

**Subject:** FW: This is excellent insight from Larry Swedroe re: the Madoff mess--

## **LARRY SWEDROE'S THOUGHTS ON THE MADOFF SCANDAL**

### **The Consequences of the Failure of Investment Process**

What do HSBC, the Royal Bank of Scotland, BNP Paribas (France), Banco Santander (Spain), Neue Private Bank (Switzerland), Union Bancaire Privee (Switzerland), Nomura Holdings (Japan), Aozora Bank (Japan) whose top shareholder is legendary U.S. private-equity firm Cerberus Capital Management), the Elie Wiesel Foundation for Humanity, Yeshiva University, Brigham and Women's Hospital in Boston, the Jewish Federation of Palm Beach in Florida, Steven Spielberg's Wunderkinder Foundation, The Tremont Group (a large hedge fund investment firm owned by OppenheimerFunds), Man Group's (one of the largest hedge fund's in the world) RMF, prominent business executives, sports team owners, celebrities, high-profile lawyers, university endowments, and numerous members of the Palm Beach Country Club all have in common? They are all victims of the Madoff scandal that might have a cumulative cost to investors of as much as \$50 billion. This loss is a tragedy of epic proportions. However, the real tragedy is that had investors followed some basic rules of prudent investing, the investments would never have been made.

### **There is Nothing New in Investing, Only the Investment History You Don't Know**

Many aspects of the Madoff affair are depressingly familiar.

- The exclusive nature of the hedge fund "club" creates an aura that seems to attract investors the way swim-up bars attract guests at all-inclusive resorts. Investors seem to value the sense of membership in an exclusive club; they yearn to be members of the "in crowd."
- In addition to their "sex appeal," hedge funds lure investors with the ever-present hope of market-beating returns.
- Trust in the promoter due to some social affiliation encourages investment.
- The lack of complete transparency of the investment strategy.
- Returns that seemed too good to be true.
- Lack of audited financial statements.
- The speed of the ultimate collapse.

Investors should also have been aware that the very consistent returns reported by Madoff were inconsistent with his general strategy of buying puts and selling covered call options on stocks in the portfolio. During bear markets, the strategy should have resulted in losses, though less than that of the overall market. Yet, Madoff was reporting consistent profits. That alone should have alerted investors (in fact, some potential investors were scared off). There is an old saying about something being too good to be true. But if that were not enough, the number of trades that would have been required to execute the strategy far exceeded the number of trades reported on the entire exchange!

In addition to these problems, as the evidence presented in the chapter on hedge funds in *The Only Guide to Alternative Investments You'll Ever Need* demonstrates, hedge funds have not only had a hard time keeping up with the risk-adjusted returns of riskless Treasury bills, there is no evidence of any persistence of performance beyond the randomly expected. Therefore, there is no way to identify ahead of time the few winners (who receive all the press).

Perhaps it was the combination of the aforementioned problems and the historical evidence on returns that led Professor Eugene Fama, in an interview with Bloomberg in November 2002, to state, with great prescience: "If you want to invest in something (hedge funds) where they steal your money and don't tell you what they're doing, be my guest."

### **Principles of Prudent Investing**

At the very heart of Buckingham Asset Management's investment philosophy is that our advice is based on scientific research, not our opinions. Strict adherence to that principle has served our clients well. We are just as proud of the investments we have helped our clients avoid, as we are of the ones we have recommended.

Our management efforts are focused on the only thing we can control, risk. We do that by designing portfolios that provide our clients with the greatest chance of achieving their financial goals without taking more risk than they have the ability, willingness or need to take.

The scientific research also led us to conclude that the prudent strategy was to accept market returns. We recognized that while doing so basically meant giving up the hope of outperforming the market, it also meant that we would avoid the risk of underperforming the market—and the evidence demonstrated that this was the far greater likelihood. Thus, the only equity

funds we recommend are those that are low cost, tax efficient, passively managed asset class funds, like those of Dimensional Fund Advisors (DFA). And our fixed income strategy is based on the same principle of earning market returns. Pay No Attention to the Man Behind the Curtain. I am Oz, the Great and Powerful Wizard.

