

Christopher Miller, February 2009

Madoff: our last word (probably)

First

We were one of the very first to go on the record in the media about Madoff when London woke up to the story on 12th December 2008. At that time, most of the financial world was split between:

- Those who had invested in Madoff and were frozen in a state of shock, denial and terror;
- Those who had no idea who he was or the impact this would have; and
- Those who had actively avoided investing or advising anyone to invest in Madoff or his feeders.

Luckily, we were in the third group, but we nevertheless trawled through our archives to make sure that nothing had slipped through the net. We found this quote in a confidential report to a client: "Many including Allenbridge HedgeInfo argue that the returns are too good to be true." And we have only ever advised either not to invest or to divest.

Much has been said about Madoff and probably remains to be said, so we aim to avoid repeating other publicly available material.

Calm shattered

The financial markets were starting to breathe a sigh of relief that September and October were over, when another hammer blow fell to knock confidence. It is at times like these that we look for small mercies. And there was one. Because compared with other blow-ups like Amaranth and LTCM, this was much larger, but there were no trades to unwind, which is where the majority of the systemic risk comes from.

Red flags

Very rapidly, lists of red flags appeared, with reasons why no sane investor would give Madoff the time of day, let alone any money. Reputations were in tatters across the globe.

During this period we had already been in touch with journalists, regulators and politicians internationally to help them understand what hedge funds really do. The rulemakers were in danger of cutting off vital lines of market liquidity just to satisfy the uninformed mob, and we were not prepared to leave things to chance. Hedge funds are not always easy to understand, and they were doing their best to get up to speed in a very short time.

Slippery slopes

One such participant asked us, off-the-record, to help them understand why seemingly intelligent people had been taken in despite these long lists of obvious red flags. So we put some thought to that.

We have enormous sympathy for those private individuals in the US, who did not have the financial sophistication to understand what the issues were, but their plight is mainly due to the regulatory differences between the US and Europe.

We are more concerned with market professionals who fell for it. We are not talking about the sort of Nobel Prize idiot who is too engrossed in analysing the relationship between two imaginary numbers to think about common sense. There were many seasoned market professionals, whom one would otherwise describe as intelligent and rational, who were taken in. Some of them may have thought they understood the split strike strategy, but no one else was doing anything similar they could compare with.

So instead of concentrating on the red flags, we looked for reasons why such people could be duped. We came up with eight distinct groups of people, which we have listed subjectively in increasing order of concern:

Professionals who were taken in

- Investors who did due diligence, knew that there were issues, so allocated only a small percentage (so what if a 2% allocation gets wiped out). Worth the risk for the returns.
- Investors who did due diligence, knew that there were questions, but he had been running so long, was known to give money back instantly, and was so well known, plus the SEC had checked him, that the issues must be smoke without fire. Full allocation.
- Investors who knew someone else had done due diligence and invested, but who didn't know the caveats.
- Investors through the Feeder funds, who did no due diligence because they were sold investments by regulated firms audited by big name auditors who hadn't asked enough questions.
- Big name auditors apparently accepted the documentation they were given and the opinions from the tiny auditor that Madoff used. This is not just a hedge fund issue, this is a global auditing issue. There is no suggestion that big name auditors did anything illegal, but perhaps their terms of reference need to be looked at.
- Feeders may not have wanted to find anything inconvenient that would have reduced the intermediary fees they received for doing remarkably little.
- Investors who did due diligence, knew that there were issues, but thought it was insider trading, front running or profit smoothing.
- The SEC's audit of Madoff is possibly the most flagrant individual dereliction, in the face of compelling evidence from Harry Markopolos in his celebrated but secret submission to the SEC in 2005. But why did these SEC investigators let it go? There is a simple answer, that they didn't understand the maths, but there are probably other issues too. Investors have two main options: invest or not invest. The SEC also had two options: Give the OK, or sound the sirens. And no single person dared to do that. We know a manager who says he had legal threats from Madoff for telling someone he thought it was a fraud. We will refrain from any stronger allegations.

We specifically differentiate between "feeder funds" and funds of funds. A feeder is something that invests (almost) exclusively with one manager, making it more like a single manager hedge fund with an outsourced investment manager. A fund of funds is diversified, and paid fees to conduct due diligence and assess risk. But we recognise that all investments have risk, so a diversified fund of funds manager is paid to make judgements on the risk/return balance, and the investments that make a profit are supposed to outweigh the investments that make a loss.

4 out of 5 auditors can't be wrong, can they?

Four out of the top five auditors are implicated in lawsuits relating to Madoff. We hesitate to guess at the number of funds of funds, but it is high. So the average investor and the average auditor was taken in. Many people close to Madoff invested their own money with him; it wasn't just auditors and intermediaries suspending disbelief for the fees.

Risk averse heroes

We have spoken with investors who specifically avoided investing and we have great admiration for them. In many cases, their clients, shareholders or marketing people put them under significant pressure to invest with Madoff for better returns, or to set up a feeder.

The type of investor who resisted all this is typically a risk-averse personality, who would generally have had slightly below market returns and risk, but generally, superior risk-adjusted performance, despite the flattering effect from Madoff's spurious returns. These are not usually the people to go to for high octane investing. Conversely, they are better for wealth preservation. Funny that.

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Allenbridge Hedgeinfo

17 Hill Street
Mayfair, London
W1J 5NZ United Kingdom
Tel: +44 20 7409 1111
Email: info@hedgeinfo.com
Web: www.hedgeinfo.com

Contact:

Christopher Miller
Chief Executive Officer,
Allenbridge Hedgeinfo
Direct: +44 20 7318 6303
Email: christopher.miller@hedgeinfo.com