Letter from America - The Financial Scandals in Perspective

by Charles Lewis Sizemore, CFA
Chief Investment Officer

Would you consider putting your investable assets in “a company for carrying on an undertaking of great advantage, but no one is to know what it is”?

A prudent investor might require a little more due diligence and demand a little more information about this company of “great advantage” before buying shares. But during the British South Sea investment mania of the 1720s, £2000 in investment capital was raised by the founder of said company – which would be between £270,000 and £3 million at today’s prices, depending on how you account for inflation, according to research site measuringworth.com. Not too surprisingly, the founder of this venture quietly disappeared to the Continent and was never heard from again. “Of great advantage” indeed, at least for the promoter.

This was certainly not the first financial scandal in history, nor was it even particularly significant in comparison to larger contemporaneous scandals in both Britain and France. For example, there was John Law’s Mississippi Land Scheme. Banque Generale Privee managed to bankrupt France and her nobility and sowed the seeds of the French Revolution, which would break out a generation later.

But in many ways, our small-time scandal above is the most instructive of how normally prudent and rational people can be caught up in the euphoria of a bubble and allow themselves to be duped by unscrupulous fraudsters.

Madoff’s mendacity

Perhaps no one better fits the description of unscrupulous fraudster than the infamous Bernard Madoff, the runner of the largest Ponzi scheme in history – estimated at $65 billion – who was recently sentenced to 150 years in U.S. federal prison. Barring a presidential pardon, which is highly unlikely given the lives and reputations Mr. Madoff has destroyed, it is almost certain that Mr. Madoff will die as a ward of the state. We doubt that there will be many present at his funeral.

For those unfamiliar with the term, a Ponzi scheme is a fraudulent financial operation in which money taken in from new investors is used to pay existing investors. Of course, none of the participants realise this at the time. They believe their funds are being legitimately allocated, generally in investments with high returns not available elsewhere. The scheme can only be sustained by attracting ever-larger crowds of new investors. If not detected sooner the project will collapse under its own weight when, inevitably, the new money fails to meet existing commitments. (The name “Ponzi” comes from the American purveyor of such a scheme in the early 1900s, Charles Ponzi. Mr. Ponzi’s was not the first recorded case of the scheme that bears his name, but his was the first of its size and notoriety).

Mr. Madoff did more than ruin his victims financially. Perhaps even more significantly he shook investor confidence in the entire financial services industry and in the regulators charged with safeguarding it. The U.S. SEC and FINRA somehow failed to detect his wrongdoing for more than a decade, as did many of the world’s biggest banks and financial advisors, including UBS, Bank of America, Banco Santander and Citi.

Investors with accounts at Madoff’s brokerage firm will be partially compensated with Securities Investor Protection Corp (SIPC) insurance, which for the purposes of this article can be thought of as US government FDIC insurance for brokerage houses. But SIPC only covers $500,000 in securities per investor, and it does not cover persons or institutions who invested via one of the numerous feeder funds and sub-feeder funds. Hedge fund investors and their managers are presumed by the authorities to be sophisticated enough to know better, thus not needing the government’s protection.

The lawsuits have already started, with investors suing their financial advisors and hedge fund managers for their failures in due diligence. Though we cannot comment on the merit of any of these suits, we would tend to sympathise with the plaintiffs. When a financial advisor accepts client fees, it is assumed that the advisor is offering his or her expertise in return. Failure to question Madoff’s abnormally high and abnormally consistent returns – as prudent analysts and advisors rightly did – is a sign of either negligence or incompetence, and in either case the advisor in question carries some amount of responsibility.

Bernard Madoff was not the only major scammer to be exposed in the past year, though he was certainly the one with the highest profile. Sir Robert Allen Stanford, originally of Texas but knighted as a citizen of Antigua and Barbuda, also was charged in early 2009 with running a massive Ponzi scheme through his Stanford Financial Group, primarily through his offices in the Caribbean.

Moving further south, Argentine private banker Hernan Arbizu, while working with UBS and Chase, allegedly raided the accounts of some wealthy South American clients to cover shortfalls in promised returns to others, sometimes personally flying from South America to New York to do so. Though not technically a Ponzi scheme, Mr. Arbizu was certainly robbing Peter to pay Paul, so to speak, in order to fraudulently inflate his clients’ returns.

And of course, though there is no single “poster boy” for the housing and credit crisis that caused the implosion of the global banking system in 2007 and 2008, there was widespread fraud (or at the very least gross irresponsibility) at nearly every link in the chain. This includes consumers who lied or withheld information on mortgage applications, the bankers and mortgage brokers who either explicitly or tacitly encouraged them to do so, the large banks who bundled these loans into securities knowing the collateral to be of dubious value, and the bond ratings agencies who gave their stamp of approval to the finished product (while being paid to do so by the bond issuers).

