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Where Did Madoff's Money Go?

One of the hallmarks of a Ponzi scheme is that most of the missing money ends up in the hands of unwitting investors, not the perpetrator of the fraud. Rick Antle, a professor of accounting at Yale SOM who is helping in the Bernie Madoff restitution effort, discusses the complexities of cleaning up Madoff's mess.

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By Conrad de Aenlle

Bernard Madoff was so successful at separating people from their money—investors lost about $18 billion of the $65 billion they entrusted to him—in part because the story he told them, at first blush, didn't seem too good to be true.

The perpetrator of what is considered the largest swindle in history didn't tell prospective marks that he could make them rich overnight. Many of them were charities or wealthy individuals who were unlikely to be swayed by such a pitch. Instead he promised them relatively modest returns—in line with those of the stock market—that carried almost no risk of loss.

As with any Ponzi scheme, Madoff's created the appearance of returns by paying income to early investors out of capital committed by later ones. As more investors are lured into a Ponzi scheme, still more must be recruited to pay them. When too many new investors are needed to pay existing ones, the money runs out and the fraud is discovered—or, as in Madoff's case, adverse market movements lead to demands for redemptions that can't be met, giving the game away.

After his scam was uncovered in late 2008 and Madoff was sentenced to 150 years in prison, authorities set about recouping his victims' money. Rick Antle, the William S. Beinecke Professor of Accounting at Yale SOM and a member of the team engaged in the recovery effort, noted in a conversation with *Yale Insights* that restitution for victims of any Ponzi scheme comes from two sources: the assets of the perpetrator and the apparent profits of early participants.

"You have to follow the money," he said, including into "the hands of people who took out more money than they put in." Even though it's "emotionally wrenching," Antle said, "you have to claw that back and redistribute it to people who actually lost money."

Finding investors' capital and dividing it up in an equitable way is especially difficult because a Ponzi scheme "shuffles money around among a lot of people," he pointed out, "taking one person's money and giving that to someone else." Even though the person committing the fraud "takes a relatively small percentage of the take," he or she is "making a huge mess" in the process.

Such confusion is a common element in Ponzi schemes as the orchestrator tries to keep the fraud going and hide what is occurring. It was true of the fraud committed nearly a century ago by Charles Ponzi, an Italian immigrant in Boston who cheated investors out of $20 million by convincing them that they could make a bundle by buying an obscure type of postal order whose value differed from country to country and redeeming it for a profit in the United States.

Ponzi schemes existed long before they bore Charles Ponzi's name. In fact, he got his idea after working at a Montreal bank whose founder had bilked depositors. Indeed, the Bible refers to endeavors that bear the hallmarks of Ponzi schemes, Antle noted. It may be no coincidence that they are also called "rob Peter to pay Paul" frauds.

Among the more notorious examples of the last century or so, William "520 Percent" Miller of Brooklyn promised to pay 10% weekly interest (apparently not compounded) in a banking scam in 1899. Another fake banker, Dona Branca, duped poor Portuguese savers in the 1970s and 1980s with the promise of 10% monthly interest—more modest but just as illusory.

In an operation similar to Madoff's in its method and its high-tone victims, but much smaller, the San Diego commodity trading firm J. David & Co. ripped off investors for $80 million in the 1980s. In 2005, Syed Sibtul Hassan Shah, a science teacher in Pakistan, attracted nearly $900 million from investors with tales of a stock-trading system that he had picked up in Dubai.

Two years later, an estimated one million Chinese were taken in by a ploy involving ant farms used to produce an alleged aphrodisiac.

Common sense might have alerted victims of schemes with such outlandish promises that something was amiss. For more subtle ones, like Madoff's, a greater understanding of the relationship between risk and reward is required.

"The underlying tenet of the efficient-markets hypothesis…is you can't get a higher expected return without taking risk," Antle said. When presented with the opportunity Madoff offered, "you could say, 'Oh, my God, I found the holy grail,' or if you really take this efficient-markets hypothesis to heart and take as your working hypothesis that you can't get rewarded without taking some risk, you become very suspicious of this…. It's too good to be true."

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