

Advisory News Brief

The Bernie Madoff Scandal: Will Investors Ever Learn?

Bernard L. Madoff, New York investment broker and former chairman of the NASDAQ stock exchange was recently arrested and is accused of perpetrating one of the biggest scams ever to hit Wall Street, a huge Ponzi scheme in which investors may have been defrauded of as much as \$50 billion.

The list of investors allegedly duped by Mr. Madoff is already long and growing daily. Individuals impacted include a veritable Who's Who of the rich and famous; a Steven Spielberg charity, a trust of Mortimer Zuckerman- real estate tycoon and owner of the New York Daily News and U.S News & World Report, Fred Wilpon- owner of the New York Mets, Norman Braman- former owner of the Philadelphia Eagles, New Jersey's Senator Frank Lautenberg, Leonard Feinstein- co-founder of Bed, Bath & Beyond, and many, many more.

A number of large foundations, charities, and universities have already been hurt directly, including the New York Law School, The Elie Wiesel Foundation for Humanity, and Yeshiva University. Some smaller organizations have been forced to close their doors and the potential fallout from reduced endowments and lost donations will be felt by not-for-profits for years to come.

Several international banks have exposure to potential losses in excess of \$1 billion each, including Grupo Santander (Spanish), HSBC (British), and Union Bancaire Privee (Swiss). Many other financial institutions, including Britain's Royal Bank of Scotland, France's BNP Paribas, and the Swiss bank Reichmuth & Co. face possible losses in the range of \$500 million each.

But some of the biggest dollar damage from this fraud is being felt in the shadowy world of hedge funds. In particular, by several large hedge fund firms that claimed to be offering investors some modicum of diversification via a 'fund of hedge funds' approach but who were instead investing solely with Madoff's firm.

Notable hedge fund operations acknowledging fraud related losses so far include \$7.5 billion by Fairfield Greenwich Advisors (nearly half of their total asset base), \$3.3 billion by Tremont Capital Management, Maxam Capital Management, Man Group PLC, and Ascot Partners; the last hedge fund (founded by GMAC Chairman J. Ezra Merkin) having essentially all it's \$1.8 billion in assets held by Madoff.

We suspect that this list will continue to grow as more individuals and organizations, including large pension funds and endowments, ultimately acknowledge that they too had been either directly or indirectly lured by the siren song of artificially low risk and high return, eventually falling victim to Bernie Madoff's deception.

What Exactly Happened?

Ponzi schemes are nothing new and come in various forms but all essentially involve paying or padding the returns of current investors with either distributions of existing investment principal or new dollars of incoming investors in the guise of true investment earnings. Given the relatively small sum of money remaining in Madoff's investment firm, it is likely that both methods were used to perpetuate the fraud in this situation.

Regardless of the exact mechanics involved, Madoff captured the essence of this type of deceit when, according to prosecutors, he admitted that he had "paid investors with money that wasn't there". However, it is the scope, magnitude, and complexity of Madoff's rendition of a classic Ponzi scheme that makes it unique.

Whether Bernie Madoff started off with the intention of defrauding investors or whether he initiated the scam as a way to hide investment losses or stolen dollars is a riddle for the prosecutors and forensic accountants to solve. Whatever the motive, the fact remains that there were many, many warning signs along the way that should have alerted both regulators and investors alike. While it is clear that the former were again asleep at the switch, we have long cautioned our investors to be extremely wary of the types of red flags that were flying over the Madoff operation for years.

Some Background

Bernard Madoff co-founded an investment broker-dealer firm in 1960 that eventually grew into one of the United States' largest market makers- the business of serving as middleman between large institutional equity buyers and sellers. His reputation and recognition expanded through this brokerage/trading business exposure and, as noted, he eventually became chairman of the board of directors of NASDAQ and a member of the board of governors of the National Association of Securities Dealers.

Based on what is known today, most of the issues that led to Madoff's ultimate downfall did not come from the original trade processing side of his business. Instead,

his problems appear to have started at some point after his foray into directly managing client money via the very secretive wealth management arm of Bernard L. Madoff Investment Securities. However, it is important to note that his firm's involvement as *both* designated broker-dealer *and* investment adviser played a critical role in facilitating the fraud. More on that later.

