Disambiguating Bernie Madoff
By Alan Snyder

Holidays are warm, wonderful and a respite from the daily grind. As the year ends and a new one begins, now it's time to reflect, yippee. We offer the following to reassert key principles for any portfolio changes under consideration.

Mr. Bernie Madoff

Most of the $64.8 billion in his hedge fund evaporated, the largest investor loss on record. Here was a man who was a genius, which may shock some, a chameleon-like psychopath, and sadly for his 16,000 investors, an unprecedented crook. He has been in the press from 1960 through present and today resides in the steel hotel, jail. Rather than relitigate and rehash, we focus on the lessons to be learned from this mess.

The Back Story

Born on April 29, 1938, Bernie started his firm in 1960 with $5,000 he earned as a lifeguard. The firm's growth was ferocious from trading penny OTC stocks in its early days as a market maker while later on expanding into blue chip stocks. It bought trading volume by paying undisclosed fees from the spread it earned, a controversial practice that became accepted over time (editor's note: not unusual for Wall Street). Bernie was accepted, even welcomed, into the Wall Street club, serving as Chairman of Nasdaq in 1990, 1991, and 1993. However, it was not enough.

Leveraging his success, he founded a hedge fund allegedly using split-strike conversion option strategies to "collar" risk. The track record was phenomenal, generating consistent returns with little volatility. There was a gusher of money from the Jewish community and many others (viz. Steven Spielberg, Kevin Bacon, Kyra Sedgewick and the owner of the N.Y. Mets, among the notables). Much of the money came from charitable trusts and foundations seeking long-term gains with **scant liquidity requirements, Genius Point #1.**

Since Madoff was recognized as a Wall Street "stud muffin," investors felt lucky indeed to even be accepted into this money printing machine. The strategy was secret and above the ken of mere mortals. There was a **total and willing suspension of disbelief** in the guise of Aristotle's Principles of Theater (**Genius Point #2**). Much like in a great movie, investors sacrificed realism and logic for the sake of this phantasmagorical enterprise. Our charismatic charlatan displayed all of the trappings of great success: private jet, penthouse, yacht, vintage watch collection and vacation homes around the world. Regulators were **blinded by charm and guile (Genius Point #3)**. Madoff embodied the old adage of keeping your enemies close. There were rumblings. One scold, Harry Markopolos, was unrelenting but unsuccessful in outing this Wizard of Oz.

Charles Ponzi in 1920 set the stage for Madoff, who followed in his footsteps. A Ponzi Scheme is a form of fraud where belief in success is fostered by the payment of "returns" to the earlier investors via the capital contributions of later investors. As such, a growing capital base is required to keep the pyramid intact. The sharp and steady equity market decline of 2008 - 2009 did Bernie in. Capital inflows slowed to a trickle. With fear high, investors tried to withdraw. The jig was up. Some subsequently surmised that no trades were ever actually made, a truly incredible possibility.

Lessons to be Learned

Fraudulent investments are a challenge to unmask. Fundamental lying makes uncovering the truth difficult. In such cases, evidence must be dug out indirectly with scant reliance on input from the principals. Nevertheless, Shinnecock did avoid Madoff despite the overweening temptation. Investors could have known a priori that this investment was too good to be true. What were some of the tipoffs for active due diligencers?

To be fair, it would have been harder to avoid this mess in the early days given the shorter track record of heroic returns, but possible.
1) The option strategy was not unique and, deployed on its own, insufficiently robust to avoid declines or more volatile results.
2) Any asset manager unwilling to fulsomely describe what they are doing must be avoided. No one ever saw actual trading records, a critical step. No wonder, there may not have been any.
3) Inadequate service providers. The auditor was a "no-name" two-person firm. Moreover, there was no independent administrator to control cash and undertake independent investor reporting.
4) Family members were in critical control positions, clearly lacking independent objectivity.

Later on, when there were significant assets under management, the true picture would have been even clearer upon careful examination.
1) As the asset size grew, it would have been impossible to deploy the strategy in the option markets without severe dislocations.
2) A tiny audit firm could never have successfully examined a fund of such scale, even working 24/7.
3) In general, the Madoff staff was too small to have managed the trading frequency ostensibly required.
4) As the years wore on, the results became ever more improbable.

The Aftermath

On June 29, 2009, Madoff was sentenced to prison. There were some recoveries, estimated as approximately half of the capital, circa $31 billion. Funds continued to be distributed to the Madoff Victim Fund as recently as 2017, a long, sad wait for the defrauded investors.

Postscript: Chutzpah – On July 24, 2019 it was reported that Madoff petitioned the Justice Department for clemency from Donald Trump. Madoff remains in jail, serving a 150-year sentence.

We must offer two <u>mea</u> <u>culpas</u>:

1) Have we avoided all sketchy investments? Alas, not, but once burned, twice shy. We have detailed an early mistake we made in article number 17 (below). Learning from past mistakes is our destiny. With good fortune, we will live long enough to outrun these foibles or, at a minimum, have the courage to share the learnings to help others.
2) Years ago, we had the good fortune to invest in Jim Simons' Renaissance Technologies, the best performing hedge fund of all time. Did we diligence it? Yes… yet was it possible to understand everything they were doing… no. Unlike Madoff, the experience of the principals involved was noteworthy given their relevant backgrounds, coupled with controls, blue-chip service providers and no family members in vital positions. Sometimes, Lady Luck smiles on us but it is unlikely we would make a similar investment now. Our conservatism and no doubt age, has made us ever more risk averse and willing to miss a hidden gem in order to protect principal.

Conclusion

After-the-fact analysis of a problem must guard against glib conclusions. However, in this case there were enough troubling facts to keep careful investors away. We have published detailed suggestions for due diligence, listed below. Let's be bold. Even our most sophisticated readers might find a kernel or two of useful content in them.

Always, we welcome additional insights for we are shameless in our goal of trying to be ever better in this challenging business.

1) Curiosity Killed the Cat – Addressable Market for Hedge Fund and Alternative Information (the market)

2) Investment Answers from the Gnomes of Zurich (getting started)

3) Lighter Fare but Possible Homework (ha) (sources for basic Alternatives knowledge)

4) 7%+ Net, 6 Months Duration, No Leverage, Hard Asset… STINKS (return expectations)

5) Water, Water, Everywhere and Not a Drop to Drink (finding the best investments)

6) Mirror, Mirror on the Wall, Who's the Fairest of Them All? (due diligence starting point)

7) Due Diligence Data Requests (what information to get)

8) Document Stew, Svengali and Buyer's Remorse (underlying documents to review)

9) Manager Due Diligence Questions and Information Requests to Consider

10) An Investor's Guide to the Risk Versus Return Conundrum: Isolating Critical Considerations, Identifying Challenges and Evaluating Alternative Approaches

11) Quantitative Hedge Fund Analysis and the Infinite Monkey Theorem

12) Guide to On-Site Due Diligence

13) What's Your Edge?

14) Ten Reasons Not to "Phone It In" and One to Smile (onsite diligence)

15) Reluctance to Withdraw from an Investment Manager Versus "Damn the Torpedoes, Full Speed Ahead"

16) We are Not Retreating, We are Advancing in a Different Direction (macro economics)

17) Bright Shiny Objects, All That Glitters Isn't Gold, and Lessons Learned from Richard Cory (lessons to be learned from the past)

18) Building a Portfolio, Due Diligence and "Les Trois Mousquetaires" (more lessons to be learned from the past)