Madoff was able to execute his massive fraud because he operated behind "a curtain." On the other hand, publicly traded mutual funds operate with a high degree of transparency. Among the advantages of investing in publicly traded investment vehicles are:

1. Publicly held mutual funds are a highly regulated industry (the SEC). Hedge funds are totally unregulated.
2. Mutual funds are required to have audited financial statements. In the case of DFA, PricewaterhouseCoopers LLP, a major accounting firm, performs annual audits. The audits verify the financial statements of the mutual funds including correspondence with the custodians, brokers, and transfer agent of the funds that confirms the securities held.
3. Mutual funds do not act as custodian of the assets. In the case of our clients, their funds are custodied at either Schwab or Fidelity.
4. Mutual funds do not perform the fund's accounting themselves. In the case of DFA, fund accounting is performed by PNC Bank.

In addition to these benefits the following is also an important consideration. There is nothing to incent DFA to take risks to try and outperform (the failure of such efforts often leads down the path to perdition as fund managers seek to recoup losses). DFA does not attract assets the way hedge funds do by weaving stories about how they can beat the market or earn market rates of return while taking less risk. DFA's goal is simply to earn market rates of return. There are no incentive fees (to tempt managers to take risks) as is the case with hedge funds. And the historical evidence demonstrates that the returns earned by DFA's funds are consistent with their stated strategy. There are no episodes of either dramatic over or underperformance beyond that which would be randomly expected.

#### **Eggs and Tennis Balls**

If you drop an egg and a tennis ball off the table, the egg will shatter while the tennis ball will bounce back. Investors who made the mistake of investing in opaque investments with Madoff have seen their portfolios shattered like the dropped egg. Once shattered there is no recovering. On the other hand, those investors that have suffered losses in their public equity holdings at least have the opportunity to see their asset values bounce back, like that tennis ball. And history suggests that if they have the discipline to stay the course the odds greatly favor their being rewarded for their patience.

#### **Summary**

Among those who experienced the greatest losses from the fraud perpetrated by Madoff are some of the largest banks and some of the largest hedge funds. Each of them touted their ability to identify the money managers who would deliver market-beating returns on a risk-adjusted basis. They proudly discussed their superior due diligence efforts that serve to protect investors. As the academic evidence has demonstrated, such claims are without merit. There is no better example of the triumph of hope and hype over wisdom and experience than this episode.

The saddest part of this great tragedy is that if investors had known the historical evidence and followed the basic rules of prudent investing this tragedy would have been avoided. I have spent my entire career managing financial risks for corporations or advising other corporations, individuals and endowments on the management of risks. Based on those experiences I cannot understand why anyone would give their hard earned assets to someone who invests those assets in a way that is not completely transparent, where you take 100 percent of the risks but they take 22 percent of the returns, you earn those returns in a tax inefficient manner, and there is no evidence of any persistence of performance beyond the randomly expected. Simply put, it is the triumph of hype and hope over wisdom and experience. And hope is not an investment strategy.

#### **Larry's Disclaimer:**

Larry Swedroe is the author of [The Only Guide to Alternative Investments You'll Ever Need\\*](#) (2008), [Wise Investing Made Simple\\*](#) (2007), [The Only Guide to a Winning Investment Strategy You'll Ever Need\\*](#) (2005), [What Wall Street Doesn't Want You to Know\\*](#) (2000), [Rational Investing in Irrational Times - How to Avoid the Costly Mistakes Even Smart People Make Today\\*](#) (2002), and [The Successful Investor Today: 14 Simple Truths You Must Know When You Invest\\*](#) (2003), and co-author of [The Only Guide to a Winning Bond Strategy You'll Ever Need\\*](#) (2006). He is also a Principal and Director of both Research of [Buckingham Asset Management](#) and [BAM Advisor Services](#) — a Turnkey Asset Management Provider serving CPA-based Registered Investment Advisor (RIA) practices — in Clayton, Missouri ([www.bamservices.com](http://www.bamservices.com)).

His opinions and comments expressed within this column are his own, and may not accurately reflect those of the firm.