The Beginning of the End

It is unclear exactly when Bernie Madoff first started managing client money. The *Wall Street Journal* recently reported that the Securities and Exchange Commission sued two Florida accountants in 1992 for raising money to be managed by Madoff, guaranteeing investors returns of 13.5% to 20%. Since Madoff denied knowing the funds were raised illegally and the courts determined that all the money collected was indeed in the clients' accounts, he was never sued by the SEC.

The *WSJ* also reported that in a 2001 interview, Madoff had compared himself to a "broker who handles investors' accounts and gives them tips on where to put their money". Likewise, another *WSJ* article quoted one hedge fund executive as observing that Madoff was always very low-key and would say, 'Look, I'm a market-maker and I don't want anyone to know I'm running money'. In addition to enhancing his allure, mystique, and reputation for exclusiveness, this secrecy was perhaps for good reason. Despite obviously managing billions of dollars in client assets, Madoff did not formally register his firm as an investment adviser until September 2006.

But the facts are that Madoff was indeed managing money long before taking that step. A May 2001 article in *Barron's* noted that he was privately managing over \$6 billion for wealthy individuals, more than enough to place that portion of his business among the world's five largest hedge funds at the time.

Much of his money management business appears to have avoided scrutiny by falling into the regulatory dead zone that currently surrounds the hedge fund industry and its managers. But even this explanation is not entirely adequate because Madoff never created an actual hedge fund into which investors could put money. Instead, other funds would appoint him as a sub-manager, often the only one, and thus create a conduit through which investors could access his 'expertise'.

The Siren's Song

The same *Barron's* article referenced above observes that even in 2001 his investment results bordered on legendary, purporting to have produced average annual returns in excess 15% for over a decade, with most client's never experiencing a negative year. His management of the largest Fairfield Greenwich hedge fund offering was no less spectacular, logging positive returns of at least +11% per year and only experiencing *four months* of negative returns since its inception in 1989, a full twelve years prior.

The *Barron's* article went on to note that Madoff's expressed hedge fund strategy, a "split-strike conversion" that relied on coordinated equity and options trades using mega-cap stocks like Coca-Cola and General Electric, could not be replicated by options trading experts in anyway to produce anywhere near the returns that were purportedly earned. The article even broached speculation that Madoff may be using proceeds from his broker-dealer operation to help 'subsidize and smooth' his double-digit hedge fund returns, a proposition that Madoff dismissed as "ridiculous

Even in 2008's horrible investment environment, when practically every asset class imaginable was being decimated and hedge funds were collectively down an average -20% year-to-date through November, Madoff's management approach appeared undeterred, with two large hedge funds using his services reporting positive returns of +5.6% and +7.5% for the period..

Instead of inspiring suspicion and serious scrutiny, for many unfortunate investors this amazing consistency in performance from an investment strategy that others could not duplicate just added credence to Madoff's apparently uncanny capabilities. One New York investment manager was recently quoted by the *WSJ* as saying, "His results were reported to be so good for so long...the strategy incredibly liquid...like a bank account that earns 10%." Well, not exactly.

The Warning Signs

While the financial fallout from the Madoff scam has impacted many sophisticated investors who likely should have known better, diligent investors who prudently focused on investment fundamentals and resisted the lure of unreasonable returns from murky strategies were spared from the disastrous results.

Since inception, Roof Advisory Group has always decried, and fastidiously avoided, any investment vehicle, manager or firm whose structure, methodology, or returns were less than totally transparent. While the Bernard Madoff scandal takes opaqueness to a whole new level of black, there were several warning signs along the way that should have alerted investors to take their money and run. Here are just a few:

Lack of Clarity

When it comes to the management of their portfolio, investors should know what is being done, how it's being done, and why it's being done. Madoff's purported asset management approach was light on all three.

