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Madoff Scandal Draws Attention to Hedge Fund Risks

Overview: Investors around the country and around the world may have experienced some panic when the scandal involving Bernard Madoff — described as a $50 billion Ponzi scheme — became known. Some investors may be wondering if their assets may fall prey to the same kind of situation. The following discusses why investors in mutual funds are not exposed to the same kinds of risks.

What do the Royal Bank of Scotland, Nomura Holdings (Japan), the Elie Wiesel Foundation for Humanity, Yeshiva University, Tremont Group Holdings, Steven Spielberg's Wunderkinder Foundation and the owner of the New York Mets all have in common? They are all victims of the Bernard 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
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. Many aspects of the Madoff affair are depressingly familiar:

- Trust in the promoter due to some social affiliation encourages investment.
- There is a lack of complete transparency of the investment strategy.
- Investors received returns that seemed too good to be true and a lack of audited financial statements.
- The whole affair unraveled at an amazing speed.

Investors should also have been aware that the very consistent returns reported by Madoff were inconsistent with his particular 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, 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.[1] 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 Wealth Manager* 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."[1]

Principles of Prudent Investing

At the very heart of our firm'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 capture the returns markets provide. 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 (such as 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 That Man Behind the Curtain"

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:

- Publicly held mutual funds are a highly regulated industry governed by the Securities and Exchange Commission. Hedge funds are basically unregulated.
- Mutual funds are required to have audited financial statements. 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. In the case of DFA, PricewaterhouseCoopers LLP, a major accounting firm, performs annual audits.

- Mutual funds do not act as custodian of the assets. In the case of our clients, their funds are primarily custodied at either Schwab or Fidelity.
- 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 no incentive for DFA to take risks to try to 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 outperformance 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 shatter 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 the 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.

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. It is hard to understand why anyone would give their hard-earned assets to someone who:

- Invests those assets in a way that is not completely transparent
- Lets investors take 100 percent of the risks while taking 22 percent of the returns
- Provides returns to investors in a tax-inefficient manner
- Demonstrates 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.

[1] For more information on hedge funds, see Chapter 15 of *The Only Guide to Alternative Investments You'll Ever Need*.
[2] Lynn O'Shaughnessy, **Brain Trust.** *Bloomberg Wealth Manager*, November 2002.

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