the endowments of Harvard and Yale (until 2008), the public should be forgiven if it has been confused about the plausibility of various stated returns. All the same, any intelligent person ought to know that you can't consistently, say, double your money over a succession of months or
years. A 15% return is very far above the average that any plausible investment strategy could earn over a span of years.

Usually, Ponzi schemes run on the promise of extraordinary returns. Madoff, however, had a fiendishly clever trick for overcoming the usual standard of "too good to be true." Rather than promise most of his investors extraordinary returns, he lured in the cautious ones with a history of a very good but not unreasonable average return combined with extraordinarily low risk. In the graph below, from one of the "feeder funds" for Madoff's scam, the steadily rising line represents the purported value of an investment in Madoff's fund. (If this

[Graph]

graph really was constructed from the returns that Madoff was reporting contemporaneously, then he evidently had the good sense and steady nerve to invent returns that were worse than those of the stock market during the dotcom boom.) As Harry Markopolos, the whistleblower who repeatedly reported Madoff to the SEC to no avail, said in his Congressional testimony in February, such smoothly increasing returns, of such magnitude, over so many years, are next to impossible in the real world. Madoff invented a series that combined the returns of stocks and the lack of risk of cash. Regardless of Madoff's claims to have an investment strategy beyond your limited comprehension (as he would have had you think), these numbers were still grossly implausible.

What can an investor do to protect himself from being gullible by such obviously fraudulent data? Unless the investor is familiar with the markets, these data may not appear to be obviously fraudulent. All the same, we know that many of Madoff's victims invested with him because they indeed recognized these returns

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as extraordinary. That very extraordinariness should have aroused their suspicion, or at least curiosity, and led these investors to consult disinterested or at least trustworthy experts who had an intuitive grasp of the standards for returns and risk. I will return to this when I consider the fifth lesson, concerning trust.

2. You should not allow the manager of your investments also to have custody of them.

This is the most simple and straightforward lesson. The investment manager may have discretion to move your assets about as he sees fit, but the custodian is the overseer who observes them passing into and out of your account. If the custodial company is independent, then it provides a check on the investment manager.

If you visualize your stocks, bonds, and mutual fund shares as being represented by pieces of paper (as they once were), then the custodian is the party that keeps them under lock and key, pays for insurance on them, and sends you monthly reports of all the pieces of paper in your account. The investment manager can't do anything with this property of yours without checking in and out with the custodian. Now remember that all your stocks, bonds, and mutual fund shares are represented in electronic databases rather than on slips of paper. The custodian's function is still the same. Clearly, you'd prefer the custodian to be an independent and disinterested party, rather than the investment manager. The custodial company issues its own reports on the holdings of your accounts, which, if it is independent, thereby considerably lessen the possibility of theft.

Perhaps if your assets are being managed by a large national bank that has a custody department, the conjunction of roles is excusable, but otherwise, the shared responsibility of management and custody presents too great an opportunity for mayhem balanced by no discernible benefit. This shared responsibility of manager and custodian can also be a problem with large brokerage companies. There have now been suggestions that the separation of custody and management be required by law. I doubt that this will come to pass unless there is an exemption for the banks and large brokerages.

As an investor, you don't hire the custodian yourself. You should simply ask anyone who proposes to manage your assets who would be the custodian, and then check to be sure that it is a reputable company independent of the investment manager. You can easily search the company's name on the Internet.
3. The old chestnut, "Don't put all your eggs in one basket."

This is the lesson that has been misunderstood by some in the financial press and by some of the public. By itself, the lesson is not wrong. Diversification, thoughtfully implemented, is central to good portfolio management. It is a mistake, however, to infer from this that you should not give all your money to one investment manager. There ought to be a professional who has a comprehensive view of your finances.

