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Legendary Investors, Part II

In July I wrote about the passing of a legendary investor I had known reasonably well over the years. Sir John Templeton died on July 9, 2008 at age 95. Sir John was a great man, intelligent, even brilliant, principled, and focused unwaveringly on business and spiritual matters.

Even though the inspiration for writing about Sir John was a very sad event – his passing – this note is in many ways even sadder. I am writing about another legendary investor I knew reasonably well, Bernie Madoff.

Like Sir John, Bernie came from humble origins, worked unceasingly, was a great innovator, was personally very persuasive and was humble about his wealth and success. Where they differed is that while Sir John worked to benefit his clients, Bernie allegedly worked to deceive and defraud them.

The unveiling by Madoff on Thursday of what he himself called a "lie" and a "Ponzi scheme" (an investment fraud where purported gains to initial investors are paid not from real gains but from the capital of subsequent investors) came as a shock to Madoff's clients. Even though most investors had not heard of him, he drove the Illinois Governor and the potential bankruptcy of the entire US-born auto industry off the front pages of the New York tabloids.

Assuming Madoff lost all of his clients' money, the losses might aggregate $50 billion, a staggering sum. By comparison, the largest number I have seen requested by the auto companies is $34 billion.

Madoff ran two businesses. One was a market maker which bought and sold stocks on behalf of brokers who dealt with investors and traders. The other was a money management business. In the money management business, the customer had a brokerage account. Each month he or she got a statement showing what he or she started with, ended with and what was bought and sold in between. The account was discretionary, meaning Madoff made trades without getting prior permission of the investor. Madoff did not run hedge funds. Repeat that out loud three times each day, please, "Bernie Madoff did not run hedge funds, Bernie Madoff did not run hedge funds, Bernie Madoff did not run hedge funds." He managed separate accounts. Some of his investors might have been hedge funds and certainly many were third party aggregators of capital. But, "Bernie Madoff did not run hedge funds."

Inevitably we will see the growth of an army of people who will say, "I knew it all along," or, "Anyone could have figured that out." I will not include myself in either group. I rather was more like a market maker, being willing to take the opposite side of the trade another person wanted to make. If you said Madoff was sound, I would argue it was a Ponzi scheme. If you said it was a Ponzi scheme, I would argue it was sound.

The arguments for Ponzi scheme were chronicled by the newspapers:

1. It was difficult if not impossible to analyze his trades and see how he made 10-12% a year. Of course, if you had invested through a fund set up by a third party to invest with Madoff, you had no data upon which to make this analysis. But if you invested directly, you got the monthly statements mentioned above.
2. The magnitude of trading in his money management accounts should have been visible somewhere on Wall Street and it was not.
3. His staff for money management was thin to non-existent, which is implausible in a separate account business.
4. He was highly secretive both about his trading methodology and his business.
5. His auditor was originally a one-man-firm with a close connection to Madoff.

Pine Grove never invested in Madoff (or even considered it). The inability to link investment strategy to reported results was a deal killer. Had we made it past that hurdle, Madoff would not have survived our back office due diligence process, starting with its auditor.

But I don't blame anyone who invested with Madoff, especially individuals, as here are the reasons to think it was not a Ponzi scheme.

1. Madoff was very credible. He gave you the feeling that he was extremely knowledgeable in trading, well grounded, that you could trust him.
2. Lots and lots of very smart people were investing with Madoff and many had years of experience to provide comfort.
3. Madoff was prominent in securities industry trade and regulatory groups.
4. If this was a scam, it had been going on for a long time, and Ponzi schemes blow themselves up as time goes on - it eventually takes so much money coming in to pay the earlier investors that later investors stop getting paid and start to complain aloud.
5. Madoff had innovative software and trading capabilities which presumably made large profits and made defrauding customers even more foolhardy for him than for less wealthy investors.
6. He had undergone a rigorous audit by the SEC. (Though not many people knew of this situation.) In the early 1990's, Florida security regulators found some people selling investment contracts promising a high rate of interest (13% by memory). The regulators immediately suspected fraud and contacted the SEC. The SEC made a thorough examination of Madoff's books and found all the money to be accounted for. No charges were brought.
7. Investors got monthly statements and (thought they) could see the listing of assets in their accounts.

These arguments were all quite plausible, but as to the 7th item, monthly statements, I would argue this only proved that Madoff had a typewriter.

In any event, there will be much written about Madoff and his life and investment program, and how it got so far without discovery. But for those who invested with Madoff, especially those who trusted him with everything, this is a traumatic event. With good cause they feel cheated and they are broke, and there is no visible solution to either of these problems. To them we offer our sympathies.

Art Williams
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