BLOG

10 Years Later: Lessons Learned from the Bernie Madoff Scandal

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Investing Phase 1: Assess Phase 2: Get Ready Phase 3: Implement Phase 4: Live Phase 5: Establish

December 11, 2018 marked the 10 year anniversary of the arrest of Bernard Madoff, the main perpetrator of the largest Ponzi scheme in history. His fraud was valued by regulators at approximately $64.8 billion.

To quickly summarize what happened, Bernie Madoff started two businesses. The first was Bernard L. Madoff Securities, LLC, which grew to become a well-respected market maker that facilitated electronic trading for financial institutions. The second business was an investment advisory firm that masqueraded as a legitimate operation. It was actually a pyramid scheme paying back old investors with new investors' money. He promised his advisory clients a steady stream of positive but modest returns and created false brokerage statements and trade confirmations to support this lie.

Most experts believe he started out legitimately but at some point, he lost a sum of money he couldn't recover from. Rather than telling his investors about the losses, he began covering them up through the creation of false account statements. He fooled both amateur and professional investors alike.

In December 2008, he confessed his crimes to his sons who turned him into the FBI. On March 12, 2009, he pleaded guilty to his crimes and said that he acted alone in perpetrating his fraud. On June 29, 2009, he was sentenced to 150 years and ordered to pay $170 billion in restitution.

Since his deceit was revealed, there are still many unanswered questions. Despite these questions, there are lessons that fraud can teach all investors to avoid becoming victims of the next Madoff.

If you can't understand your investment strategy, it probably shouldn't be your investment strategy.

Bernie Madoff told his clients he was engaging in a split-strike conversion strategy, which involves selling out-of-the-money call options on index futures, buying a representative sample of the underlying equities in the index, and purchasing in-the-money put options.

Let's pause here for a moment. Do you know what a split-strike conversion strategy is? Does this strategy do well when the stocks are up, or does it do well when stocks are down? Do you know the difference between writing a call option and buying a put option? Do you know what out-of-the-money or in-the-money means?

If you didn't know the answers to any of those questions, that's probably a sign this isn't a strategy you should be engaging in.

Investing requires discipline and commitment to a strategy. If you don't understand your investment strategy, you'll likely have a very difficult time adhering to it when times get tough. Abandoning your investment strategy when it's out of favor can be a recipe for losses.

Don't trust someone just because they have the same religious or ethnic background as you.

Madoff's impact on the Jewish community was devastating. His earliest clients were from social connections he made through a Jewish summer camp where his family vacationed in upstate New York. The Palm Beach Country Club, which was founded by a group of Jewish men in the 1950s in response to their exclusion from the other country clubs in Palm Beach, was an epicenter of Madoff victims. His list of victims includes numerous prominent Jewish individuals and charities.

This is just one example where people develop trust in someone because they think they have shared values or experiences, and their trust turns out to be misplaced. Shared values are a reasonable starting point for learning more about a firm, but that should never be the end of your research.

Develop an awareness of signaling.

Part of what made Madoff so dangerous was that he became a master of signaling. Signaling is when you outwardly display behaviors, objects, activities, or qualifications to convince others of something. In Madoff's case, he was signaling to the outside world that he was an incredibly successful and trustworthy investor:

- He owned multiple homes, a collection of Rolexes, and a 100 ft. yacht he named "Bull" (you can't make this stuff up).
- Served a term as Chairman of the NASDAQ Stock Exchange.
- Served on regulatory advisory committees.
- Gave generously to charities.
- Was always immaculately dressed in custom pinstripe suits.
- Belonged to several elite country clubs.
- Had a prestigious office in Manhattan and London.

Signaling can be a useful tool for judging people and situations; however, it can also be used against you if the person you're judging is aware of what you're looking for.

Also, just because someone is signaling that they're successful does not mean that they are running a Ponzi scheme. How someone holds themselves out to the world should help you in your decision, but it should not be your sole deciding factor for assessing an investment.

Only work with an adviser that uses a third-party custodian.

In Madoff's case, he was the custodian and the investment adviser for his clients. The role of a custodian is to hold clients' investments, create statements, settle trades, report account values, handle deposits and disbursements, and many other important duties. The role of an investment adviser is to make the actual investment decisions for their client about which securities to invest in, how much to invest, and decisions around the timing of when to get in or out of investments. Because he was doing both of those jobs, he had the ability to manipulate the statements to support the story he was telling his advisory clients.

