What Investors Should Learn From Bernie Madoff

By Russel Kinnel| 5-24-2011 11:09 AM

Russel Kinnel: Hi. My name is Russ Kinnel. I am director of mutual fund research for Morningstar, and today I'm going to be talking with Diana Henriques, author of *The Wizard of Lies*, a book about Bernie Madoff who pulled off the greatest Ponzi scheme ever.

The first question I want to ask you is about some of the research you did looking into his early life, and it's really striking to see the signs of what would later become a giant Ponzi scheme were really there early on if you knew where to look.

Diana Henriques: That's true, Russ, and I was quite surprised at that, as well. One of the mysteries I'm afraid, that will live as long as Madoff does, is when exactly the Ponzi scheme started. But I was able in my research to uncover an incident in 1962 when he was a very young over-the-counter trader with his own little firm.

He had invested money that was given to him by friends and family in very speculative, risky, over-the-counter stocks. In a market air pocket in May 1962 the bottom just dropped out of those stocks, and they lost all their money. But rather than confess that to them, he covered it up. He bought the shares back from their portfolios at what they paid for it and didn't reveal but for that they would have been completely wiped out.

Now, he insisted to me, after the prison interview I had with him in August of 2010, that he kept it a secret from the investors because he knew that if he told them about it, they would insist that they take the losses and that he not nearly bankrupt himself to cover them up for him. But I don't really buy that. I think he burnished his own reputation as the boy genius in the family and managed to hang on to those investment clients by lying to them about what he had done to prevent those losses in their accounts.

Now, that's not the beginning of the Ponzi scheme, there's no doubt about that. But it certainly was a very telling experience in the young life of the young Madoff.

Kinnel: You certainly get the sense that he, and maybe even his father to a degree, were trying to put a veneer on things that made things look better. And maybe all along he was trying to make it look like maybe he was a little more skilled investor than he was and that everyone was better off than they really were?

Henriques: I think that's a fair conclusion, although his father was far less successful at that veneer than Madoff himself was. Ralph Madoff was a serial business failure. He

had started a sporting goods company that Bernie Madoff expected actually to inherit and run someday, and it failed. It filed for bankruptcy with enormous debts. A second venture in that business also failed.

Another venture his father went into failed dishonestly. His father's credit was so bad by this point that when he started a little brokerage firm called Gibraltar Securities, he put it in Bernie's mother's name rather than his own because his own credit was too bad. So, Ralph Madoff was a business failure at a time when the country was booming and everybody was successful.

Madoff acknowledged to me that that was a traumatic time for him and for his family, experiencing those financial uncertainties. It's a little armchair psychology, but I think it's fair to assume that Madoff was determined to be more of a success than his father and perhaps his almost pathological refusal to admit failure at anything was rooted at his father's own failures.

Kinnel: I think there's an interesting takeaway there for investors, too, that the next broker or someone else who you want to entrust your money to, they're probably not going to be the next Madoff. But you can at least check their record and see that maybe there are some signs and don't simply dismiss any previous infractions simply because they seem like small potatoes.

Henriques: I think that is a good lesson for investors. You're absolutely right. The very first thing they should do is check out their track record of their broker. They also need to be aware, and this is one of the points I tried to make in *The Wizard of Lies*, they need to be aware that that person they've decided to trust is bringing with him a great deal of personal baggage, a great deal of history, and they are basically just human beings subject to the same temptations and the same flaws as all of us are.

The subtitle of my book is called The Death of Trust for a reason, not that it's necessarily a good thing that people should trust no one, but they need to be aware that making decisions based solely on trust, which as you know, Russ, unfortunately far too many of us do, is a very bad way to make those decisions. You need to ground those decisions in fact and in research.

Kinnel: Trust, but verify, if I could steal someone's phrase. I think to an investment professional the thing that jumps out is you see that perfectly straight line upward of 12% or so and many investment professionals would look at that and say that's not possible, even I think physicists or scientist would say that doesn't happen in the natural world. But many smart people who maybe weren't necessarily investors could be taken in by that. And I think partly it comes from having your best friend, who

maybe a smart person or smart doctor or lawyer in other field, recommend Bernie instead of doing your own homework.

Henriques: I think that's true and certainly you're right, a great number of sophisticated people got fooled or actually more seduced by that consistency. But Madoff had unusual Ponzi scheme, Russ. A typical Ponzi scheme tries to exploit people's greed; it promises them double your money in 10 months or whatever.

Madoff was very clever; he did not promise outsized returns. And many periods of this fraud, Russ, you could have done better in the Magellan Fund or one of the other fine funds Morningstar covers than you did with Bernie Madoff and certainly compared with the world of hedge funds. His returns were nothing at all to write home about, but what they were was consistent. So he was a exploiting actually people's fear rather than their greed, and he was doing so with returns that kept him well below the regulatory radar that would normally have tripped up a high-flying Ponzi scheme of this scale and this duration.

Kinnel: He certainly did a lot of things that sort of kept him in those sort of regulatory cracks; it wasn't really a hedge fund or a mutual fund. He lived well but he didn't have cricket contests where every wining cricket player gets a million dollars some things we have seen elsewhere.

Henriques: Just to pick something out of the air, right?

Kinnel: Yes. But another part of the book that's certainly fascinating is how tantalizingly close so many regulators and others come to actually spotting the fraud in this scheme and just are one or two phone calls to counterparties or others away from figuring out just how big a fraud that was.

Henriques: Well, as tantalizing is as that was to read, it was agonizing to write. I felt like I was watching the Titanic head for the iceberg. I kept wanting to say, "Turn the wheel." As you say, make that call; send that letter. But the problem was regulators relied on Madoff himself for most of the information they got about Madoff rather than seeking independent third-party confirmation.

If there is a takeaway for individual investors, that's one of the big ones. If you're dealing with someone who doesn't give you a way to provide third-party confirmation, such as he is using an independent custodian or he's got big outside audit firm. Then you should be instantly suspicious because they just entered into this theme park that Bernie Madoff had created, this Potemkin village, and never looked outside it for confirmation that what he was telling them was actually true.

Kinnel: One of the great things about mutual funds, of course, is that they do have auditors and custodians. It doesn't mean that there is no chance of fraud, but it certainly gives you a much more reason to be confident.

Henriques: [Investing in mutual funds] substantially reduces the risk of fraud, absolutely. One of the things that mystified me, Russ, about the Madoff investors, there were many of them with whom I spoke, who based on their personal circumstances should never have deviated outside the four corners of publicly regulated mutual funds and bank certificates of deposit because they were investing money that they truly could not afford to lose all of.

And yet even if Madoff had been honest, what was he running? He was running a secret, unregistered, unregulated, sort of quasi-hedge fund that produced no prospectuses. He wasn't even registered as an investment advisor for most of his career. So they were way outside their risk perimeter. When they invested with Madoff even if he had been honest, of course the great tragedy was he wasn't and they lost everything, but they were still taking an enormous risk that they did not realize they were taking.

Kinnel: Well, thanks Diana. This is really an interesting book, a great read, and I am impressed that you're able to uncover that much new information given how much coverage has been already of Bernie.

Henriques: Thank you.