Financial fraud (and bad investing too, for that manner) can go undetected for years during bull markets. When stocks are rising in value, few investors bother to ask questions. It is only during panics and crashes – when the “tide goes out,” in the words of the great Warren Buffet – when we can see “who has been swimming naked.” It is during volatile bear markets when the celebrity analysts and investment managers of the boom years – the “prophets” of the new era -- are discredited. Think back to the technology bubble of the late 1990s and the instant “experts” it produced. Most have faded into obscurity or have left the financial services industry altogether. Some – such as former Merrill Lynch analyst Henry Blodget and former Credit Suisse First Boston investment banker Frank Quattrone – even faced lengthy trials for various bubble-related offenses (to be fair, neither were found guilty). But of course, the biggest scandal of the 1990s and early 2000s was that of the Enron Corporation, which for many became the symbol of the excesses of the era. Enron’s fraudulent accounting, hiding debts and losses in special purpose entities that were not reported in the firm’s financial statements, cost investors billions and led to the ruin of Arthur Andersen, the company’s auditor and one of the largest and most respected accounting firms in the world.

In the case of Bernard Madoff, his Ponzi scheme might have continued undetected for several more years had it not been for the market collapse that began in late 2007. Virtually all money managers lost money in 2008, and most lost a staggering amount. The few who actually made money – such as hedge fund manager John Paulson – did so by aggressively shorting the financial and real estate sectors. No one questioned how Mr. Paulson made his money; he was very forthright in explaining his strategy. But Mr. Madoff remained silent as to how his funds managed to avoid catastrophe, and their odd consistency amidst the chaos began to look increasingly suspicious. Finally, perhaps knowing that an investigation into his firm was imminent. Madoff admitted to his sons that the firm’s success was “one big lie.” His sons then informed the FBI, and the rest is history.

Perhaps the most important question now would be “how do we, as investors, avoid falling victim to a future Madoff?” Financial scandals are as old as finance itself; no matter what the response of the regulators might be, they will not prevent all would-be scandals from ensnaring unwitting investors in the future.

Unfortunately, there is no easy answer here. The simplest solution is to diversify. It is risky to put too high a percentage of your assets into one stock – as those who invested heavily in Enron discovered. A diversified portfolio is essential to reducing your risk to any single company. In the same sense, dividing your assets among several brokers and advisors will insure that all of your funds are not lost due to criminal activity by one unscrupulous scam artist. For American investors, the most risk averse will want to avoid having more than $500,000 with any single broker unless that broker has supplemental insurance in addition to the standard SIPC.

In the case of financial advisors, pay attention to what banks or brokers the advisor uses for trading and custody. There is nothing wrong with employing a small, independent advisor, and many investors prize such advisors for their independence and objectivity. But if you do go with a small independent, make sure that the advisor is holding your assets at a reputable custodian and that you receive statements directly from the custodian in addition to any statements you receive from the advisor. If the custodian is not a large, household name, you should at least ask to see the audited financial statements. This should have been a major red flag to Madoff investors. A firm of Madoff's size and complexity should have used a Big 4 accounting firm, or at least something significantly bigger than the firm he used – a three-person outfit that operated out of a suburban New York shopping centre.

Perhaps most importantly, if returns look too good to be true then they probably are. Even Warren Buffett – considered by many to be the greatest investor of all time – has the occasional bad year. His Berkshire Hathaway lost half of its value in 2008. Even though Mr. Buffet has resoundingly beaten the market over his career, his returns are still correlated to the market, meaning that they tend to move in the same direction over time. If a manager's performance differs wildly from his or her peers and benchmark, they should have a good explanation as to why in their annual reports. Generally, managers are proud of their exploits and want to tell you about them. If they are reluctant to do so, this should be a warning sign.

Finally, high net worth investors should be particularly careful. Despite widespread perceptions to the contrary, financial regulations are generally designed to protect smaller investors, not the wealthy – just ask those who invested with Madoff via feeder funds! As we said earlier, wealthy investors are presumed to be sophisticated enough to take care of themselves. So, make sure that you do extra due diligence on potential hedge fund, private equity, and limited partnership deals. Be certain that you understand the manager's strategy and that you are comfortable with the risk being taken. Read the auditor's reports. If you do not understand the investment, then your money is better placed elsewhere. And naturally, don't allow yourself to be duped by those offering the modern equivalent of "a company for carrying on an undertaking of great advantage, but no one is to know what it is."

Sizemore Capital Management LLC
www.sizemorecapital.com

Got views on the above news?

Email your comments to the email address below, each week a selection of comments will be added to the news stories

Send your comment to media@thepublishinggroup.co.uk