When selecting an investment adviser, I would consider it a best practice to only work with firms that use a third-party custodian. The third-party custodian is then responsible for holding the investments, and the adviser is responsible for choosing the investments [https://rodgers-associates.com/newsletters/active-vs-passive-choosing-funds-portfolio/].

Steer clear of investments that seem exclusive and demand secrecy.

Madoff didn't advertise for his investment advisory business. It didn't have a website. Its entire existence was based on "whisper down the lane." People heard rumors of celebrities, business moguls, charitable foundations, and hedge funds that trusted him with their money. If asked, he'd claim to not be accepting new clients. But maybe you heard from your friend at the country club that he'd occasionally make exceptions…but not for just anyone. Being accepted as a client was something of a status symbol.

Make sure a firm is registered with the proper regulator.

Firms with more than $100 million under management are required to register with the Securities & Exchange Commission (SEC). Firms smaller than that are required to register with their state securities regulator. In the case of Madoff, his investment advisory firm was not registered with the SEC until the SEC compelled him to do so in 2005. This would have been a helpful warning had you been evaluating an investment advisory firm prior to 2005. If you had evaluated the firm between 2005 and 2009 when Madoff's fraud unraveled, this rule would not necessarily have helped you, except for the questions you might have since you knew people who had invested with Madoff since the 1980s.

Don’t rely solely on regulators to vet an investment adviser.

The SEC failed to detect his fraud. They examined his business through audits several times. Before his fraud was discovered, they had received several tips from outside parties explaining that the strategy he purported to be engaging in for his clients was statistically impossible. Most of their audits appeared to pursue the theory that Madoff was using privileged information from his market-making business to benefit his investment advisory business. It appears they suspected he might be engaging in front-running his market-making clients’ trades with his investment advisory clients’ money. Had they looked deeper, they could have determined that the volume of some of the options contracts he claimed he was trading exceeded the total number of outstanding options contracts that traded in the markets.

Ask about your adviser’s process for selecting outside investment managers.

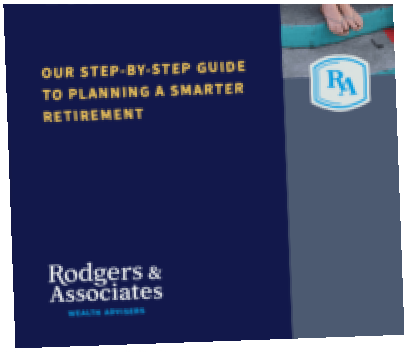
Many of Madoff’s victims didn’t even know they had money invested with Madoff because their investment was made through a “feeder fund”. A feeder fund is a fund that generally invests money with a number of other investment managers. These were run by professional investors who were supposed to be skilled in due diligence and financial analysis. Their mistakes were similar to those of many of the individual investors. They saw the returns he was claiming and through either lack of curiosity, trust in Madoff’s reputation, fear of missing out, or some other reason, didn't dig deeper and ask the tough questions. One red flag was that Madoff claimed that he wasn't charging the customary assets-under-management plus a percentage of profits fee that most hedge fund managers charge. Instead, he told them he was making money from the commissions of the broker-dealer side of his firm.

Don't ignore red flags.

In retrospect, there were many red flags that could have stopped people from investing with Madoff, but people ignored them. A constant stream of steady returns from an investment strategy that invests in stocks and options? An advisory firm that isn't registered with the SEC or a state securities regulator? An exclusive investment opportunity with none of the fees that similar money managers charge?

There's no question that there were red flags. So the question remains, why did all these people ignore them? In my opinion, what it ultimately boils down to was people looked at all of those factors together and allowed things like reputation, signaling, fear of missing out, celebrity and greed to overrule those warning signs.

Additional Reading: "Too Good to Be True: The Rise and Fall of Bernie Madoff [https://www.amazon.com/Too-Good-Be-True-Bernie/dp/1591842875/ref=sr_1_9?crid=RFEYX7RSNH1M&keywords=madoff+book&qid=1555007896&s=gateway&sprefix=madoff%2Cap 9]_" By Erin Arvedlund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