A common observation among Madoff investors was that they loved the performance but had no idea how he did it. It is critical for investors to have a clear understanding as to the investment philosophy and ongoing management techniques being deployed on their behalf and not simply be satisfied with the end results. Those professionals and clients who did thoroughly

analyze Madoff's supposed trading methodology saw things that just did not add up.

For example, while the stock/options trading strategy Madoff claims to be using is indeed a valid portfolio management tool, options trading experts have noted that this approach is more akin to a loss protection strategy and could not have generated the consistent double-digit returns touted by Madoff fans.

A recent *WSJ* article provided even more damning evidence by noting that if Madoff's firm was actually executing the number of options trades needed to successfully execute this strategy for even a small fraction of his clients, on the days the *WSJ* examined, his firm's trades alone would have eclipsed the total daily trading volume for that given option contract on the entire Chicago Board Options Exchange.

Finally, the same article observed that there was no line item pricing on the client's statement indicating the true value of the stocks held in the account, an omission that should immediately raise any investor's suspicion. In this specific situation, if the investor had seen the market value decline of the stocks involved for the period covered they might have realized that the drop in market value alone would have completely eliminated any gains realized via the options trades, leaving them with a sizable loss.

Understanding the investment approach and parameters governing any portfolio management process allows investors to maintain control. Roof Advisory Group is committed to this imperative and works diligently not only to effectively manage client portfolio, but also to keep clients up-to-date and fully informed. We stress that an investor should never abdicate his/her responsibility to know 'what, how, and why'.

Lack of Objectivity

In addition to the obvious, Madoff's firm and investment approach had several potential conflicts of interest that should have raised red flags for his investors. One of the most notable was that all trades for his investment management clients were placed and cleared through his commission-based brokerage business, a scenario rife with possible abuse.

For example, compensation for his investment management of hedge fund dollars came entirely in the form of trading commissions paid to the broker-dealer side of his operation. Professional, objective, client-focused investment management decisions should be made independent of any compensation consideration or consequence. The connection between making an investment decision and then earning a commission on the resulting transaction eliminates that objectivity.

Roof Advisory Group has always maintained that neither a firm nor individual can serve two masters and properly do both; objectively manage client portfolios with a fiduciary level of care while also having the

opportunity to financially benefit from client transactions or the sale of commissioned investment products.

Madoff was perhaps even acknowledging this inherent conflict of interest himself when he described his role with wealthy investors as one where he was like a "broker who handles investors' accounts and gives them tips on where to put their money". Unfortunately for his clientele, at some point Madoff's 'handling of investors' accounts' took on a very literal meaning.

Lack of Independent Custody

Not only were all client assets that were being 'managed' by the Madoff firm also being directly traded through the Madoff firm's brokerage arm, it is likely that these same assets were also, in some way, collectively held in custody by the Madoff firm. This lack of segregation of duties is a recipe for disaster that should have had investor instincts flashing 'red alert'.

An independent, institutional custodian whose job is to keep assets segregated and accounted for at the client level would have eliminated the possibility of the pricing omission and/or manipulation referenced earlier. It likely also would have provided some additional reporting clarity and continuity that may have allowed investors to spot discrepancies earlier in the scam.

Most importantly, an independent third-party custodian assures that all client assets are properly present and accounted for and that these assets cannot be accessed by anyone other than their rightful owner.

Roof Advisory Group utilizes a variety of large, independent, institutional custodial firms to assure our clients' assets are always remain clearly segregated from the firm's management function.

Lack of Reasonable Returns

Investors should resist the temptation to believe that somehow, somewhere, someone has an investment goose that always lays golden eggs. As painfully evidenced by the Madoff example, all too often such fairy tales go from being Grimm to grim.

Most sustainable investment performance comes from applying diligence, discipline, insight, and hard work to maximizing returns and minimizing risks within ever changing market conditions. Be extremely wary of unwavering stellar investment returns that seem to buck every negative market trend. As detailed in a moment, even the biggest, best, and brightest will suffer during extended market downturns. Madoff's clients chose to ignore this basic investment truth.