Let's first consider the purpose of diversification: it is to control investment risk and to increase the rate of growth of our investments (though this latter reason is seldom recognized). Usually, when we talk of diversification, we are referring to diversity of investment asset classes (stocks, bonds, real estate, and so forth), diversity within asset classes (large-company stocks, small-company stocks, "value" stocks, "growth" stocks, and so forth), and diversity of investment management styles ("growth" managers, "value" managers, and so forth). In order to receive the benefits of diversification, the portfolio has to be carefully constructed with an understanding of the risks that are being controlled. Naïve diversification, that is, just broadly spreading the money around without regard to where it's going, may do little good and will likely produce poorer results than a carefully constructed portfolio would.

The purpose of diversification is normally not to limit exposure to fraud. It can serve that purpose, but fraud is rare, and that should not be the primary reason for diversifying.

Hence, the implications of diversification for the choice of investment managers are mixed.

There is a forgivable confusion among the public about what investment managers do. This is the fault of our profession, whose practitioners are often unclear among themselves about what it is they do. We also lack a distinct vocabulary or jargon that would help us explain our responsibilities succinctly.

The confusion arises because some investment managers devote their entire efforts to implementing an investment strategy that applies to a narrow range of investible assets, like stocks, or even more narrowly, something like large-capitalization "value" stocks, while others, in contrast, devote their efforts to building and managing a portfolio for each client across a broad spectrum of investible assets, like stocks, bonds, cash, commodities. Sometimes we call the latter kind of investment manager a "portfolio manager," but that term itself varies in its meaning depending upon the portfolio manager's employer. I suggest "financial advisor" or "wealth manager" as more suitable terms, though even the former is problematic, because it implies a broader responsibility than I intend.
Some financial advisors will manage your entire financial wealth themselves, and others will apportion it among different investment managers (in which case you will pay the financial advisor's fee in addition to the fees of the different managers).

So, although the principle of diversification implies that you should not hand over your entire financial wealth to one manager or company that is pursuing a single, narrowly-defined (not to mention occult) investment strategy or investing in a single asset class, it is wrong to forego the services of a single financial advisor who can advise on the disposition of your entire portfolio and in doing so help you avoid making precisely the mistake of concentrating your holdings too narrowly. Without the services of someone who understands how to build a portfolio, you will be at the mercy of risks that you may not understand, even if your money is managed honestly.

Moreover, fraud is committed more often by the kind of investment manager who pursues a narrowly designed strategy, because these strategies sound much more "sexy" and alluring. A wealth manager or financial advisor is less glamorous and doesn't offer "bragging rights." A conman is therefore less likely to pose as a wealth manager.

It is true that Madoff's nearly perfect results would, if taken at face value, have suggested that a financial advisor was unnecessary because he seemed to deliver financial success with no risk. But even if his numbers had been real, an experienced and wise financial advisor would have assumed that any complex trading strategy must one day fail, and to hedge against that eventuality, other investment managers besides Madoff would have to be included in the portfolio.4

4. Pay close attention to fees.

This lesson will reward you even if you never encounter a fraud. Some investors, if they pay attention to fees at all, mistakenly believe that higher fees correspond to superior investment performance. For investment management services, there is no economic law that demands that you get what you pay for. There is ample evidence to falsify this belief. Also, any fee, however it is structured, provides incentives. You should consider what incentive an investment manager's fees provide, and to whom.

One very suspect aspect of Madoff's operation was that he did not ostensibly charge a fee for his service. He claimed that he made money from the commissions on his trades. This is another aspect of his operation that was too good to be true. It was grossly implausible that if he had the skill that he claimed to have, he would not charge a fee - a large one - for his services.
At the same time, Madoff's investors were paying enormous amounts of money to the firms (the "feeder funds") that were giving them access to Madoff's operations, and while it is certainly plausible, it is also entirely reprehensible that a firm would charge such fees merely for taking the money from the investor and giving it to Madoff to manage. This required no skill, and even the due diligence that they claimed that they were performing on Madoff (and that, as we now know, they were not) ought not to have commanded such exorbitant fees.