Knowing how portfolio returns are generated is an investor's best clue as to 'reasonableness'. In addition to providing our clients with detailed performance attribution numbers, part of Roof Advisory Group's ongoing review of outside managers and mutual funds includes tracking performance versus not only benchmark but also peer group. Returns far outside the norm, either to the positive or negative side, deserve further scrutiny.

It Was A Tough Year All Around

Part of what may have attracted some of Madoff's investors and blinded them from seeing some of the potential warnings, may have been the misplaced belief that they had indeed found something too good to be true.

Or perhaps it was that his experience, expertise, or inside connections in some way allowed him to remain entirely above the market's fray. If the latter, 2008 has certainly burst that bubble for good.

From the largest, most market-savvy, institutions to the most well-heeled, sophisticated individual investors, this market has taken its pound of flesh.

So to share some sense of perspective (or perhaps in a fit of schadenfreude), here are a few examples of how even the biggest, and supposedly best and brightest, investors have also suffered through an investment year that most are more than willing to bid auf Wiedersehen.

As an example, a recent report showed that Harvard University's huge endowment fund suffered investment losses of at least -22% during the four-month period from June 30 to October 31. However, this decline does not even factor in losses from its extensive holdings in harder to price assets such as real estate and private equity, which comprise a significant percentage of the endowment's overall investment portfolio.

Looking forward, the university is planning for about a -30% decline in the endowment's asset value through June 30, 2009...which means a dollar loss of over \$11 billion during the one year period. And we suspect it will be even larger than expected. Ouch. Despite Harvard's endowment being recognized as performing extremely well for the past several years, the market's downturn did indeed leave an indelible mark.

Nor were the endowments of other institutions of higher learning spared the wrath of the market during this relatively short four-month period. Amherst College lost \$1.7 billion or approximately -25%; Grinnell College fell by \$1.2 billion, likewise nearly -25%; and the University of Virginia saw its coffers reduced by -18% or nearly \$1 billion from the end of June to the end of October.

On the local front, even owning the sweetest resort & amusement park on earth - and much of the chocolate company that makes it so - could not muster up sweet returns for the Hershey Trust Company's year end as of October 31, 2008. Its overall asset value slipped \$2 billion, over -25%, from its 2007 value as of October 31st.

Individuals fared no better, as was evidenced by a Vanity Fair article from the *beginning* of October that outlined the projected losses from peak value experienced by some of America's uber-wealthy. Bear in mind, the numbers used by Vanity Fair are *before* the S&P and DJIA indexes managed to decline an additional -23.1% and -18.6% respectively from the end of September to the end of November.

The article listed Bill Gates' pain as being a loss of \$12 billion or -40%. Rupert Murdoch's News Corp

was shown as being down -63% or costing him \$4.8 billion. Google founders Sergey Brin and Larry Page experienced a -56% downswing from their peak wealth, to the tune of a \$12.1 billion loss. And even the venerable 'Oracle of Omaha's' Berkshire Hathaway holding had taken it on the chin at the time by being down -25%, costing Warren Buffett a paltry \$16.3 billion.

In actuality, Mr. Buffet's percentage loss was rather mild when compared to the majority on the list. The most devastating by far was Sheldon Adelson's -91% loss in the Las Vegas Sands, which had dropped approximately \$25 billion from top to bottom.

It is indeed doubtful that readers of this update will be moved to the point of starting a collection to help the now somewhat-less-wealthy listed in Vanity Fair. Nor is it an attempt to perversely illustrate how good we must have it by wallowing in the misfortune of others.

There are several observations and very basic investment tenets that all investors can take away from the illustrations in this *News Brief*. First, as trite as it may be it does bear repeating; if it sounds too good to be true, it most often is. Second, any highly concentrated, non-diversified asset position can be a two-edged sword. And third, no one is immune when the bottom falls out of the market and the economy heads south.

**Happy New Year!!
Cheers to a healthier, and wealthier, 2009!**

E. Jeffrey Roof

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Contact the firm at 507 N. Front Street, Harrisburg, PA 17101 and by phone at 717-260-9281.