It has been reported that a number of investors thought, because he was not charging a fee, that Madoff was stealing (by a process known as "front-running") from someone else, but not from them. That is, the fee structure did correctly arouse suspicions in some, as it ought to have done, but not the right suspicions. And that these investors continued to "invest" through Madoff despite those suspicions was at best amoral.

5. You must have a basis for trust in your financial advisor.

This is the lesson of the Madoff affair that is most difficult to attend to, and the most elusive. The faith of many in financial advisors generally has been destroyed by their having been robbed (or, in effect, advised to be robbed) by Madoff, whom they trusted. Of course, the financial system depends almost entirely on trust, with individuals more dependent upon trust than institutions are, and it is therefore key to the success of the conman or Ponzi schemer that he, too, gain the trust of his victims. I am no psychologist, and I cannot provide guidance to tell you how to know when someone is lying.

By the accounts that I have read, Madoff was a somewhat retiring figure who seldom recruited his own victims, though he did go to some lengths to create the illusion that he was not eager to take additional funds under advisement. But as Harry Markopolos noted in his testimony, Ponzi schemers operate by working through a network of affinities, comprising individuals who share a social context. Madoff was more successful than most such schemers in having created at least two such affinity networks: well-to-do Jews of the Northeast (and Florida, which is the Northeastern part of the Southeast), and European minor aristocracy. The former were able to draw in still others who were outside their affinity network. One of Madoff's agents, Ezra Merkin, was regarded as an investment genius, but his other useful fools were not. The victims' trust was displaced from Madoff to those who funneled their money to Madoff. These sometimes were reputed experts, like Merkin, but in many instances they were merely respected social contacts. If you are relying on the social standing rather than the manifest investment professionalism and expertise of your advisor, then your trust in that advisor is misplaced. And a successful man of business is not necessarily an expert in investment management.

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The danger of outright theft is for most investors very slight. Far more often, money is needlessly lost through misplaced trust in the skills of someone whose tales of investing prowess are grossly overblown but who is not a thief. Those especially who do not understand investing must rely on an experienced financial advisor.

Unless at some point you have the courage to place your trust in a financial advisor, you will end up hiding your cash in a mattress. The lack of trust can become self destructive.

If you are unfamiliar with investment processes and history, and cannot tell what is too good to be true, then you require the services of a financial advisor. It can be expensive to retain an advisor who is completely disinterested, that is, who will gain nothing from the management of your wealth. For most private investors, then, you should have an overall financial advisor who will also manage some large part of your financial wealth. At the very least, your financial advisor should be able and willing to answer all your questions, hiding nothing. Correspondingly, though, if you trust your advisor, you should not be giving him orders. For good reason, financial advisors do not welcome being second-guessed on their every move. "Trust but verify" is an apothegm that every investment management client should bear in mind.

Conclusion

All these lessons are more easily grasped than applied. The individual investor may lack the knowledge to apply the first and the third, and even the lesson on custody, which is the most straightforward, may not be applicable if your account is held at a large bank or brokerage firm. The last lesson, about trust, depends on finely calibrated judgments of the character of individuals and businesses. Ultimately, you must either take full responsibility for managing your own investments, with the educational requirements that that task entails, or place your trust in a financial advisor who has a comprehensive understanding of your finances and the financial markets.

1 Joe Nocera wrote an opinion piece that blamed Madoff's victims for being complicit in the crime, and though I agree with him by and large, he fails to discriminate among the victims, some of whom were entirely blameless. "Madoff had Accomplices: His Victims", New York Times, 13 March 2009
2 According to prosecutors, Madoff did actually promise "select" investors returns of 46%. These were, presumably, the more credulous ones.
Madoff kept up appearances. As legal custodian for his clients' accounts, he evidently paid for SIPC insurance on them, which guarantees that his clients will get back up to $500,000 each.

If the financial advisor were foolish enough to believe Madoff's numbers, he would not have been able to use conventional asset class allocation software, which, knowing only the numbers fed into it, would also have allocated nearly the entire portfolio to Madoff. The financial advisor would therefore have had to rely on mature judgment, not the crunching of numbers.

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